



REFLECTIONS & OUTLOOK

47th ANNUAL AUTOMOTIVE SYMPOSIUM

October 30 – October 31, 2023

PRESENTING COMPANIES

<u>Company</u>	<u>Exchange</u>	<u>Ticker</u>	Oct. 31		
			2023	2022	2021
			Price	Price	Price (a)
AutoNation Inc.	NYSE	AN	\$ 130.08	\$ 106.31	\$ 121.12
AutoZone, Inc	"	AZO	2,477.13	2,532.88	1,784.84
Canoo Inc.	NASDAQ	GOEV	0.27	1.37	8.02
CarParts.com	"	PRTS	2.83	4.68	15.23
ChargePoint Holdings, Inc.	"	CHPT	2.54	13.98	24.78
Dana, Inc.	NYSE	DAN	11.38	15.43	20.99
Donaldson Company, Inc	"	DCI	57.66	56.55	58.12
Electrovaya Inc.	NASDAQ	ELVA	2.66	3.45	4.90
Gentex Corp.	NASDAQ	GNTX	28.68	26.06	34.23
Genuine Parts Co.	NYSE	GPC	128.86	173.79	124.82
Monro, Inc.	"	MNRO	24.82	46.49	58.83
Motorcar Parts of America, Inc	"	MPAA	7.22	19.00	18.92
MP Materials Corp.	NYSE	MP	16.40	30.04	33.85
Myers Industries	"	MYE	16.77	19.75	19.49
O'Reilly Automotive	NASDAQ	ORLY	930.44	837.17	622.32
Penske Automotive Group, Inc.	NYSE	PAG	142.34	109.00	101.73
Rush Enterprises, Inc.	"	RUSHA	35.42	32.38	33.02
Sonic Automotive, Inc.	"	SAH	47.85	45.69	47.38
Standard Motor Products, Inc.	"	SMP	34.93	36.82	45.37
Strattec Security Corporation	NASDAQ	STRT	22.75	26.00	34.67

(a) Adjusted for splits and dividends

Brian C. Sponheimer
Portfolio Manager
(914) 921-8336

A. Carolina Jolly, CFA
Research Analyst
(914) 921-7762

Guillermo Herrera, CFA
Research Analyst
(914) 921-5226



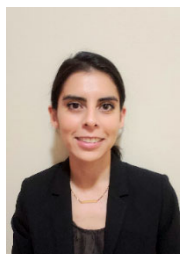
47th Annual Automotive Aftermarket Symposium

Our team hosted the Gabelli Funds 47th Annual Automotive Aftermarket Symposium in Las Vegas on October 30th and 31st, 2023. Over the course of the conference, industry executives from leading automotive original equipment dealers, suppliers and aftermarket parts retailers discussed both the present and future of the automotive ecosystem.



Brian Sponheimer is a portfolio manager of The Gabelli Dividend & Income Trust and an analyst for the infrastructure and industrials sector with a focus on automotive- and machinery-related companies, OEMs and infrastructure. He joined the firm in 2008. Previously he was a research analyst at The Water Fund/Terrapin Partners and before that director of sales and trading of US Equities at CIBC World Markets.

Brian graduated cum laude with a BA in government from Harvard University and holds an MBA from Columbia Business School.



A. Carolina Jolly, CFA, is a senior research analyst covering industrials and materials sectors with a focus on the automotive industry. She joined the firm 2015. Prior to that she was a senior research analyst and impact investing specialist at Glenmede Investment Management.

An industry expert, Carolina has been quoted in several publications, including the Financial Times and Barron's.

Carolina holds a BA in economics from Williams College and an MBA in finance and entrepreneurial management from Wharton School at the University of Pennsylvania. She is a CFA charterholder.



Guillermo Herrera, CFA, joined the firm as a research analyst in 2023. He covers the industrials sector with particular focus on commercial truck OEMs and suppliers, as well as EV charging. Previously, he interned with Artisan Partners as an Equity Analyst, and led Strategic Finance teams in the Life Sciences and Healthcare Technology spaces.

Guillermo graduated with a BA in Economics and Mathematics from Boston College. He also holds an MBA from Columbia Business School, where he graduated with Dean's Honors and received the Robert H. Montgomery Prize in Accounting. Guillermo is a CFA charterholder.



REFLECTIONS

2023 AUTO SYMPOSIUM

RESILIENCY VS. “SHORT TERM-ISM”

Gabelli Funds has, for nearly five decades, held an automotive conference the week of the Automotive Aftermarket (AAPEX) and Specialty Equipment Market Association (SEMA) industry events. Our 2023 Automotive Symposium, recently held at Encore in Las Vegas, brought together over 22 leading automotive companies and speakers to discuss both the present and the future of the global auto industry.

Each speaker, representing their own niche of the broader automotive ecosystem, helped form a “mosaic” of sorts for attending portfolio managers and analysts to help those in the audience and via zoom understand the drivers of profitable growth for the key stakeholders supporting the 1.3 billion vehicles on the road globally, including nearly 290 million in the United States.

In our view, the most prominent observation coming out of the symposium could be summed up in one word: Resiliency. While our presenting companies are not impervious to the various economic crosswinds currently being navigated within various end markets, the collective strength of the business models that supply, service, and innovate within the automotive industry have helped drive profitable growth through a wide variety of economic backdrops throughout our history in Las Vegas. We left the symposium certain that such resiliency would allow many of our presenters to endure through adversity and ultimately thrive – benefiting investors in the process.

This reflections piece attempts to capture the spirit of our symposium, initially with key analyst takeaways summarizing the two days. The report then delves into industry-specific data to frame the environment in which our companies operate. We conclude with takeaways on the companies themselves.

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AUTO SYMPOSIUM REFLECTIONS

Conference Highlights

RESILIENCY IN THE FACE OF CROSSWINDS

Though challenges regarding near term issues related to inflation, interest rates, labor, and geopolitical tensions were topical in Las Vegas, our fireside chats overwhelmingly focused on the longer term prospects for the automotive ecosystem, most notably in the opportunities ahead as electric penetration continues to rise.

We highlight below some of the major topics discussed, along with our thoughts on the future as the industry works through near term challenges with innovation and reinvention.

Exhibit 1 ChargePoint (CHPT) Charging Station



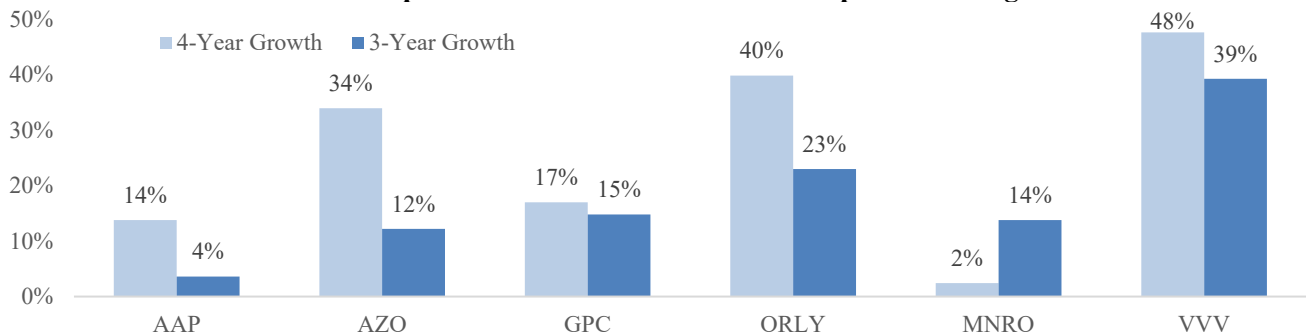
- **AFTERMARKET GROWTH CONTINUES WITH MIX SHIFT**
 - As expected, aftermarket parts retailers and distributors have been well positioned to pass along rising input costs in both DIY and DIFM channels due to the less discretionary nature of the business. Companies that have invested in distribution, technology and data appear to be taking share from those that have not or cannot. These companies will benefit from the continued consolidation of the market, while others will lose.
- **ELECTRIC AGE MAY TAKE A LITTLE LONGER TO COME**
 - Presenting suppliers and dealers noted that vehicle electrification continues to be an automotive market inevitability, albeit one with a less certain path. Despite considerable government incentives (on a global basis) to drive EV adoption, concerns about affordability, combined with range anxiety and residual value unknowns have led to a deceleration in demand that has led to some Original Equipment Manufacturers (OEMs) pushing out battery and assembly plant capital expenditures.
- **PENT UP DEMAND PROVIDING A FLOOR FOR NEW VEHICLE SALES DESPITE RATE INCREASES**
 - While presenters spoke to some improvement in semiconductor chip availability and logistics, problems still persist across both the original equipment and aftermarket supply base to such a degree that production and shipping predictability remains incredibly difficult.
 - As a result, low inventory – a factor that has contributed to help dealers reach all-time highs in per unit gross profit – will likely persist and keep the status quo for longer than anticipated.
- **VEHICLE AFFORDABILITY IN THE FACE OF HEADWINDS**
 - Rising interest rates and vehicle prices, declining used vehicle prices, and a reduction in the availability of leasing and zero percent financing all have the potential to cap upside in new vehicle sales in the near term as affordability continues to be pressured.

AUTOMOTIVE AFTERMARKET OUTLOOK

INTRODUCTION: DRIVING IS NOT GOING AWAY ANYTIME SOON

Prior to the COVID-19 pandemic questions on self-driving electric vehicles permeated throughout earnings calls. And, when in April 2020, miles driven dropped 40% and COVID-19 spread throughout the US, investors panicked asking if we would be returning to the road. However, what we learned at Gabelli's 47th Annual Automotive Symposium is: *People need their cars. People keep their cars. And, people fix their cars.* Nothing highlights this fact more than the last four years of growth in the \$300 billion aftermarket where public aftermarket companies have averaged ~+25% growth rates (Exhibit 2).

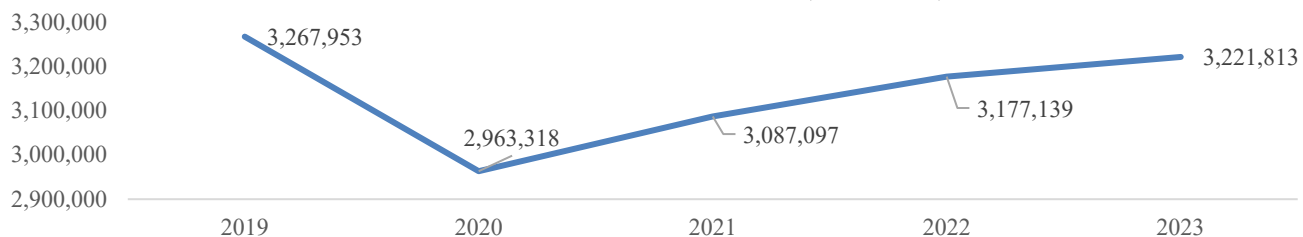
Exhibit 2 3 & 4-Year Comp Rates of Public Aftermarket companies Average 20-30%



Source: Company filings

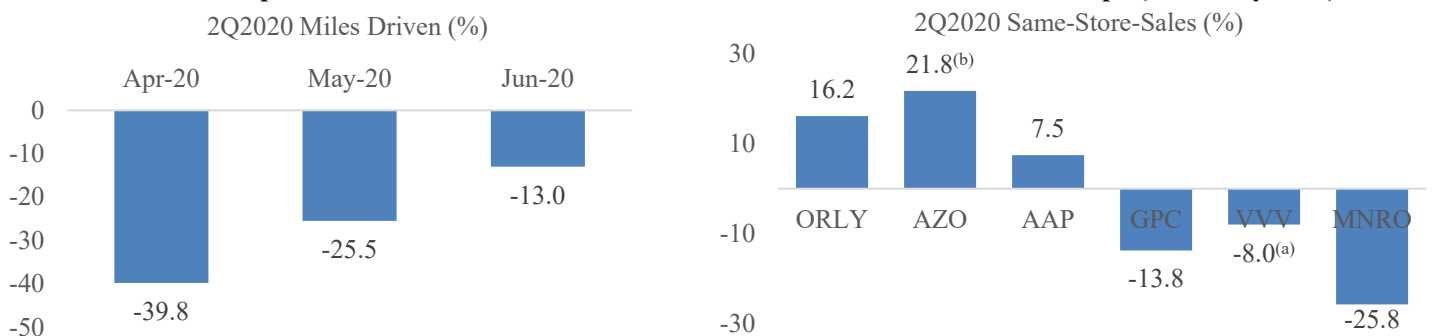
This section delves into the resiliency of the aftermarket, factors that are driving continued growth and explanations as to why owners of vehicles are keeping and maintaining their vehicles for longer. We explore the catalysts behind this double digit growth rate despite flat miles driven since 2019 (Exhibit 3) and how in 2020, when miles driven fell 40%, 25%, and 13% in April, May, and June respectively ORLY, AZO and AAP posted positive monthly comps of 16%, 22% and 8% respectively (Exhibit 4). We use data to better understand the essential nature of the aftermarket.

Exhibit 3 Miles driven are flat over last 4-Years (2019-2023)



Source: Federal Highway Administration (fhwa.dot.gov), company filings

Exhibit 4 Sharp decline in miles 2Q2020 miles driven vs 2Q2020 Aftermarket comps (driven by DIY)



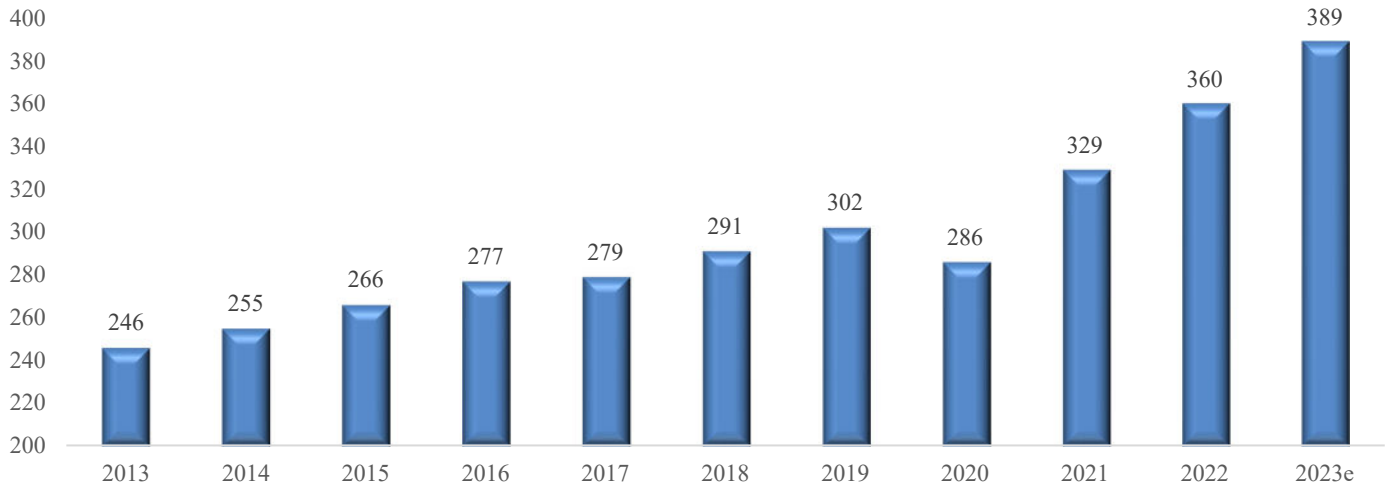
Source: Federal Highway Administration (fhwa.dot.gov), company filings

A REVIEW OF INDUSTRY BASICS

The Automotive Aftermarket Suppliers Association (AASA) projects that the \$389 billion light vehicle aftermarket will grow to \$435 billion by 2026. Demand fell in 2020 to \$286 billion in response to the COVID pandemic and less on-road travel; however, 2021 rebounded by 15% and the AASA is projecting an additional 20%+ growth over the next four years.

Exhibit 5 The US LV Aftermarket Continues to Grow (2013-2023E)

(\$ in billions, USD)



Source: MEMA/AASA

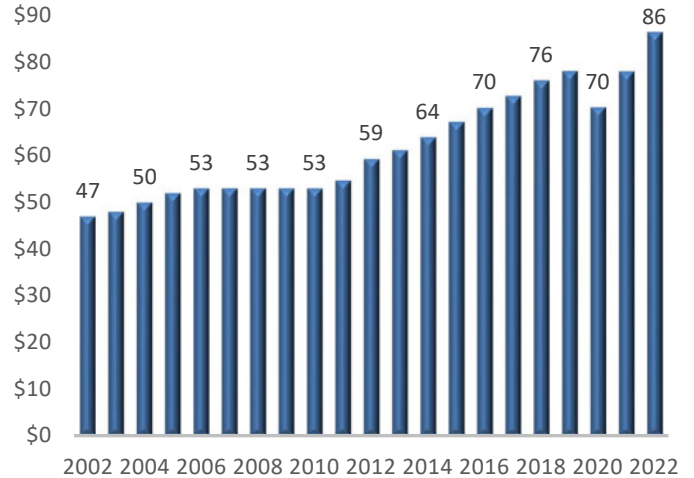
We estimate that parts account for \$190 billion of the aftermarket after excluding tires and labor. Parts sales are divided into two segments: commercial “do-it-for-me” (DIFM) and retail “do-it-yourself” (DIY). Specific to the Big 4, it is estimated that ~\$140-\$150 billion would be considered the addressable market. Using wholesale dollars the DIFM parts market is ~10% larger than the DIY market, despite the 2020/2021 COVID-related jump in DIY sales (Exhibits 6 & 7). According to the AASA, complexity, changing consumer demand, and telematics will drive DIFM market share over the next several years.

Exhibit 6 DIY Market Size (\$B) 2002-2022



Source: ORLY Presentation, ACA Factbook

Exhibit 7 DIFM Market Size, ex-Labor (\$B) 2002-2022



McKinsey has estimated that the global aftermarket can grow to \$2.7 trillion in 2030, from ~\$740 billion, driven by new technology.

AFTERMARKET ECOSYSTEM

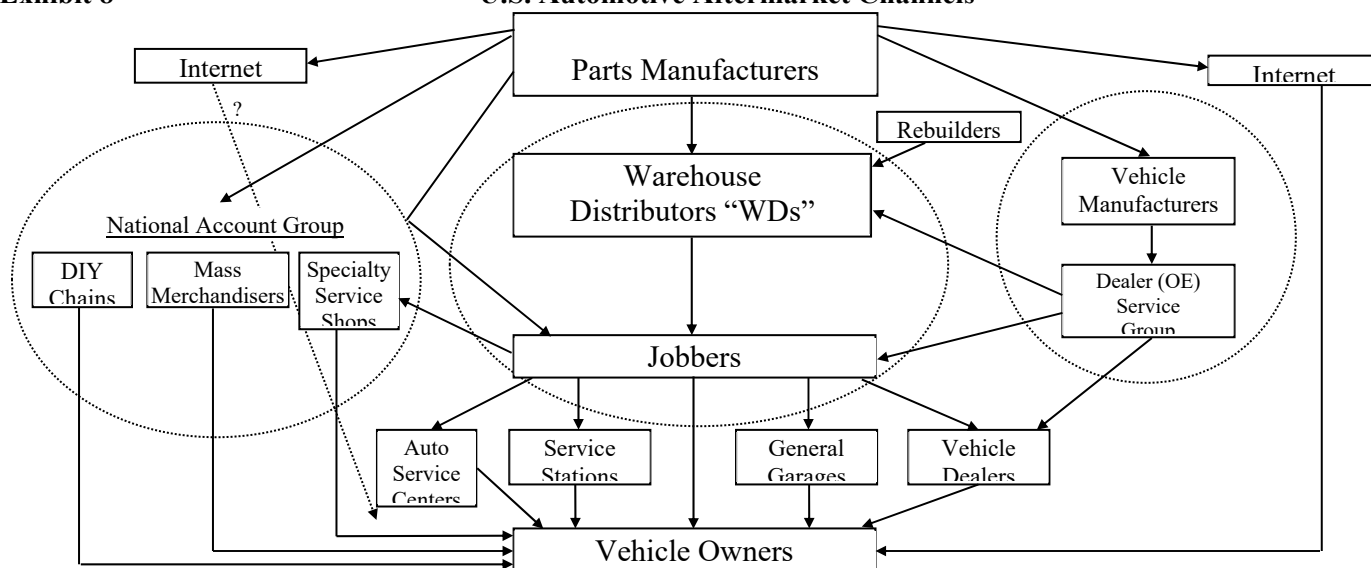
There are approximately 285 million light vehicles on the road in the US operated by ~240 million licensed drivers. The aftermarket is comprised of the replacement parts and labor that keep these vehicles operating after the initial sale. Servicing those vehicles are individuals working on their own cars (DIY), 130,000 repair outlets, and 100,000 gas stations that also do repair work. Roughly 600 warehouse distributors and 37,000 parts stores provide components to this fragmented buyer population. Over 1,000 aftermarket parts suppliers exist in North America, with tens of thousands of other manufacturers located in low-cost countries around the world.

The traditional or “three-step” parts distribution system consists of the warehouse distributor (WD), the jobber, and the end-user or installer (Exhibit 8). The leaders amongst WDs and jobbers continue to be NAPA (Genuine Parts), CARQUEST (part of Advance Auto Parts), and O’Reilly Automotive. The largest service chains include Midas, Jiffy Lube, and Monro Muffler Brake (MNRO). While the three-step system produces lower margins for distributors, this system remains efficient and provides the broadest range of parts deliverable within the shortest amount of time. The ability of new forms of distribution to gain share, most notably e-commerce, will depend on the ability to meet required delivery speeds of 30-45 minutes after an order is received.

In the retail “two-step” system, parts are distributed *directly* through consumer accessible chain stores, the largest of which are AutoZone, Advance Auto Parts, and O’Reilly Automotive, as well general retailers such Costco and Wal-Mart. In this system, the DIY chain or retailer acts as both distributor and retailer (Exhibit 8). In the OE Service “two-step” system, part suppliers ship products to a dealer service group (e.g. Ford or Toyota), which typically warehouses the product and ships it off to franchised vehicle dealers and other repair operations.

Exhibit 8

U.S. Automotive Aftermarket Channels



Source: Gabelli Funds

Amazon has invested in the automotive aftermarket. While it will take massive investment to build out the necessary inventory and distribution, the ~\$300 billion aftermarket parts industry is one of the largest retailing segments in which Amazon does not have significant share. Traditional e-commerce competitors such as US Auto Parts, have utilized both distribution systems, either going directly to the consumer, or through a WD or jobber/retailer which is a much lower margin business. Previously, these competitors have not achieved the same distribution proximity, and therefore delivery speeds, as brick-and-mortar competitors. AMZN has instituted a platform to go directly to the installer base, wherein the consumer buys on AMZN and connects with a local repair shop via the site. We have seen little traction on these types of platforms. However, in China, Alibaba purchased into Carzone and QCCR, which integrated the whole supply chain. We note that WorldPac is now on the market and could provide e-commerce with quick distribution capacity.

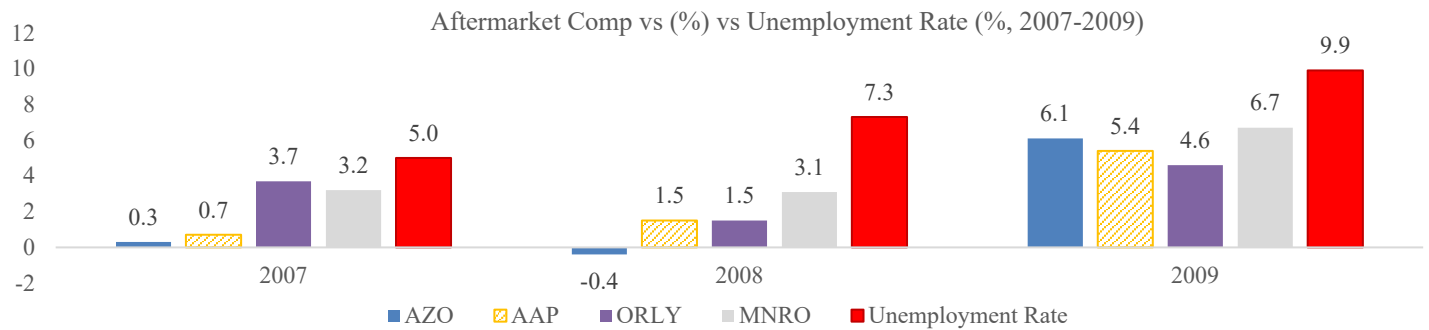
AFTERMARKET DRIVERS

The automotive aftermarket is traditionally driven by four primary dynamics: 1) the number of vehicles on the road; 2) the age of the vehicle population; 3) employment and wage growth; and 4) the number of miles driven by consumers. Aftermarket growth has ranged between 1-4% over the past thirty years, proving to be recession resistant.

Recession Resistant – Aftermarket Posts Strong Comp in 2009 Amidst ~10% Unemployment

The aftermarket is resistant to recessionary pressures. This is best exemplified by the average 5.7% comp posted in 2009 when unemployment reached 9.9% (Exhibit 9). While we do not know what 2024 will bring, we believe that economic ambiguity, low vehicle supply, and higher cost of living will drive owners to maintain their vehicles.

Exhibit 9 Aftermarket comps remain strong during high rates of unemployment (2007-2009)



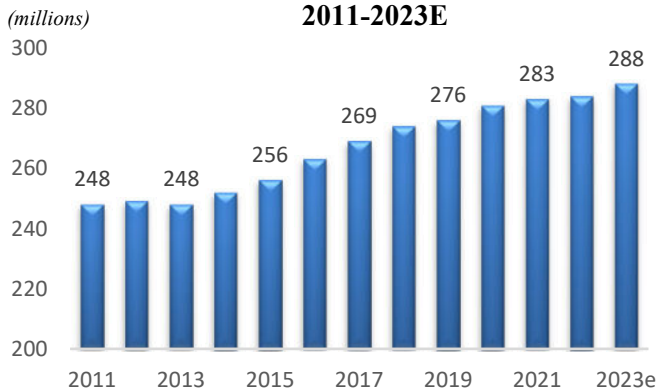
Source: Company filings, Bureau of Labor Statistics

More Vehicles on the Road –Trend Towards Personal Vehicles & Maintenance

U.S. Vehicles in Operation (VIO) grew consistently over the last ten years (Exhibit 10) driven by an improving economy that bolstered new vehicle sales and manufacturing quality that reduced scrappage rates (4.2%). The AASA expects VIO to grow to 300 million by 2030 from 285 million in 2023 driven by suburbanization, higher quality parts that keep vehicles on the road longer, and new household formation (as the percentage of young adults living with a parent declines from 52%). In 2023/2024, low new vehicle supply and high used vehicle prices should continue to drive the tail-end of the curve as owners are forced to invest in maintaining vehicles longer.

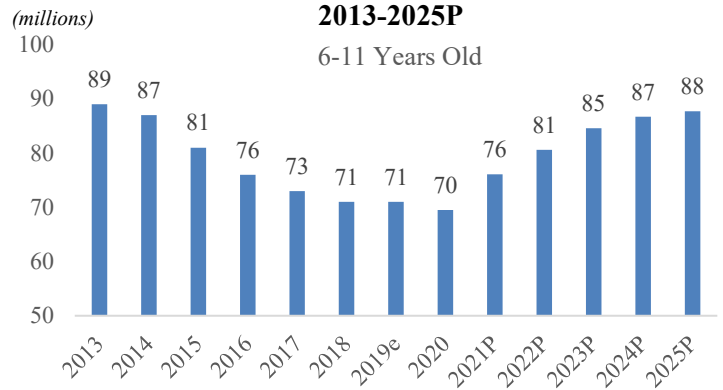
However, starting in 2026, the aftermarket ‘sweet spot,’ or those aged 6-11 years, will see decelerating growth. VIO in the sweet spot fell from 81 million in 2015 to 70 million in 2020. This is due to lower vehicle sales during 2008-2011 (the Great Recession) that entered the aftermarket at lower rates than previous model years. This “air pocket” is expected to reverse to 88 million through 2025 (Exhibit 11). While we experienced much of this growth through 2023, flat sales in 2015-2018 will not drive similar growth rates after 2025. Higher quality parts that increase the return on investment on maintenance repairs should offset some of this deceleration

Exhibit 10 US Light Vehicle Population 2011-2023E



Source: AASA, Experian

Exhibit 11 Number of Vehicles in Sweet Spot 2013-2025P

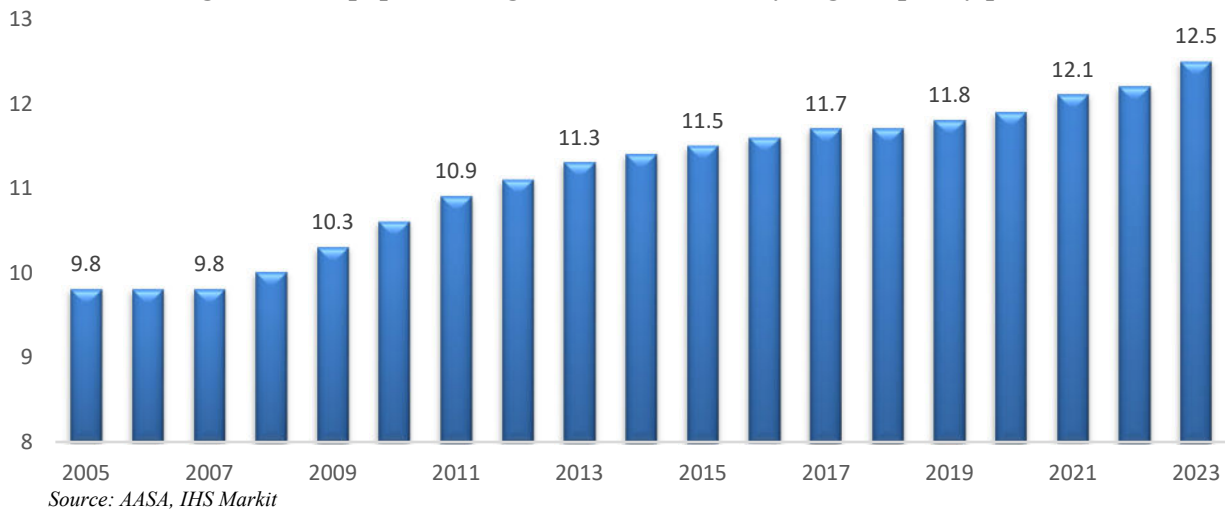


Source: AASA, IHS Markit

Vehicle Age Drives Aftermarket Growth

The average age of a car on the road has grown to 12.5 from under 10 over the last 20 years (Exhibit 12). As owners are able to drive vehicles longer, they are more willing to invest in repair and replacement of parts. We believe this additional investment has effectively expanded the age range of the “sweet spot,” or age in which the owner sees value in repairs. An older vehicle parc bolsters the sale of alternators, starters, brake calipers, and brake master cylinders, as these parts are generally only replaced later in a vehicle’s life. Higher numbers of replacement jobs generate more aftermarket demand as service providers diagnose ancillary problems in these older vehicles. Further, in response to recent higher costs pressuring consumers, historic lows in new/used vehicle supply, and high new/used vehicle prices, many consumers have decided to maintain their vehicles longer. Both of these recent and historical trends should drive aftermarket age and replacement demand.

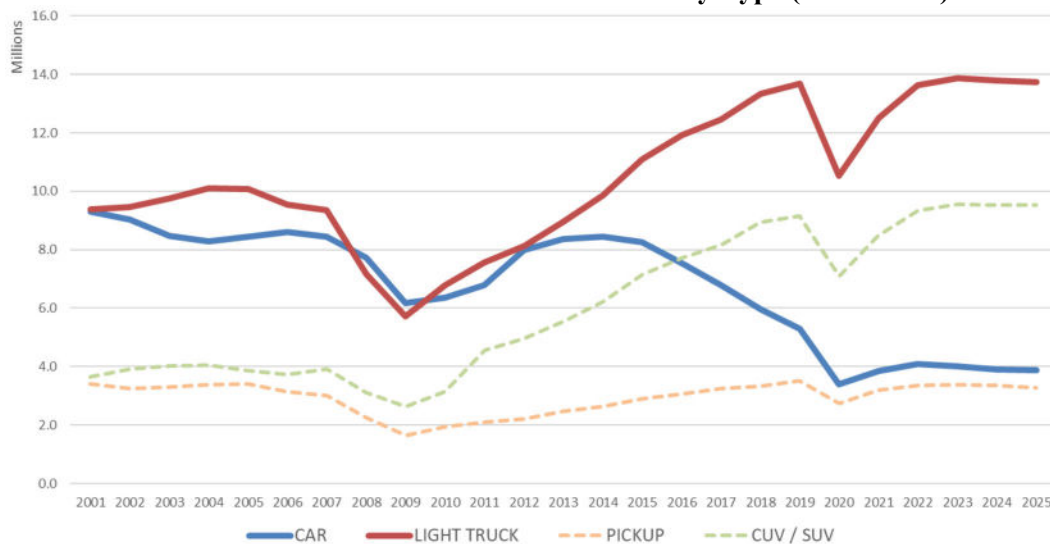
Exhibit 12 US Light Vehicle population ages with low inventory, higher quality parts



Larger vehicles drives aftermarket growth

On top of grow new vehicle sales, North Americans have shifted to larger vehicles over the last 10-15 years which drives aftermarket demand. Light trucks went from ~50% of sales in 2013 to ~75% in 2021. Larger vehicles tend to require more repair dollars with a mid-size crossover costing 12.5% more per mile repair and maintenance cost than a small car.

Exhibit 13 North American New Vehicle Sales by Type (2001-2025e)

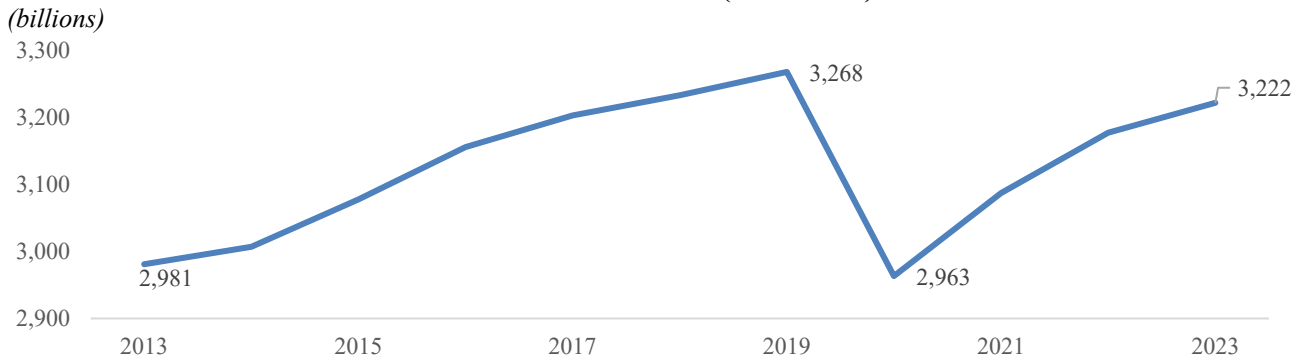


Miles Driven to Grow: Need for Personal Vehicles, Suburbanization, and Return to Work

Miles driven (outside of warranty) is a historic indicator of broader vehicle wear and tear. However, from the beginning of the COVID pandemic, there was a clear spread between miles driven and aftermarket demand. We attributed this to: 1) owners of older vehicles tended to be essential workers who continued to drive; and 2) stimulus and time. First, previously declining categories tailored to 12+ year old vehicles grew. Stimulus dollars supported low-income consumers in 2020/2021 who are more likely to own older vehicles and utilize independent repair shops over dealers. Total spending by lower-income consumers did not change in 2020 relative to down 7% for higher income consumers. This allowed for investment in older vehicles to keep them on the road while the costs of buying used/new vehicles was high. Further, appearance and performance categories significantly outperformed in 2020/2021. These products are not tied to miles driven, but an indication of time, money and interest by the end consumer.

Going forward, suburbanization (partially in response to COVID and age demographics), a return to work trend, and shared mobility along with a focus on discretionary trips should support continued growth. Shared mobility (Uber and Lyft) appears to be adding to miles driven. For example, Transport Policy estimated that ride hailing increased vehicle miles driven of users by 114% in NYC and UC Davis noted that 49-61% of ride-hailing trips would not have been made at all, or by walking, biking or transit. Further, ~30% of workers continue to work from home according to CCC. With increasing pressure to go back to the office, work-related miles driven may rebound while discretionary trips continue to grow.

Exhibit 14 U.S. Vehicle Miles Driven (2013 -2023)



Source: US Department of Transportation Federal Highway Admin

Gas prices are now \$3.47 in line with a year ago, above \$2.11 in 2020, but below highs of \$4.87 in 2022. Higher gas prices may temporarily pressure miles driven in the near-term, but are most likely not a headwind at current levels. Previously at this conference, aftermarket companies have stated that prices above \$3.50 may hinder consumers’ interest in driving, as these prices would impact discretionary income.

Exhibit 15 U.S. On Highway Gas Prices



Source: eia.com

NEW TECHNOLOGIES PROVIDE SIGNIFICANT OPPORTUNITY

The impacts of future electric vehicle penetration is unknown; however, the industry has shown that the adoption of CASE technology (Connected, Automated, Shared and Electrified) has created profit opportunities. More newly designed parts, the redesign of existing replacement parts, complex, higher priced repairs, and increased miles driven should drive growth. McKinsey estimates that shared mobility, data connectivity and upgrade services will lead to a \$2.7 trillion global aftermarket in 2030 vs. \$740 billion in 2016. However, those that cannot invest will most likely lose share.

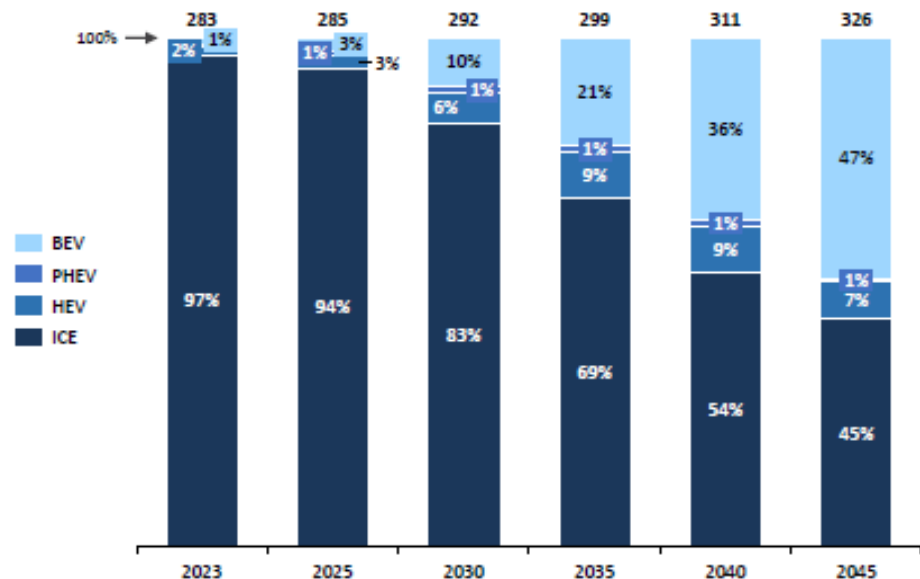
Electric Vehicle Penetration a Disruptor and a Catalyst

As electric vehicles increase as a percentage of new car sales, questions around the rapidity of penetration of the car parc and impacts on the aftermarket remain. However, the transition towards “electrified,” and “autonomous” including the adoption of full hybrids, mild hybrids, and ADAS technologies will drive part demand and the value of those parts. The AASA projects that vehicles with some level of ADAS technology will account for ~40% of the market by 2030 and the total addressable market will grow 4x by 2030, driving significant aftermarket value.

- *EV's cost the same amount to repair as ICEs.* While our previous estimates suggested a 30% reduction in aftermarket value for an EV vs an ICE, there are several data sources showing that EV's cost more to repair than ICE's. For example, according to RepairPal, a Tesla will cost you \$832/year to repair vs \$652 for the average ICE vehicle. Further, data from NADA (dealerships receive more EV repairs than the aftermarket at this point) recently showed that EVs require more service visits per year than ICE peers (2.9x vs 2.3x) and require more services per visit (3.9 vs 2.8). Of course, as EVs age and new models penetrate the market, these numbers will change. For now, the question remains as to whether the traditional aftermarket will be trained, equipped and able to complete the majority of repairs.

- *Electric vehicles will account for 5% of the aftermarket by 2035.* The AASA estimates that fully electric vehicles will account for 10% of the car parc by 2030, but only 2% of the aftermarket (vehicles 6+ years old) (Exhibit 16) which is in line with our internal estimate of 2.6%. (Table 1). Parts that have growth opportunities include tires, suspensions, non-engine drivetrain, sensors, monitoring systems, HVAC, infotainment/content and battery refurbishment, battery invertors and battery technology.

Exhibit 16 US car parc by vehicle age, 2021-2035 (millions)



Source: MEMA/AASA Industry Overview – Gabelli Conference

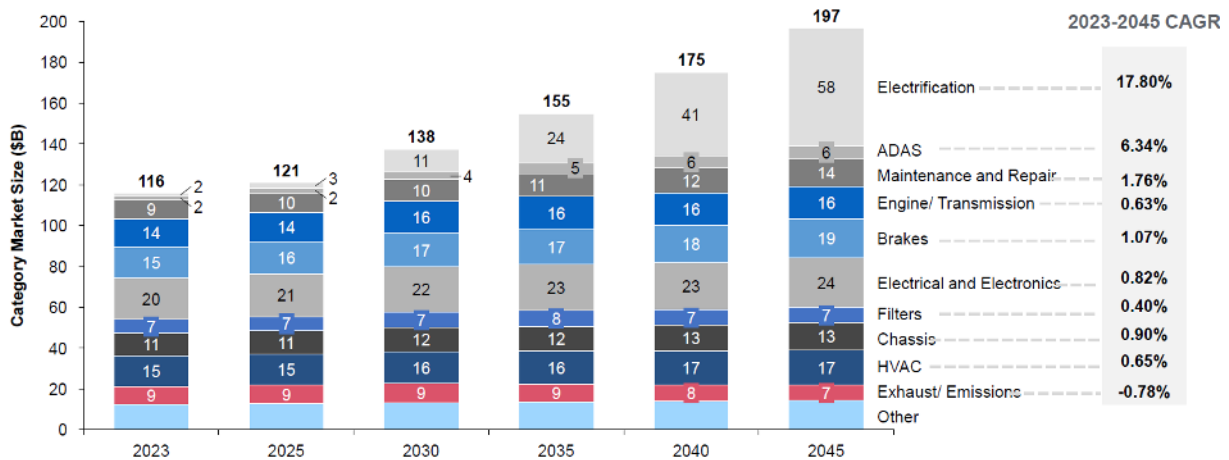
Table 1 Full Electrification Not a Large Percentage of the aftermarket (+6 year old vehicles) by 2030

	2026	2027	2028	2029	2030
Number of Vehicles in Aftermarket	199,289	197,579	198,698	198,654	201,561
Number of BEVs in Aftermarket	1,070	1,518	2,243	3,555	5,215
% of BEVs in Aftermarket	0.5%	0.8%	1.1%	1.8%	2.6%

Source: MEMA/AASA Industry Overview – Gabelli Conference, EV-Volumes.com, and Gabelli Funds estimates

- Electrification and ADAS technology to drive aftermarket growth.** As shown in Exhibit 17, traditional categories such as filters, chassis and brakes are only expected to grow by 0-2% per year; however, ADAS and electrification technologies are expected to grow at 6% and 18% per year respectively through 2045. The growth in these higher priced, higher value parts should drive aftermarket earnings as historically, the aftermarket has been able to push through prices of new technology while maintaining strong margins.

Exhibit 17 Aftermarket Growth by Product Category (2023-2045)

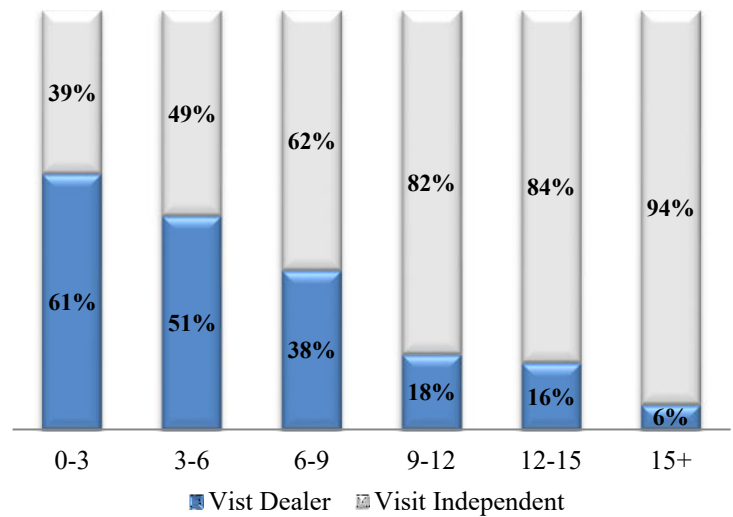


Source: Joint EV Forecast, conducted by Strategy& for MEMA Automotive Aftermarket Suppliers and Auto Care 2023

Telematics and Technology Investment Drive Share Gains for Dealers/Larger Aftermarket Chains

As vehicles age, owners are less likely to bring cars to dealers for service (Exhibit 18) as: 1) OE warranties only cover work earlier in the life of a vehicle; and 2) owners of older cars tend to be more price sensitive and look for lower cost work done by independent service chains. Previously, it was hypothesized that dealers would take share as the increasing use of technology created cybersecurity issues that could lock out aftermarket parts suppliers due to OBD-II (on-board diagnostic standards) access restrictions, making it more difficult to reverse engineer these parts. However, Massachusetts passed the pro-aftermarket “right to repair” measure in 2021, which enables aftermarket providers access to vehicle data for the purpose of service and repair. Federal regulation supporting the aftermarket is expected to follow. This reduces any risk that only dealers will have access to telematics and data within the car.

Exhibit 18 Vehicle owners trend towards independent repair shops as vehicles age



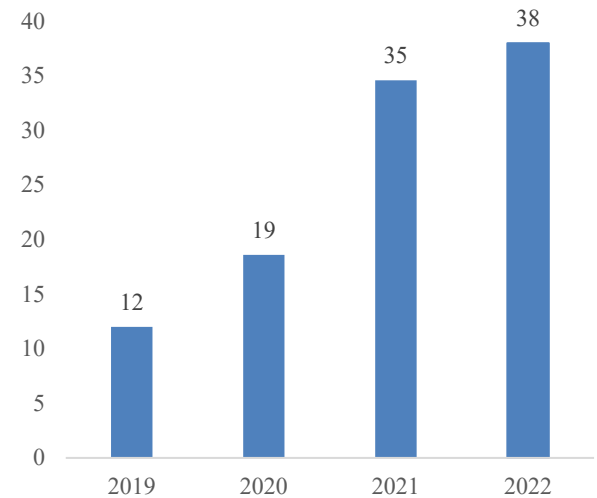
Source: Automotive Aftermarket Suppliers Association

Going forward, we believe that dealers and large repair chains will take share due to the increasingly large investment required to repair complex vehicles, train technicians, and optimize telematics/data. Complexity in parts is raising costs of doing business, providing an advantage for larger organizations, including both dealers and large repair chains that have the diagnostic and tool capability to complete these jobs. The question will be whether these shops can leverage the topline growth as costs rise.

E-tailing: Opportunities to Gain Share and Barriers to Entry

“We had years of e-commerce penetration in 12 months” – AASA Vision conference in 2021. While it is difficult to estimate the size of aftermarket e-commerce, we estimate that e-commerce sales grew from \$12 billion in 2019 to ~\$38 billion in 2022 (Exhibit 19). Most aftermarket players spoke to e-commerce doubling during the pandemic with little expectations of a reversal. However, it is still estimated that the aftermarket is one of the least penetrated industries at ~12% e-commerce penetration. Large pure play e-commerce players such as AMZN and smaller players such as PRTS are looking to gain share by going directly to the customer and cutting out brick-and-mortar storefronts. However, industry experts expect that only ~\$1 billion of AMZN’s automotive e-commerce sales relate to Big 4 categories and that much of the accessory and discretionary market had already transitioned to online over the last 10 years. As 100% online competitors look to disrupt the original landscape the large distributors need to prove that they can: 1) maintain this share by building out superior omnichannel models; and 2) maintain pricing in the face of potential pricing pressure.

Exhibit 19 COVID drives e-Tailing growth
(\$ billions)



Source: Source: Hedges & Company, CaRiD Investor

Industry experts believe that the immediacy of parts and service needed by professional installers has hindered e-tailing penetration.

- *Distribution capacity as a barrier to entry.* DIFM customers often require delivery speeds of 30-45 minutes across 100,000’s of SKUs. We believe that e-commerce players will have to build out automotive parts distribution capacity similar to ORLY’s over 55 million square feet of distribution and selling capacity, which is 100% focused on the distribution of auto parts, to meet similar delivery speeds. This distribution capacity serves as a barrier to entry. Given low distribution capacity specific to auto parts, e-commerce disruptors will have to vastly increase distribution capacity to compete in the DIFM market and meet 30-minute delivery times. Non-automotive e-commerce distribution competitors will also have to manage the low inventory turns of ~1.3x specific to the aftermarket industry. We currently estimate that AMZN has about 200 million square feet of fulfillment capacity and an additional 150 million square feet of distribution logistics across all products sold via AMZN: holiday gifts, Wholefoods, toys, etc.
- *Tech is complicated, service is needed.* Currently, a significant portion of online sales are buy-online, pick-up-in-store which indicates a certain level of service required by the DIY market. To meet service requirements, online competitors will need to dramatically increase SG&A expenses on personnel specific to parts technology or attempt to build out a crowd-sourced platform of specialists that opt to provide advice. We believe that DIY would transition to online competition easier than DIFM (the large aftermarket distributors manage digital systems).
- *Acquisitions in the future?* In China, New Carzone, established by Alibaba, Carzone, and QCCR, integrates automotive e-commerce, warehouse/retail distribution, and repair services. As distributors continue to maintain share for the above reasons, there could be a similar merger in the long-term. Advance Auto Parts is looking to sell WorldPac, a distributor of OE and imported aftermarket parts, which we value at over \$1 billion. If AMZN were to be interested in aftermarket distribution, WorldPac’s 300 distribution centers and branches could be an interesting start. In the shorter term, PRTS is a potential acquisition target.
- *The potential for pricing pressure.* E-commerce players increase market price transparency. Private label parts that often do not meet the same quality as distributor brand labels are sold at +20% discounts. This spread and online transparency may pressure margins at brick-and-mortar storefronts.

POTENTIAL HEADWINDS

Share Gains and Consolidation Drive International Expansion and Questions of Future Margin Expansion

The “big are getting bigger.” During COVID and the subsequent supply chain crisis, the Big 4 grew +25% on average, gaining share as smaller competitors or large-box retailers could not maintain inventory or keep stores open. This most likely drove further consolidation of the market. As inflation moderates in to 2024, the question remains as to how much larger the top distributors can get before running into slower growth, margin pressure and supplier issues.

Fewer domestic growth opportunities driving international growth: Company-owned stores at AZO, ORLY, AAP, and NAPA (GPC) composed 49% of the parts stores in the U.S (60% including NAPA’s independent stores). Overall, the top ten aftermarket parts providers constituted 53% of U.S. parts stores in 2021, up from 32% in 2003 (Table 2). Given market consolidation, the Big 4 are expanding globally with GPC acquiring AAG in Europe, O’Reilly announcing a larger distribution center in Mexico and AZO accelerating growth in Latin America. We believe that global market expansion is a sign that future domestic growth may be tempered. However, the DIFM market also remains an opportunity. DIFM is more fragmented than the DIY market, with professional installers often looking to local jobbers to source parts.

Supplier pressure and margin deceleration: Consolidation of buying power has significantly altered aftermarket parts sourcing (driving significant distributor margin) and pressured supplier margins. While there are no signs of change at this point, the pressure of consolidating distribution and low cost sourcing could lead to supplier interest in different distribution channels such as e-commerce and more integrated supply/distribution chains.

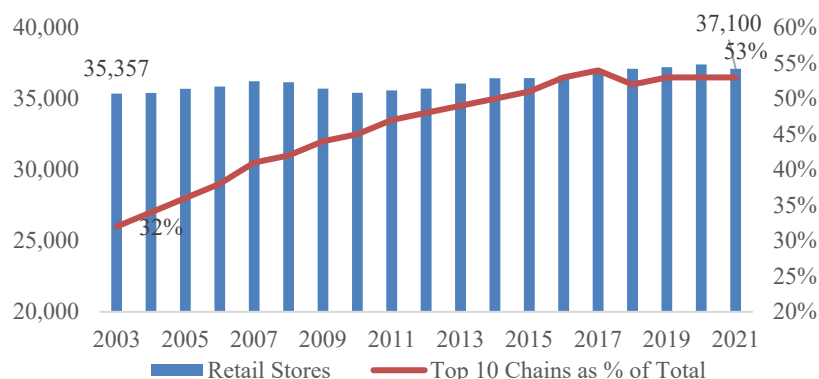
Table 2
2021 Top 10 US Auto Parts Distributors

1. AutoZone Inc.	6,115
2. O’Reilly Auto Parts	5,873
3. Advance Auto Parts	4,998
4. Genuine Parts/NAPA*	1,280
5. Pep Boys	1,000
6. Fisher Auto Parts	500
7. Auto-Wares	300
8. Replacement Parts, Inc.	175
9. Automotive Parts Headquarters	130
10. Hahn Automotive	90

Note: By US store count, Genuine Parts company-operated stores only (not inclusive of 4,618 independents)

Source: ORLY via AAIA Factbook

Exhibit 20 Top Ten Aftermarket Distributors as % of Total



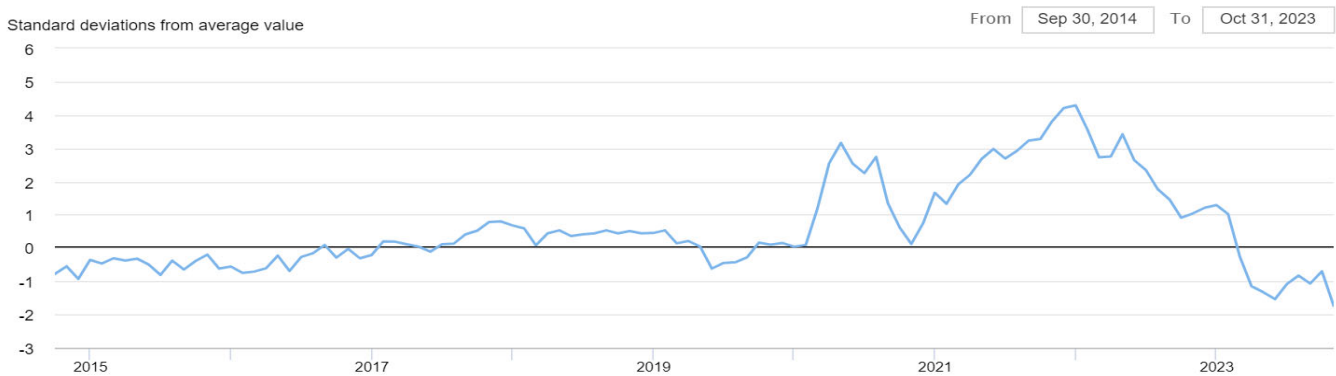
Interest Rate Increases Pressure Suppliers as Ability to Pass through Price is Limited

The Big 4 have leveraged their size advantage to extract extended payable terms and increased volume rebates from vendors. Aftermarket supplier agreements (often referred to as factoring) now allow the distributor to pay for a good in up to 360 days. Instead of holding the receivable on the balance sheet for the full 360 days, the supplier sells the receivable to the distributor’s financial institution for cash. The cost of the spread (the amount of the receivable less the upfront cash) is the discount factor, which is typically set at SOFR+. Once the supplier receives the cash from the finance institution/bank, both the cash and the expense (discount factor) are booked. During the last several years of low interest rates, suppliers utilized this inexpensive form of financing to extend terms and compete for clients while retailers pushed AP/Inventory ratios to ~130% reducing net working capital and freeing up cash flow for investments and repurchases. Over the last year, SOFR has increased from flat to +5%. If a company was holding \$1 billion in receivables from the banks, an interest increase of nearly 5% would equate to an additional ~\$50 million expense. The aftermarket suppliers have been managing this cost in 2023. Previously, distributors have suggested that any such interest rate costs could be passed along similar to any other input costs (e.g. labor, freight), but recent inflationary pressures of +10% placed on the consumer may inhibit ability to pass through these prices. We note that after years of steady growth, further expansion of these terms is most likely limited, reducing the large free cash flow growth of the past decade.

Moderating inflation, but no historic precedence for disinflation

During our 2021 conference, AZO stated that the aftermarket was experiencing the worst supply chain crisis since WWII. Inputs such as steel, semi-conductors, and resins inflated, container prices were up 6x and labor supply declined driving up wages. These issues were exacerbated by the sharp fall in demand in mid-2020 that was then followed by a sharp increase in demand driving uncertainty around optimal inventory levels. All of these factors drove significant cost pressures in the market with the distributors quoting price increases of ~15% over 2 years. This year, participants noted moderating inflation. This is best exemplified by the FED’s Global Supply Chain Pressure Index which indicated a rapid 4x growth in 2021 that began easing in 2H 2022 and has been followed by sustained moderation (Exhibit 21). Presenting suppliers such as SMP and MPPA, that have superior fill rates, are less exposed to overseas sourcing and we believe the supply chain is moving towards Southeast Asia, Mexico and even locally in the US. All companies stated that the aftermarket has never been in a position of lowering costs and do not believe most categories will experience deflation.

Exhibit 21 Fed Global Supply Chain Index (CPI Index data: 2015-2023)



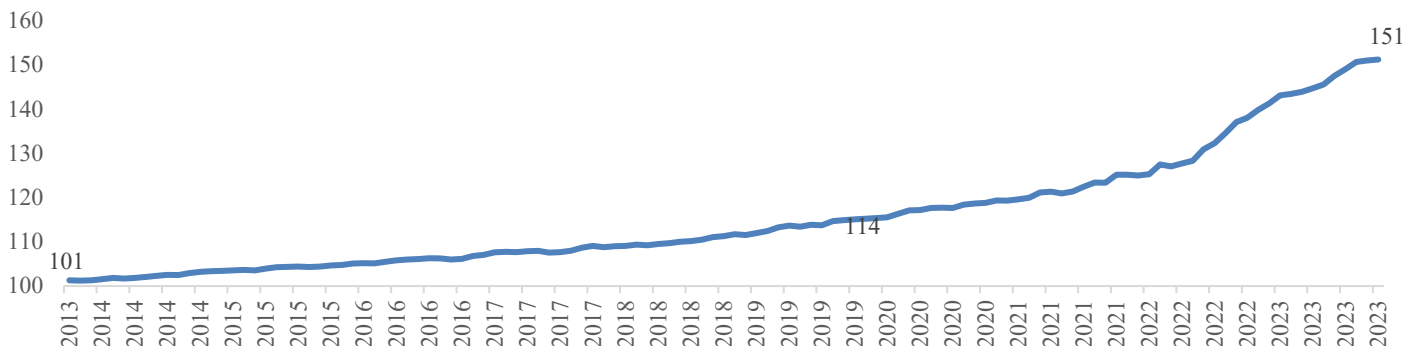
Source: AASA via Federal Reserve Bank of New York, Global Supply Chain Pressure Index

Increasing Costs vs Consumer Elasticity

Increasing complexity and advanced technologies, along with the aforementioned cost increases, have been driving aftermarket pricing. Vehicle Maintenance and Repair CPI has gone up +50% over the last 10 years, including ~10% in the last year (Exhibit 22). There are two main reasons for the long-term growth: 1) higher quality of parts has allowed vehicles to remain on the road for longer – increasing the value of maintaining one’s vehicle; and 2) new technology, such as ADAS and sensor-based technologies have driven up the complexity and value of aftermarket parts.

Historically, aftermarket distributors have been able to push through prices while maintaining margin and suppliers maintain gross profit dollars. We believe that at some point the additional costs of ownership will weigh on the consumer; however, the current spread between buying vehicles versus repairing a vehicle is high as the prices of new/used vehicles remains elevated.

Exhibit 22 The Increasing Costs of Vehicle Maintenance and Repair (CPI Index data: 2013-2023)



LIGHT VEHICLE MARKET OUTLOOK:

A March Back to 17 Million Vehicles Begins

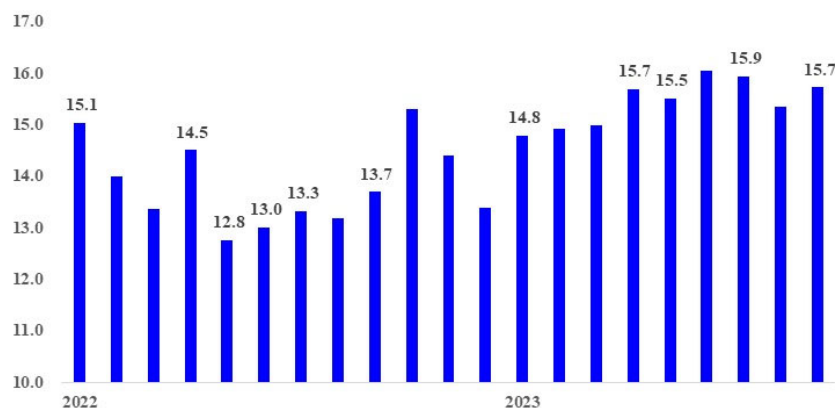
Inventory availability, the primary hurdle in keeping new vehicle sales from returning to historical levels, finally improved during 2023 after two years of barren dealer lots. Consumers who had been waiting months for their desired vehicles to arrive at dealer lots were finally rewarded, albeit after a period where they could have enjoyed the benefits of low interest rates on loans along with record high used vehicle prices to assist with trade-in value.

Sales of light vehicles held firmly in the 15 million SAAR (Seasonally Adjusted Annual Rate) range as pent up demand for new vehicles and the return of fleet sales helped offset headwinds related to new vehicle pricing, interest rates, and softer used vehicle pricing.

Prior to 2020, New Vehicle sales largely ran in the 16 to 17 million range for the better part of the last decade, with roughly 3 million units per year sold through fleet channels, including rental car companies, government, and commercial customers.

COVID-related demand deferrals and supply-chain related production disruptions factored into a drop in demand for the past three years, ultimately leading to up to ten million units of pent-up demand that our presenters believe is helping set a floor for broader industry demand. This demand was further augmented by the return of manufacturer-funded incentives that have assisted in offsetting the impact from rate-related impacts to average monthly payments.

Exhibit 23 2020-22 Monthly US Light Vehicle SAAR



Source: Ward's

The improvement in inventory noted above was driven by improvements to supply chains, which had been severely impacted since the arrival of COVID in March of 2020. Presenting suppliers' managements were delighted to speak on improvements in supply chains, with lessening inconsistencies in parts availability that drove costs higher, including in areas such as premium freight. Suppliers of original equipment parts and systems were largely able to enjoy greater year over year sales on both volume and price, albeit with increased costs associated with parts and labor inflation – a topic for later in this reflections piece.

Dealer Inventory Rebounds Somewhat

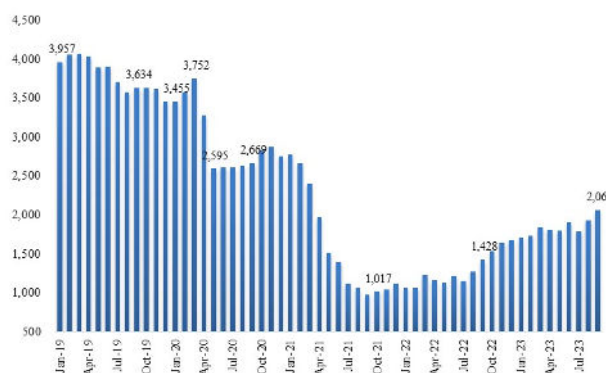
Supply chain improvement, particularly regarding the availability of semiconductor chips, as well as improved logistics capacity, helped automakers increase production to refill dealer lots.

Dealers finally have found some relief, with inventory levels back above 2 million units. While far below the 3.7 million units on dealer lots in early 2020, the recovery from under 1 million units enabled unit sales to increase.

Even with the added relief, dealer days' supply stood at roughly 40 days vs. a pre-Covid "sweet spot" in the 55-60 day range.

Exhibit 24 US Monthly Dealer Inventory, 2020-22

(Units in thousands)



Source: Ward's

We continue to believe that this lack of inventory has created a great deal of pent-up demand that is likely to smooth downside cyclical in US Auto Sales in the event the US economy falls into a period of recession. With the automotive market coming off of lower highs, we would expect a "higher low" from a production standpoint. Additionally, while automakers have enjoyed greater profitability per unit with inventory at historically low levels, nearly all would like dealers to be more adequately inventoried than current levels. Conversations indicate that that a happy medium exists at around the 2.5 million-unit range. This ultimately means that production must grow in excess of demand by one million units in order to re-supply domestic dealers with product.

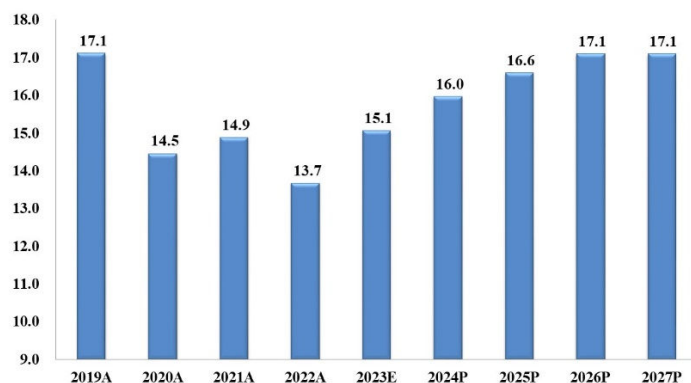
The Spring Loaded Recovery (Take Three?)

We expect the recovery in vehicle sales to continue in 2024 and beyond as inventory availability, pent up demand, and fleet needs offset headwinds in vehicle affordability via higher interest rates and low used vehicle prices. Regarding pent up demand, industry sales in the United States ran between 16 and 17 million vehicles from 2013 to 2020. Assuming a 16.5 million unit normalized demand environment, up to 9 million units of below trend sales would have been lost in 2020-2022 (two million in 2020 and 2021 and 3 million in 2022).

Headwinds clearly persist, in the form of vehicle affordability and credit availability. Beyond macroeconomic data that suggests a more constrained consumer, a lack of available low mileage used vehicles continues to create pockets of vehicle mix where equilibrium between new and used vehicles remains out of sync. Be that as it may, the aforementioned pent-up demand is likely to create at the very least a strong foundation for which new sales can increase.

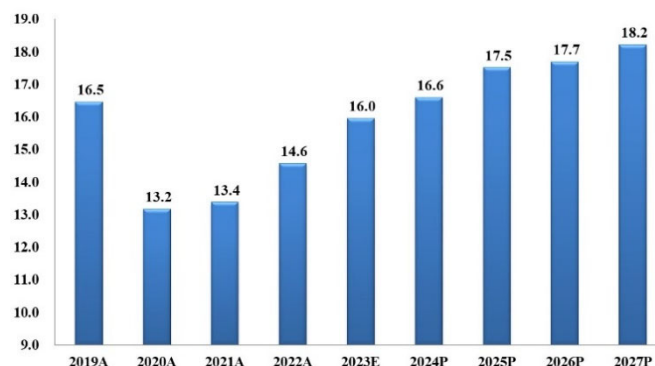
We expect US Light Vehicle sales to continue to grow in 2024 and 2025 before finally hitting typically normalized levels of 16.5 million once again in 2026.

Exhibit 25 US Light Vehicle Sales 2019A-26P



Source: Ward's, Gabelli Funds estimates

Exhibit 26 North American LV Prod. 2019A-26P

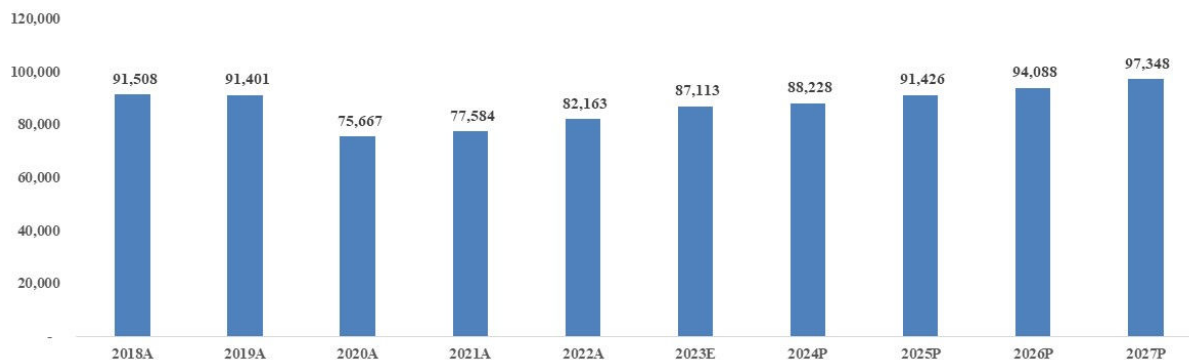


From a stock perspective, the backdrop is generally positive, as the likelihood for production declines in the coming years is very low. Additionally a slowing in inflation and broader declines in commodity prices including steel should turn from headwinds to tailwinds beginning in 2023 and help earnings for original equipment suppliers. This is likely underappreciated by the stock market, which continues to assume a coming contraction in earnings. Additionally, we look forward to hearing from companies over the coming year as to how they grow their electric vehicle supply portfolio in a manner that is both profitable and cash flow generative.

GLOBAL OUTLOOK

Thinking beyond domestic shores, the outlook for light vehicle production is mixed as European demand continues to lag, with higher rates and vehicle inflation weighing on consumers. Elsewhere, the outlook in China calls for a relatively flat 2024 at 28 million units of production. We expect China to resume its steady march back towards 30 million vehicles, beginning in 2025 and continuing through the balance of the decade. India is also likely to become a source of growth as the market matures off a low base of 5 million vehicles this year. Overall, we see the potential for 100 million units of global automotive production in the 2028 time frame. From a mix perspective, Electric Vehicles (EVs) will constitute nearly all the category growth, at the expense of Internal Combustion Engines. We explore this potential in our next section

Exhibit 27 Global Light Vehicle Production



THE ELECTRIC AGE MATURES

EV Growth Takes a Slight Pause but the Road Ahead is Lined with Chargers

Our 2023 Symposium featured a measured optimism regarding Electrification, albeit with a path less certain than at the same time a year earlier. Presenting original equipment suppliers were still excited about the potential opportunities that electric vehicles would bring with regards to new content at potentially higher margins than legacy Internal Combustion Engines. Aftermarket participants, including dealers, were also continuing to prepare for the coming need to repair the Electric Vehicle population as it matured. Our event served as a confirmation that an electric future is coming, though the path may take somewhat longer than anticipated.

EV GROWTH – FRAMING THE DISCUSSION

We expect annual global electric vehicle sales to grow from 13 million units in 2022 to 36 million by 2030 and the total number of electric vehicles on the road to grow from 40 million to just under 230 million over the same period (Tables 3 & 4 below). This outlook now incorporates a slightly lower growth trajectory for EV sales than was anticipated in 2021 and 2022, but nonetheless on

This includes both battery electric/fully electric vehicles (BEVs) and plug-in hybrid electric vehicles (PHEVs).

Table 3 Global Electric Vehicle Sales 2023E – 2030P

<i>(units in thousands)</i>	2023E	2024P	2025P	2026P	2027P	2028P	2029P	2030P
Light Vehicle (ICE) Sales	70,674	72,267	73,788	73,703	73,542	73,141	72,493	70,840
	1%	2%	2%	0%	0%	-1%	-1%	-2%
Light Electric Vehicle Sales	13,341	16,050	18,684	21,543	24,561	27,905	31,585	36,360
	31%	20%	16%	15%	14%	14%	13%	15%
Total Light Vehicle Sales Sales	84,015	88,316	92,472	95,246	98,103	101,046	104,078	107,200
	5%	5%	5%	3%	3%	3%	3%	3%
EV Market Share	15.9%	18.2%	20.2%	22.6%	25.0%	27.6%	30.3%	33.9%

Source: Ward's, Inside EVs, IEA, Gabelli Funds Estimates

Table 4 Global Electric Vehicle Population

<i>(units in thousands)</i>	2023E	2024P	2025P	2026P	2027P	2028P	2029P	2030P
Global LV ICE Population	1,390,180	1,431,886	1,474,842	1,504,339	1,534,426	1,565,115	1,580,766	1,596,573
	4%	3%	3%	2%	2%	2%	1%	1%
Global EV Population	40,546	56,750	77,215	101,057	127,667	157,779	191,552	229,214
	48%	40%	36%	31%	26%	24%	21%	20%
Global Light Vehicle Population	1,430,727	1,488,636	1,552,057	1,605,396	1,662,094	1,722,894	1,772,318	1,825,788
	5%	4%	4%	3%	4%	3%	3%	3%
EV Market Share	2.8%	3.8%	5.0%	6.3%	7.7%	9.2%	10.8%	12.6%

Source: Ward's, Inside EVs, IEA, Gabelli Funds Estimates

Price Cuts, Model Affordability Create Near Term Concerns

Electric vehicle juggernaut Tesla began cutting prices of all of its models at the beginning of 2023 and continuing throughout the year. This put some question into the minds of investors as to how real underlying demand for electric vehicles is, at this point in time.

Two schools of thought emerged as to the reason for the cuts. Some felt the profitable Tesla was attempting to undercut competition by deepening the Electric Vehicle (EV) losses of both new and legacy automakers that have been investing billions into Property, Plant, and Equipment while launching new vehicles. The second, more simplistic explanation was simply that demand for Tesla's Models S,X,E, and Y were flagging somewhat, and that the company was reducing price to spur demand.

Evidence from other automakers suggest the latter was the more likely reason, as once-hot models such as the Ford F-150 Lightning began to accumulate on dealer lots. Similarly, sales of Mercedes EV models have waned, with dealers often resorting to considerable pricing cuts to move product and reduce inventory days on hand. Ford and General Motors have recently announced delays to ambitious EV sales targets.

In our view, the current sales malaise is likely a short term hiccup as hurdles such as range anxiety due to a perceived lack of charging infrastructure hold back the release of underlying demand.

Exhibit 28 Ford F-150 Lightning EV



Source: Google Images

Exhibit 29

US Electric Vehicle Average Selling Prices



Source: Edmunds

Regulations Remain a Primary Driver

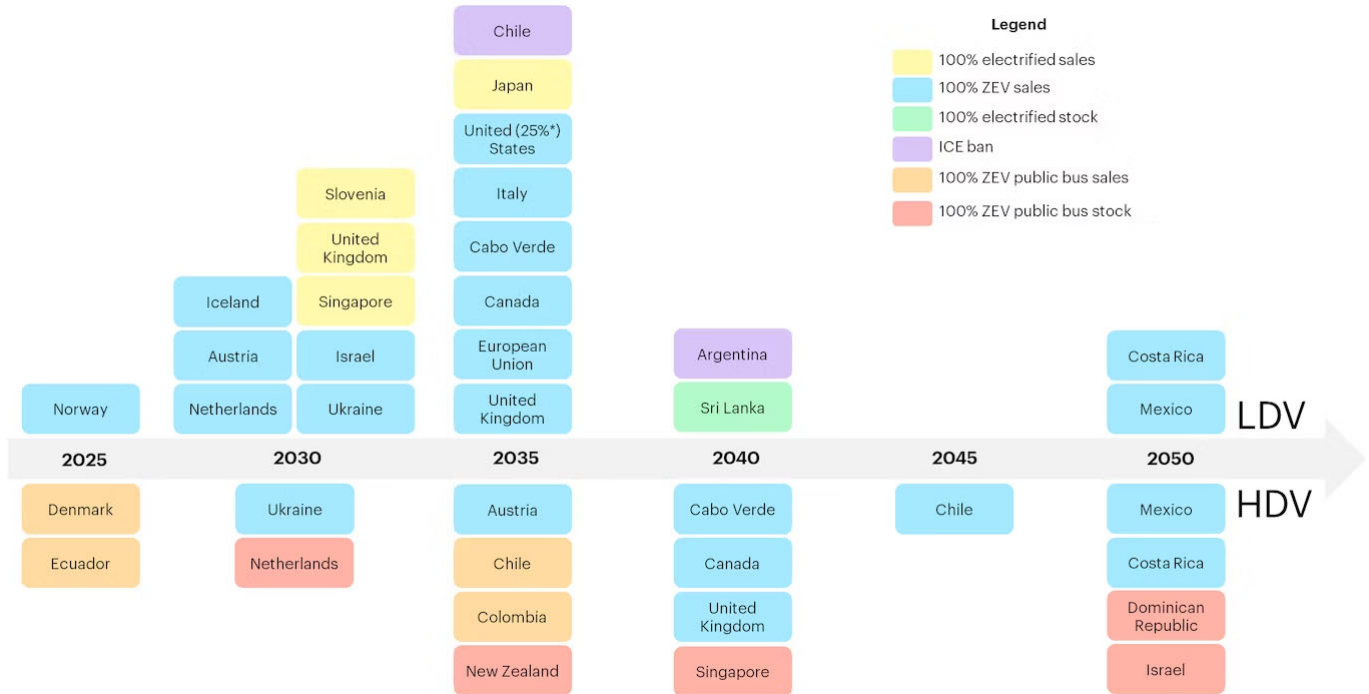
Despite what we believe is a near term hiccup in EV excitement, the EVs are coming – with government support (or mandates in some respect) remaining. This is most clear in China and Europe, where either state-mandated or climate-driven laws are set to phase out Internal Combustion Engines in consumer vehicles nearly entirely over the next 15-20 years.

Automakers are met with the choice of whether to compete or risk missing an opportunity on a market entirely. Exhibit 30 (below) depicts the coming regulatory hurdles ahead for automakers by geography. Initially, smaller countries such as Norway (2025) seeking 100% Zero Emissions Vehicle (ZEV) sales will aim to eliminate ICE sales, followed by larger markets such as China and Japan, who both target 100% electrified (including hybrids) sales in 2035.

European automakers must reduce average CO2 emissions targets for new passenger cars from 130 g/km in 2015 to 95 g/km by 2020 and 60 g/km in 2030 and face heavy fines for exceeding targets, which we believe could serve as a €30 to €35 billion industry headwind over the next decade. Simply put, automakers cannot be compliant without producing electric vehicles. Nearly all have made what is becoming an easy decision to make the expensive shift.

Exhibit 30

Global Emissions Regulations/ICE bans



Source: International Energy Agency (IEA)

In the U.S., California originally announced plans to ban sales of internal combustion engine vehicles by 2035. Washington, New York, and Massachusetts have followed suit, with others likely to join.

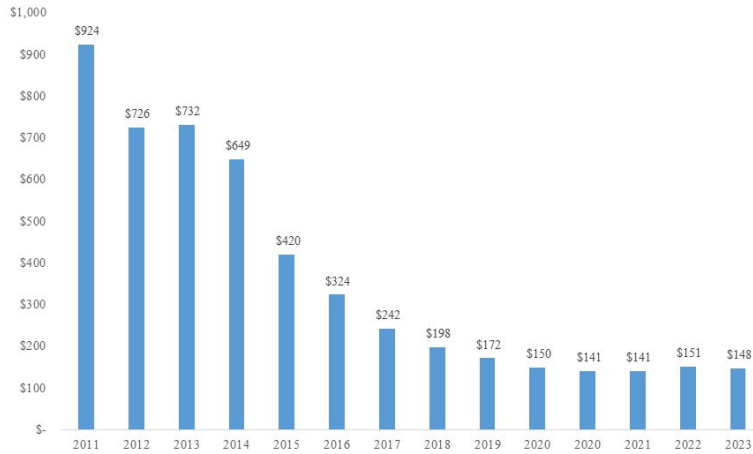
More Cost Effective Batteries Support Broader EV Adoption

The ultimate success of these initiatives will likely rest on the creation of, not only attractive, but affordable vehicles. To that end, battery development plays an incredibly important role.

With the battery by far and away the most expensive single component in an electric vehicle, much of the affordability issues battery producers’ face will rest on their ability to work down addressable cost curves. GM, in its recent investor day, spoke to the ability to reach \$85/kWh by 2025 on the back of improved production techniques, simplified pack designs, standardized platforms, increasing order size, continued penetration of high energy density cathodes, and economies of scale.

Exhibit 31

Average Lithium-ion Battery Pack Prices 2013A – 2026P



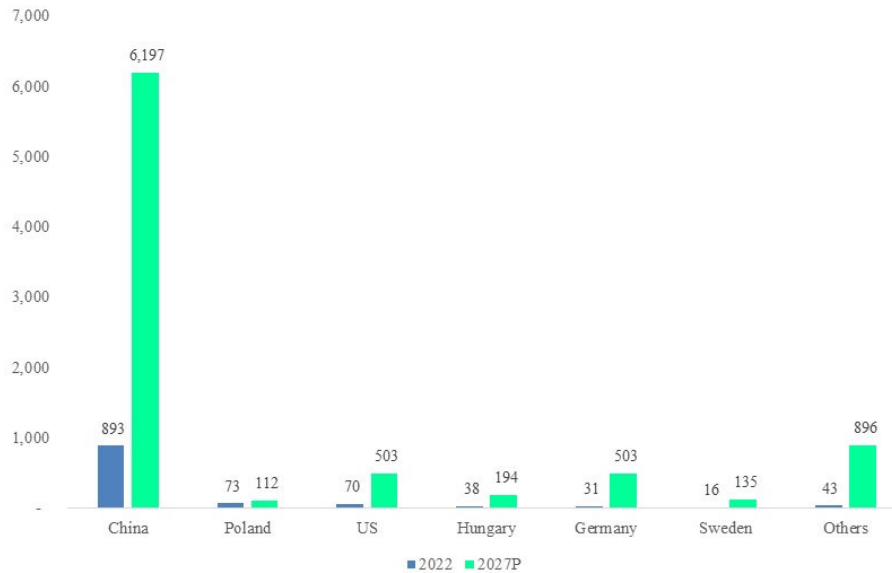
Source: Bloomberg NEF, Gabelli Funds Estimates

“The Battery 101”

The EV Battery Industry is estimated at roughly 200 GWh (Giga Watt Hours) of production capacity in 1H22 – with the nearly 70% of global battery capacity residing in China. Notably – four suppliers – CATL, LG Energy Solutions, BYD and Panasonic – hold more than two-thirds of total market share (see Exhibit 32 below). Market share can fluctuate given the growth profile of the industry with most participants currently in the process of either expanding manufacturing capacity or green-fielding new plants at a rapid rate.

Exhibit 32

Battery Cell Capacity by Country, in GWh



Source: Bloomberg New Energy Finance

Lithium Ion Batteries Explained

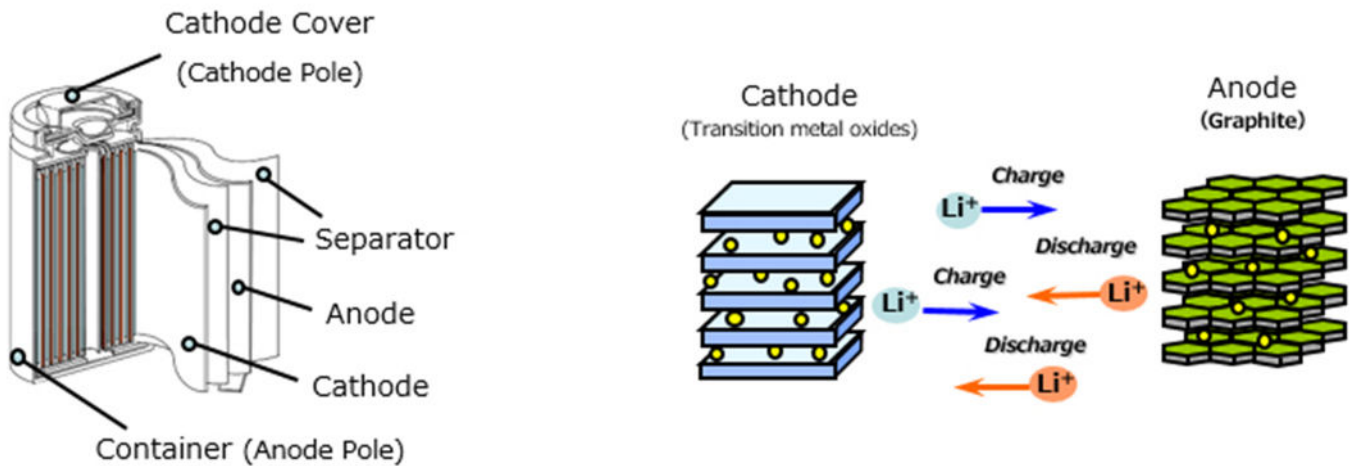
A lithium-ion battery generates power (DC) through a chemical reaction as lithium ions move from the anode to the cathode during discharge (see Exhibit 34 below). During the charge phase – lithium ions transition back from the cathode to anode. This process is repeated continuously through up to thousands of battery cycles. Lithium-ion batteries are valued for their: 1) high energy density versus other rechargeable batteries (including nickel metal hydrides, nickel cadmium, and lead acid batteries) making them smaller and lighter; 2) greater relative power (output); and 3) long life cycles as they are rechargeable.

Ex. 33 Leading Lithium-ion Battery Cell Manufacturers



Exhibit 34

Lithium-ion Battery Illustrated



Source: Panasonic

Investing in the Automotive Battery Through Legacy Suppliers

Investing via public companies in the automotive battery itself provides limited options to a degree, with most capacity (and publicly traded companies) residing in China or South Korea. Raw materials suppliers in the Lithium Ion battery supply chain (those that provide Lithium, Nickel, etc.) provide a more direct way than most but remain outside the auto industry.

Dana Incorporated (DAN) once again spoke to opportunities in EV batteries through battery cooling systems. Similarly, Modine (MOD), another supplier with a long history in the automotive heating and thermal solution segment is similarly developing technologies for batteries in buses and off highway vehicles. Companies such as Aptiv (APTIV) and Lear (LEA) in the wire harness space, support increased electrification in vehicles, including the battery powertrain.

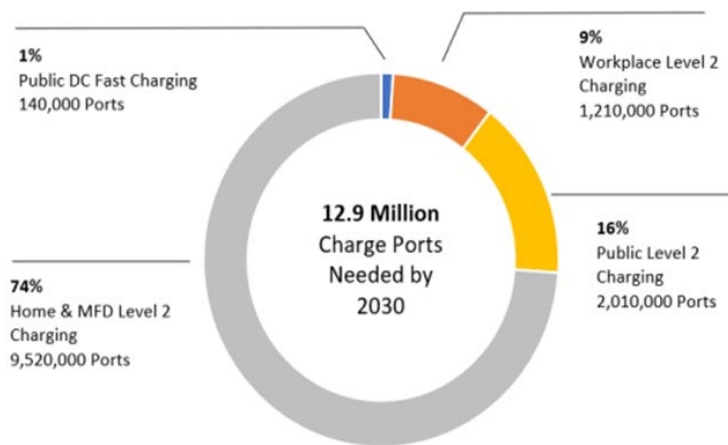
Charging Stations - Another “Fuel” of Adoption

The coming need for EV Charging Infrastructure was once again a highlight of our two days in Las Vegas, with ChargePoint Chief Revenue Officer Michael Hughes providing a keynote address highlighting the coming need for EV charging on a global basis.

ChargePoint believes that we are at the beginning of a 30-year arch in terms of charging growth, as adoption curves move “up and to the right” throughout the United States. While it will take years before a material portion of the 290 million US car parc to be electric, the need for charging infrastructure presents a top-line opportunity in the range of 54% growth per annum over the next 5 years.

In 2022, European charging solution company Wallbox spoke at our conference and similarly noted that EV adoption would largely hinge not only on vehicle model proliferation, but also massive investment in growth in charging infrastructure. Globally, Wallbox sees the need for upwards of 100 million chargepoints (at over 12.5 million charging stations) installed for passenger electric vehicles by 2030, a 10x ramp from what the 12 million today. Similarly, Blink Charging (BLNK), expects US EV Charger sales to increase from roughly 500,000 chargers in 2021 to 1.8 million by 2030, with the total number of charger sales over the next decade to add up to just shy of ten million chargers.

Exhibit 35 US Charging Needs by 2030



Charging solutions are likely to take several forms, with Home and Business Charging systems in the 7-22 kW range (according to Wallbox, over 70% of all charging occurs at home and work) the overwhelmingly greatest need. Public Charging stations utilizing Level 2 (60-150kW) chargers will likely constitute the next greatest set of charging equipment needs, while “superfast” 150-400kW Public DC fast chargers will likely find some level of demand for highway driving and/or other specialized cases.

Most recently, charging companies have sought to work together with public utilities on “bi-directional” charging that provide opportunities to integrate renewable energy, battery storage (via the vehicle itself) and the broader electrical grid. The opportunity to reduce energy costs, reduce dependency and stress on the grid, along with the potential for carbon emission reduction all combine to increase the opportunity that exists within the charging space.

Currently, market participants remain focused on building out L3 DC fast charging networks for public use as a key to reduce public concerns about “range anxiety”. ChargePoint indicated that within a decade, consumers will begin to use vehicles in a similar manner to their other electric devices - fueling will be reframed as a continuous, smaller increment exercise, rather than the “stop and fill” behavior we have grown accustomed to with the gas station model.

AUTO DEALERS: PROFITABLE GROWTH THROUGH FIXED OPERATIONS

Coming off a 2021-22 period of record profitability despite a SAAR in the low teens, US Auto Dealers saw the beginning of a long anticipated normalization as inventory levels slowly recovered throughout the year. Despite considerable compression in both new and used vehicle gross profit per unit, dealers continued to enjoy growth in highly profitable revenue streams such as Parts & Service (Fixed Operations). Additionally, dealers continued to improve attach rates of Finance & Insurance products (such as extended warranties and GAP insurance) that helped cushion the blow on lower gross per unit levels.

Our presenting dealer groups in Las Vegas - AutoNation, Penske, and Sonic, spoke at length regarding opportunities ahead across each of a dealers' diversified revenue streams – notably through greater share of wallet in both Used Vehicle sales as well as the aftermarket.

2023 has reinforced our belief in the dealer business model – one that has survived and thrived over the past 47 years through recessions and recoveries, massive changes in vehicular technologies, and a global pandemic. We further believe that lessons from the pandemic, combined with what is likely to be a more disciplined automaker base (at least in the medium term), have informed our view that dealers have become structurally more profitable entities with higher trough earnings than the market appreciates. We expect these businesses are set to increase earnings with lower fixed costs and drive considerable cash flows to either invest organically, use for M&A, or return to shareholders over the next several years.

Table 5 Top Public Dealership Groups in the United States, 2022 (by new units)

Unit Rank		Total New		Total Fleet Units	Total		Dealerships	2022 Total Revs (\$ millions)
		Retail Units	Total Used Units		Wholesale Units	Total Units		
1	Lithia Motors, Inc.	271,596	311,764	13,293	82,865	679,518	296	\$ 28,506.0
2	AutoNation, Inc	229,971	299,806	565	66,914	597,256	260	26,985.0
3	Penske Automotive Group	185,831	261,739	5,461	86,686	539,717	292	27,814.0
4	Group 1 Automotive	154,714	196,696	-	25,076	376,486	204	16,222.0
5	Asbury Automotive Group	151,179	151,464	-	-	302,643	146	15,433.0
6	Sonic Automotive Inc.	101,168	173,209	2,115	35,323	311,815	171	14,001.0

Source: Automotive News

Dealers 101

To refresh, franchised auto dealers are diversified businesses that generate sales and profits from four distinct operating lines: 1) new vehicle sales, 2) used vehicle sales, 3) parts & service, and 4) finance & insurance. While new vehicle sales constitute the majority of an auto dealer's revenues, dealers historically have relied heavily on the higher margin service & parts business to cover fixed costs and generate considerable gross profit. Dealers benefit from a variable cost structure in which primary fixed costs consist of building maintenance, administrative overhead, and base advertising. A dealer's sales force is generally compensated via commission, helping maintain dealer profitability at low new vehicle sales levels by naturally reducing SG&A. To highlight this, AutoNation, Penske, and Lithia all reported positive EPS in 2009 and again in 2010 despite the largest percentage decline in new unit sales since World War II. In 2020, as automotive repair remained an "essential" activity in the spring despite COVID-related shutdowns, service bays remained open and enabled dealers to continue to generate positive operating income.

Dealer Model Driven by Parts & Service

Table 6 (right) provides a snapshot of the public dealers' businesses by revenue (excluding Penske's Commercial Vehicle operations).

While the top portion of the table highlights what appears to be a model driven largely by variable operations (selling more units), the bottom depicts a more telling reality. Dealerships draw a considerable percentage of their profits from the combination of selling Used Vehicles along with providing Aftermarket Parts & Service; line items largely independent of broader cyclicalities within the new vehicle market. This unique feature of the operating model is a primary reason (but not the only one) that dealers have remained resilient through nearly every economic headwind faced through their history—including the Great Financial Crisis and COVID.

Table 6 Franchised Dealer Operating Model (2022E)

(\$ in millions)	AutoNation	Penske (a)
Revenue by Operating Line		
New Vehicle Retail	\$ 11,755	\$ 10,051
Used Vehicle	9,021	9,011
Finance & Insurance	1,437	848
Total Variable Operations	\$ 22,213	\$ 19,910
Parts & Service	4,101	2,427
Other	31	-
Total Revenues	\$ 26,345	\$ 22,336
(\$ in millions)		
Gross Profit by Operating Line		
New Vehicle Retail	\$ 1,367	\$ 1,246
Used Vehicle	538	543
Finance & Insurance	1,437	848
Total Variable Operations	\$ 3,342	\$ 2,637
Parts & Service	1,900	1,439
Other	-	-
Total Gross Profit	\$ 5,243	\$ 4,077
(\$ in millions)		
Gross Profit by Operating Line		
New Vehicle Retail	26%	31%
Used Vehicle	10	13
Finance & Insurance	27	21
Total Variable Operations	64%	65%
Parts & Service	36	35
Other	-	-
Total Gross Profit	100%	100%

(a) Penske Automotive Operations Only

Source: Company filings, Gabelli Funds
(a) Note: PAG revenues for light vehicle business only

Lack of New Vehicle Production Impacts on New and Used Prices

As noted above, franchised dealers typically generate between 60 and 75% of their revenues from the sale of both new and used vehicles. Before internet-driven price discovery flourished over the past 6-7 years, gross margins for new vehicles ranged in the 7% range, with Used Gross margins hovering around 8-9%. This meant that gross profit for a typical \$25,000 new vehicle in 2010 was roughly \$1,700-1,800, with a \$15,000 used vehicle generating nearly \$1,300.

Over the past decade, mix shifts towards larger Crossovers, SUVs and Light Trucks along with expensive new drivetrain and electronics content have driven average selling prices (ASPs) for both new and used vehicles substantially higher, offsetting the aforementioned pricing transparency that has dramatically cut margins for new and used vehicles.

Gross Per Unit – Is \$3,000 the floor?

Lack of vehicle availability over the past three years drove automakers and dealers to shift strategies regarding pricing in order to maximize profitability. With fewer cars, trucks and SUVs available, prices rose and dealers worked to ensure each sale benefited the organization as much as possible, as the next shipment of inventory was often unpredictable. This drove gross per unit to record levels of nearly \$6,000 per unit for AutoNation in 2022.

As supply chains freed up, a reversal has begun that has created a debate within the investment community as to the floor in gross per unit will finally be found. One set of investors, including Gabelli Funds, see a new normal for dealers with a higher baseline for unit profitability, owed to two major factors. First, automakers are less likely to engage in the overproduction practices that drove excess inventory for decades. OEMs themselves enjoyed record profitability in 2021 and 2022 despite lower than peak production levels. Managements witnessed the benefits of higher prices and lower incentives, with dealers free rider beneficiaries. Naysayers believe OEMs will soon fall back to bad habits, overproduce, and dilute unit profitability.

The second variable we focus on is simple vehicle price. Dealers are likely to attempt to maintain not only per unit profit but also margins that have largely stayed constant through time. As the average vehicle price has risen to over \$47,000 from \$35,000 in 2019 (higher at publicly traded dealers), so has, in our view and those of our presenters, the baseline dollar amount that dealers will receive in gross profit.

Dealers Profitability in the New Era

The ultimate question for dealers is what earnings should look like in an operating environment once production increases and inventory normalizes. To illustrate how far operating metrics have shifted, we detail below AutoNation and Penske’s third quarter per unit metrics over the last four years.

Table 7 Dealer 3Q Same Store Unit Metrics, 2019-2022

AutoNation	2019	2020	2021	2022	2023
Avg. Selling Price/New	\$ 38,710	\$ 41,644	\$ 47,524	\$ 51,447	\$ 51,373
Gross per Unit/New	1,606	2,535	5,484	5,927	4,048
F&I/Unit	1,939	2,154	2,573	2,766	2,759

Source: Company filings

As shown in Table 7 (above), per unit profit metrics at publicly traded dealers reached new historical highs in 3Q of 2020. Both AutoNation and Penske saw gross profit per new unit reach nearly \$5,500 and \$6,000, respectively, with corresponding increases as well in F&I per unit. It remains to be seen what is the new normal dealer profitability per unit once inventory stabilizes. With that noted, OEMs across the board have realized they can maximize profitability by producing fewer vehicles, focusing on content per unit, and reducing costly (and brand dilutive) incentives.

Additionally, 2020 tested dealer-operating models in such a way that businesses learned they could generate greater profitability with considerably lower overhead. For example, AutoNation had SG&A/Gross Profit (an important metric for dealer profitability) well above the 70% range. In the interim, while the aforementioned benefits to Gross Profit Per Unit have clearly played a role, the company has enjoyed nearly a 1,500 bps improvement to around 57% for 2022E. This level of success has led to a strategic shift by management toward keeping this metric in the mid-60% range whenever values eventually compress for new vehicles. Essentially, dealers are better prepared to earn more with lower fixed costs.

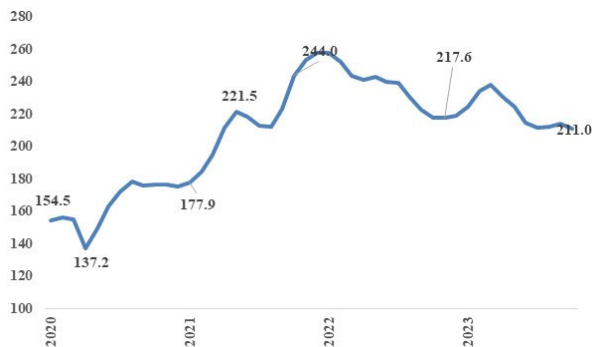
Used Vehicle Market In Flux

The largest challenge for our presenting dealers is currently in a used vehicle market out of equilibrium. Low new vehicle sales have reduced the overall supply of 0-3 year old cars that would otherwise have been set to be used as trade ins this year. This lack of broader availability has been further exacerbated by a reduction in leasing, as off lease vehicles have created a quality source of supply for dealers used vehicle endeavors. Finally, lower fleet sales to rental car companies over the past three years reduced available late model vehicle supply as well.

With this in mind, used retailers, including dealers, have needed to find quality supply where possible – in some cases sourcing older vehicles than they otherwise would have or those vehicles requiring greater than normal reconditioning.

These factors helped drive used vehicle prices to all-time highs in 2021 and 2022 before finally correcting mildly during this past year. Used vehicle prices, as measured by the Manheim Used Vehicle value index, have declined from all time highs, but remain elevated on a historical basis (Exhibit 36).

Exhibit 36 Manheim Used Vehicle Value Index



Source: Manheim

While still elevated, declines in used vehicle prices will likely cause some disruption across the automotive ecosystem. While affordability of used vehicles will improve, owners of used vehicles will have less equity to use for trade-ins for both new and used vehicles. Additionally, with fewer trade-ins with which to work (on artificially low new unit sales), sourcing of quality used units remains problematic.

It is our opinion that abnormalities in the traditional relationship between new and used prices and unit sales will continue until new vehicle production increases and prices can normalize for new retail consumers.

Dealers ready for EVs: a matter of when

Dealers are investing heavily in training and some tooling in anticipation of the coming EV models they will sell and support. With the potential for capex for service bay changes to be high, dealers spoke to a balance required between showroom updates and EV service bay support. What will be of considerable interest is how OEMs and dealers interact as it relates to EV inventory. Automakers continue to point to more of a bespoke vehicle-on-demand ordering for EV in these early days of the EV era. If OEMs see advanced purchasing as the appropriate model in the future, some dealer per unit profitability would clearly be at risk (offset by a lack of inventory carrying cost).

For vehicles currently in operation, some initial challenges have emerged. EV service hours have tended to be considerably higher than for ICE vehicles, with parts tending to also be much more expensive.



AutoNation (AN - \$135.95 - NYSE)

Structurally More Profitable

COMPANY OVERVIEW

AutoNation, Inc., based in Fort Lauderdale, FL, is the largest automotive retailer in the United States, owning and operating 336 new vehicle franchises from 243 stores. The company sells 32 different new vehicle brands, with 89% of new units sold manufactured by Toyota (incl. Lexus), Honda, Ford, General Motors, FCA US, Mercedes Benz, BMW, Nissan, and Volkswagen (incl. Audi and Porsche).

HIGHLIGHTS

- The demand outlook remains relatively positive despite consumer crosswinds. Retail sales have tracked roughly 10% below 2019 levels, with pent up demand keeping SAAR in the mid-15 million unit range. Inventory, though better, remains a challenge, particularly for import brands (Toyota, etc.). Importantly, financing remains available and leasing has slowly begun to recover.
- AutoNation saw limited impact from the UAW strike, having begun the strike period with solid availability across affected models. Further, best practices over the past three years assisted in the playbook for selling vehicles with lower availability inventory. The company did see some deferrals of service due to strikes at parts distribution facilities.
- Similar to other presenters, AutoNation sees EV affordability as a major factor in why sales have recently slowed relative to prior periods. Days' supply for EVs at AutoNation stood at 60 vs. total company DSO in the 30 range. OEMs have begun to assist with certain models through greater incentives.
- AutoNation spoke to gross margin compression and the potential for "normalization" of gross profit per unit. Pre pandemic roughly 10% of vehicles sold above MSRP. At the height of inventory constraint, roughly 70% were sold at that level vs. approximately 40% now. Average selling prices have grown from \$40,000 to over \$50,000. The lowest margin on new was 4.4% in its history. OEMs have also learned how to increase profitability at lower dealer inventory levels.
- As consumers keep cars longer, AutoNation's F&I products (CFS) have gained in value and have allowed the company to enjoy greater attach rates for their vehicles.
- Regarding what investors may look as "normalized EPS" as GPUs contract, AutoNation spoke to its Aftersales (Parts & Service, most notably). This business has grown by \$500 million from a gross profit standpoint since the pandemic began in 2020. With just under 45 million shares outstanding, this impact likely has considerable durability and raises the floor for AN EPS.
- The company continues to drive used vehicle internal sourcing above 90% and avoid auction prices which are margin dilutive. Further, "one-price" online sales have improved customer experience and grow its used business.
- AutoNation's captive finance company (CIG) provides a competitive advantage for the relationship it gives with used consumers.



AutoZone, Inc. (AZO - \$2,676 - NYSE)

Making 40 Year Decisions

COMPANY OVERVIEW

AutoZone, Inc., headquartered in Memphis, TN, is the largest specialty retailer of automotive parts and accessories in the United States. The company sells to both the DIY (Do-It-Yourself) and DIFM (Do-It-For-Me) markets. As of FY2023, the company operated 6,300 stores in the United States and Puerto Rico, 740 in Mexico, and 100 in Brazil.

HIGHLIGHTS

- AZO has proven the ability to drive earnings growth regardless of underlying economic cycles. The company grew EPS at a 5-year 21% CAGR through topline growth and share repurchases. The company has repurchased \$34 billion or 154 million shares since 1998, with only 18 million shares outstanding today.
- The company highlighted plans to deliver 500 new store openings per year by FY2028. On top of driving steady DIY and double-digit DIFM growth at the underlying store level, new stores should add 3-3.5% revenue growth. Despite current market rates, AZO is able to achieve 50% ROIC, supporting the growth prospects of this strategic decision.
- AZO operates a break/fix business with highly inelastic demand. Approximately 70% of the domestic auto business is DIY. This customer has been resilient throughout the cycle and supported by the expert advice from an in-store AutoZoner. Even with the DIY mix, the majority of the business is maintenance and failure related parts. The DIFM business trends towards even higher maintenance/failure mix.
- The commercial customer, 30% of the business, now accounts for \$4.6 billion of sales and has seen nearly 70% growth in the last three years. AZO has been able to leverage its DIY assets to grow DIFM programs to 90% of stores. There are two significant factors driving the DIFM growth: 1) investment in the DuraLast brand that provides DIFM customers with confidence and support and 2) ensuring availability via its hub and mega hub strategy placing more parts, closer to customers and driving AZO up the “first-call” list. The company has a goal to deliver 200 mega hubs and 300 hubs. Hubs carry roughly 50,000 SKUs while a meg hub closer to 100,000 SKUs. Despite this growth, AZO only accounts for 4-5% of DIFM market share with significant opportunity to continue to expand.
- Despite +10% inflation in cost of goods sold over the last two years, AZO has maintained gross profit margin of +52% as the industry has remained disciplined and the company passed through price. This is largely due to the non-discretionary nature of the parts sold. The majority of the products AZO remains under \$50. Assuming a 10% or \$5 increase on the higher priced items to ensure a vehicle is running, tends to be a good value proposition for their customers. Further, new and used car prices remain elevated at over 30% 2019 prices and AZO’s consumer has been faced with investing in their vehicle versus buying at these levels during economic uncertainty.
- The complexity of vehicles and much talked about transition to electric vehicles appears to be more and more of a catalyst for AZO as maintenance and especially failure related parts are more expensive. This has been driving up value, despite some volume loss, in the aftermarket.
- The international business, now 12% of the store base, has been on fire over the last two years with a constant currency, 2-year growth rate of 36.7% The company now has 700 stores in Mexico and 100 stores in Brazil with the ability to take Brazil to 700. AZO has been able to take share with the ability to uncover further merchandizing opportunities.
- AZO generated ~\$4.0 billion in EBITDA in FY2023 and spent \$797 million in capex providing the company with significant free cash of +\$2.0 billion for investments in growth and repurchase of shares. Management stated that debt should continue to trend towards the 2.5x net debt/EBITDAR target from current levels of 2.3x.



Canoo Inc. (GOEV- \$0.36 - NASDAQ)

Entering Revenue Generation Phase

COMPANY OVERVIEW

Founded in 2017, Canoo Inc., is a mobility technology company that designs, engineers, develops, and manufactures electric vehicles for commercial and consumer markets in the United States. The company offers the Lifestyle Vehicle and its Base, Premium, and Adventure trims; the Lifestyle Delivery Vehicle and its 130 and 190 trims; the Multi-Purpose Delivery Vehicle and the Canoo Pickup. The company is headquartered in Torrance, California, and has vehicle and battery module manufacturing facilities in Oklahoma City and Pryor, Oklahoma, respectively. The Canoo platform is purpose-built and based on a multi-layer business model. The foundational layer is the multi-purpose rolling chassis platform, which serves as the base for all vehicles. The remaining layers include both cybersecurity software as well as hardware in the form of top hat cabins, which are modular and can be tailored to specific customer use-cases.

HIGHLIGHTS

- As of October 2023, Canoo had an order book of approximately \$3 bn, with \$750m in binding commitments. Over 70% of the company's order book was B2B as of Q2 2023. Management has intentionally focused on the commercial space as the multi-year contract terms provide enhanced line of sight into production volumes and incremental investment. The company has been deploying capital and building out capacity in a staged manner, effectively only increasing manufacturing volumes up to the order sizes that have already been sold. Management believes that this ramp-based approach to production will enable the company to drive positive gross margins and generate incremental operating leverage at much lower volumes than other peers in the space.
- Canoo's vehicle manufacturing and battery cell production facilities in Oklahoma City and Pryor, Oklahoma is prepared to exit 2023 and 2024 with run-rates of 20k units and 40k units, respectively. To achieve this level of capacity, management expects to deploy approximately \$120 million in capital expenditures in each 2023 and 2024. It was too early for management to comment on investments in incremental capacity over the longer-term, but we note that the 120+ acre site in Oklahoma certainly provides the required footprint to layer on additional volumes without the need for acquiring tertiary manufacturing facilities.
- The company's flagship Lifestyle Delivery Vehicle has undergone rigid collision and temperature-controlled testing with Walmart as a key lead customer. The relationship with Walmart has proved the technology's quality and viability in commercial segments, with particular focus on the last mile delivery. Walmart has signed a definitive agreement to purchase up to 10k vehicles, with \$300m of revenue potential for the initial 4.5k unit purchase order.
- On October 2, 2023, the company announced it had entered a SPA with a foreign strategic institutional investor for an investment of \$45m, with the potential for upsizing to \$150m. While this would immediately bolster the company's current cash balance of ~\$10m, liquidity remains a concern as cash burn is expected to continue through 2025. Management was unable to provide further details on the financing round, but we expect this to be a focus area in forthcoming earnings releases.
- Management reiterated their latest guidance that the company should achieve positive gross margins and Adjusted EBITDA in 2025. Our forecast assumes that the company achieves the 40k unit run rate in 2025, exiting the year with positive margins. As seen in the following exhibits, we have projected the following year – 2026 – to be the first full fiscal year of profitability, with the company generating \$335m in Adjusted EBITDA on \$3.3b in revenues.



CarParts.com (PRTS - \$3.12 - NASDAQ)

New Model Disruption

COMPANY OVERVIEW

Headquartered in Torrance, California, U.S. Auto Parts (PRTS) is a leading online provider of aftermarket auto parts and accessories. PRTS sells to consumers through the flagship website at www.carparts.com and online marketplaces. The website and app provide customers with a comprehensive selection of over 731,000 SKUs with detailed product descriptions, attributes and photographs. PRTS' online sales channel and relationships with suppliers eliminate intermediaries in the traditional auto parts supply chain.

HIGHLIGHTS

- PRTS has driven revenue from \$290 million in 2019 to a projected ~\$680 million in 2023 (2.5x) as an online disruptor of aftermarket parts distribution. 95-97% of the business is direct-to-customer. Management believes that PRTS has been taking share as buying from carparts.com is more convenient and 50-70% cheaper on average than going to a store. In terms of electric vehicle penetration, PRTS is 90% agnostic to engine train.
- PRTS came out of the 2008/2009 recession with flat revenue and should be recession resilient going forward. Recently, the company has seen some trade-down and deferral. Management believes that there may be some customers from ORLY and AZO that may be priced out and venture to carparts.com. Vehicle owners need to fix their vehicle and during a downturn may choose the cheaper product or transition to private label as PRTS does not believe there is significant DIY brand loyalty. PRTS continues to see strong growth in hard parts.
- Historically, the company has derived revenue from collision parts; however, has had a strategic push to drive maintenance parts. Currently, 65% of revenue is collision parts, 28% hard parts, and 7% performance and accessories. Management believes that there is opportunity to grow maintenance and a European parts catalogue.
- PRTS outperforms e-commerce peers due to its distribution strategy. The vast majority of e-commerce competitors are drop shippers. PRTS has a strong private label brand that the company imports into warehouses and through an internal supply chain which drives quality and price. While AMZN is strong in traditional brick-and-mortar front of store offerings that tend to be higher volume/higher turnover, PRTS specializes in tailored parts specific to vehicle models which are lower turnover and more difficult to sell.
- The company invested in 3 new distribution centers over the last 3 years which provides better SKU availability to meet customer delivery times. PRTS now has 5 distribution centers which can meet 2-day delivery speeds across 95% of the country. PRTS customer base will often do a job on the weekend so 1-2 delivery speeds meet most needs.
- PRTS has strategic initiatives to drive both topline and earnings growth with a focus on fulfillment optimization and digital transformation. The company previously had a basket of underlying brands, which can be consolidated to drive brand recognition. The company can also drive growth with its new app which has already received 10,000 downloads/week. App conversion would drive profitability as PRTS saves 18% of sales via an app purchase vs dependence on Google advertising.
- Supply chain issues are moderating which has driven working capital efficiency and cash generation. During peak supply chain shortages, PRTS had \$168 million of inventory on hand and on water, which fell to \$120 million. This drove cash on hand from \$15 million to \$65 million. Going forward, the company plans to utilize this cash on the aforementioned strategic initiative, reinforcing a quality balance sheet and the continuation of share repurchases



ChargePoint Holdings, Inc. (CHPT - \$2.12 – NASDAQ) Market Leader with Differentiated Product Offering

COMPANY OVERVIEW

Headquartered in Campbell, California, ChargePoint Holdings, Inc., is an electric vehicle (EV) charging technology solutions provider to commercial, fleet, and residential markets. ChargePoint sells networked charging hardware, connected through cloud-based software services and extended parts and labor warranty solutions (Assure). Charging system owners, or hosts, are enabled to manage their networked charging systems, and drivers are enabled to locate, reserve and authenticate networked charging systems, and to transact EV charging sessions on those systems.

HIGHLIGHTS

- ChargePoint is the market leader for Level 2 AC EV charging in North America with a 70% share and has grown to become one of the top 3 players in Europe. Management expects the European market to consolidate, as options are plentiful, but this is ultimately an impediment to ease of use as numerous charging apps are required to travel.
- ChargePoint’s asset light business model is a key differentiator in the EV charging space. Management remains committed to its commercial strategy of selling rather than operating the charging units and is instead focusing on providing value via the underlying software and services. ChargePoint’s software platform enables operators to proactively monitor charger uptime and allows EV drivers (fleet operators and consumer passengers alike) to optimize their travel and delivery routes based on charging availability and pricing. Importantly, ChargePoint is the sole EV charging company that sells to all three fleet, commercial, and residential verticals.
- ChargePoint’s go-to-market strategy is a critical component to its business model. The company has a vast network of hardware distributors as well as installation and maintenance providers. Management is actively investing in ChargePoint training programs for network technicians and has intentionally developed modular components to allow for simple repairs made by general electricians in a matter of minutes, not hours. The service network results in a sticky customer base where “land and expand” sales are highly effective. Management noted that once a customer installs a charging station, they resultingly spend 20x their original investment over the next 11 quarters.
- Management believes that we are at the beginning of a 30-year arch in terms of market opportunity. While in certain zip codes (primarily CA) over 50% of new vehicle sales are EVs, there remain US regions where EV adoption is progressing much more slowly. It will take years before a material portion of the car parc is BEVs, but ChargePoint has estimated that even at current rates of adoption, the need for charging infrastructure presents a top-line opportunity in the range of 54% growth per annum over the next 5 years. Currently, market participants remain focused on building out L3 DC fast charging networks for public use. However, management indicated that by year 10, this will fundamentally shift back to broader acceptance of L2 AC charging as consumers are reeducated in how to think about fueling. Specifically, fueling will be reframed as a continuous, smaller increment exercise, rather than the “stop and fill” behavior we have grown accustomed to with the gas station model.
- While the commercial vertical currently comprises ~60% of the company’s new business bookings, management believes that the fleet vertical presents the greatest market opportunity over the next 5 years. In fact, less than 5% of vehicles owned by top-100 fleet operators (e.g., Avis, SIXT, FedEx, UPS, etc.) have been electrified, and these companies are increasingly seeking to make their operations more sustainable. Anecdotally, management noted that 86% PepsiCo’s delivery routes are less than 100 miles, and as such, is an excellent candidate for investing in LD/MD delivery BEVs which would be enabled by ChargePoint DC charging infrastructure.



Dana Incorporated (DAN - \$13.13 - NYSE)

EV Full Speed Ahead

COMPANY OVERVIEW

Dana Incorporated, based in Maumee, OH, is a world leader in providing power-conveyance and energy-management solutions that are engineered to improve the efficiency, performance, and sustainability of light vehicles, commercial vehicles, and off-highway equipment. Enabling the propulsion of conventional, hybrid, and electric-powered vehicles, Dana specializes in the supply of driveline products (axles and driveshafts), power technologies (sealing and thermal-management products), and genuine service parts for light and heavy vehicle manufacturers.

HIGHLIGHTS

- Dana, as a global mobility company, sees itself as energy agnostic and able to supply driveline products for the gamut of light, commercial and off-highway vehicles around the world, whether ICE or EV.
- With electrification moving power from the engine to the wheels. Dana will now have the opportunity to supply customers with an inverter, gearbox and motor at or near the axle. Further, as a leading battery cooling and thermal management supplier, opportunities abound (such as is providing 100% of the battery cooling plates for GM's Ultium platform). Dana expects to have up to \$3 billion in electrified content by 2030.
- The company does not regard itself as an auto supplier, in particular as it relates to electrification and the breadth of customers that the company enjoys. Technology for electrification is often vehicle agnostic, with some technologies capable of being used across the spectrum of Dana's vehicular markets (LV, CV, and Off Highway).
- Since joining Dana in 2015, CEO Jim Kamsickas sought to integrate a fragmented business into one Dana, a company that could enjoy scale in areas such as purchasing and tech sharing. We believe this move proved prescience as it has allowed Dana to develop and launch content for electric vehicles in all of its end markets.
- Dana sees an electric vehicle content per vehicle as 3x that of an electric vehicle, with motors, inverters, and gearboxes, with its battery cooling business potentially pushing that multiplier to 5x-10x
- Dana saw its strong operating capabilities as enabling the company to both bring facilities down quickly in the face of UAW strikes affecting major platforms for which Dana provides content (Jeep Wrangler/Gladiator, Ford Super Duty the most notable examples). Kamsickas was confident that a restart of production would take no longer than 2-3 weeks before recovering to full capability.
- Despite near term softness in electric vehicle sales, Dana remains confident in its \$3 billion end of decade target as visibility on launches remains high and overly optimistic assumptions were not baked into initial expectations.
- Dana expects commercial vehicle markets to be flat-ish for next year in North America and Europe, with Brazil the most notable area of softness.
- Dana sees itself back on a path to margins it had attained before externalities that impacted profitability over the past two years (COVID, supply chain, inflation, etc.) with performance recovery a matter of time.



Donaldson Company (DCI - \$60.14 - NYSE)

Life Sciences Opportunity

COMPANY OVERVIEW

Donaldson Company, based in Minneapolis, MN, is a global manufacturer of worldwide filtration systems and replacement parts. The company's products include air and liquid filtration systems and exhaust and emission control products. Donaldson has two reporting segments: a \$2.2 billion Mobile Solutions business, a \$1 billion Industrial Products segment, and a newly formed \$240 million Life Sciences segment.

HIGHLIGHTS

- As a technology-led filtration company, Donaldson has been able to not only solve issues for its current customers but expand its addressable markets, with the most notable example its new Life Sciences segment where it is adding to its bioprocessing and food and beverage capabilities.
- CEO Tod Carpenter spoke to opportunities for the company to provide solutions for next generation propulsion technologies. Of particular note would be the potential to create systems to ensure that hydrogen be pristine in fuel cell processes.
- Donaldson's balance sheet (<1x levered) and strong FCF make it an "acquirer of choice"- looking for established life sciences businesses with strong gross margins or those capable of considerable profitability within a short amount of time once products are introduced to the marketplace. DCI expects Life Sciences businesses to be margin accretive to the company – with the Solaris acquisition as a great example. The company plans to use its core strength to provide the foundation to buy disruptive business with leading technology. The company noted the flexibility to take leverage up to 3x should a target of size come available.
- Regarding the company's core aftermarket business, DCI has seen OE destocking while independent market partners continue to be better situated. DCI believes this destocking to have moderated and that it can grow its aftermarket business in its fiscal year ending July 31, 2014.
- The company remains comfortable with what it is seeing and hearing from OE Off Highway customers in construction and Ag.
- Donaldson noted that China (less than 10% of revenues) remains its most difficult end market as volumes, particularly for the aftermarket, have yet to recover to prior levels.
- Electrification, while theoretically negative for DCI's engine businesses, is likely to hit the company's core end markets (Off-and On-Highway equipment) last given obstacles related to fueling, downtime, and maintenance. With DCI's customers serving largely business to business customers, total cost of ownership and uptime remain overwhelmingly more pertinent – thus making adoption of electrification unlikely in the near to mid future.
- Hydrogen and Fuel Cell technology growth represent opportunities given the need for purity of inputs in order to create propulsion energy.



Electrovaya Inc. (ELVA) - \$2.67 – NASDAQ)

Niche EV Story With Optionality

COMPANY OVERVIEW

Headquartered in Ontario, Canada Electrovaya, designs, develops and manufactures directly or through out-sourced manufacturing lithium-ion batteries for Material Handling Electric Vehicles (“MHEV”) and other electric transportation applications, as well for electric stationary storage and other battery markets. The company’s main businesses include lithium ion battery systems to power MHEV including fork-lifts as well as accessories such as battery chargers to charge the batteries; lithium ion batteries for other transportation applications; and, industrial and residential products for energy storage. Electrovaya’s infinity battery platform consists of Lithium-ion ceramic cells, which are differentiated by their high cycle life, superior safety and low cost of ownership.

HIGHLIGHTS

- Electrovaya has noted the movement within the electric vehicle industry from one desiring lowest costs to one emphasizing safety – particularly as it relates to buses where fire hazards are more acute given exit options that differ considerably from light vehicles
- The EV battery market has transitioned from one where battery developed now build “to” demand as opposed to the more recent past where companies were essentially forced to build for demand that was anticipated but not promised as the EV industry has evolved.
- The company’s Jamestown, NY facility, once completed, will provide scale for the increased demand. The facility is expected to enable ELVA to see a 300-500bps increase in margins which, when added on top of incentives from the Inflation Reduction act, puts the company near a 40% gross margin. The \$45 million facility (of which equipment and engineering) was chosen partially due to proximity to headquarters along with generous incentives from New York State.
- ELVA sees the Forklift industry as an easy growth area for Lithium Ion electrification to replace more historic lead acid uses. Lithium ion batteries can increase uptime, operating on a 20 minute charge that, for all intents and purposes enables forklifts to operate 24/7 in a warehouse environment.
- ELVA also continues to work on solid state batteries, which have been referred to as “holy grail” for vehicle electrification given potential for fast charging and power density. The company sees its history in ceramic separators as being key to its edge in development most notably regarding safety as the separators – tested at 200 degrees Celsius – do not shrink and aid in fire prevention.



Gentex Corp. (GNTX- \$31.13 – NASDAQ)

Building Back Margins

COMPANY OVERVIEW

Gentex Corporation, headquartered in Zeeland, MI, designs and manufactures vision systems, dimmable devices, connectivity and sensing systems for global vehicle markets. The company also manufactures dimmable aircraft windows for the aviation industry and commercial smoke alarms and signaling devices for the fire protection industry.

HIGHLIGHTS

- CEO Steve Downing spoke to Gentex's foundation as a materials science company as a reason for its enduring competitive advantages – including an over 80% share of the global auto-dimming mirrors.
- Gentex has spent a considerable effort bringing the company's gross margins back to the 35-36% gross margins it enjoyed prior to 2021. The company hit a low of 29% in Q3 of 2022 but has rebounded, with plans to recover fully by the end of 2024. Pricing improvement represents the lions' share of that gap, up to 300-400bps. GNTX believes its customers have responded well to initial requests given the critical nature of GNTX products. The next 300bps comes of recovery is likely to come from operational efficiency combined with engineering efforts to help reduce materials costs.
- GNTX expects OEMs to attempt to recover increasing labor costs from its supply base – a conversation the company looks forward to given its foothold in the marketplace. The company views its OEM customers as partners but also does not expect the industry to look for 3 points of annual price reductions, seeing 100-200bps as more of a reasonable "ask" given the critical nature of having a healthy supply base
- Supply chains have improved considerably; lead times for problem issues have lengthened as have the number of potentially problematic parts. GNTX also sees working capital opportunities, as it believes it can reduce raw materials inventories it had built up when supply chain issues were at their most dire.
- Take rates for the company's Full Display Mirror technologies continues to grow, with next generation products considerably brighter, custom shaped and with better graphics processing. FDM mirrors come at much higher ASPs to GNTX at considerably stronger margins for GNTX.
- Regarding the potential for autonomous driving to render mirrors unnecessary, GNTX sees tail risk as further out than many have predicted. With that said, the company is developing technologies that help foster sensor execution needed in a fully autonomous world. The company is also looking to apply the light aperture technology that it currently utilizes for its aerospace product to vehicular applications.
- GNTX sees affordability as a challenge for the auto industry, and is focusing on creating features for vehicles that customers truly value and are willing to pay for – the best defense for keeping pricing high.



Genuine Parts Company (GPC - \$137.47- NYSE)

Technology Driven Global Distributor

COMPANY OVERVIEW

Genuine Parts Company, located in Atlanta, Georgia, is a premier global distributor of automotive and industrial parts. The automotive aftermarket parts business encompasses a network of ~10,000 global warehouses and jobber stores under the NAPA brand.

HIGHLIGHTS

- After successfully executing on a portfolio optimization strategy in which the company divested its electrical and office products several years ago, GPC has focused on the high-growth Automotive and Industrial segments. The automotive distribution business operates 9,715 global locations; including ~6,000 in the US. DIFM sales account for 80% of US NAPA revenue. The industrial segment, mostly marketed under Motion, sells to the conveyance, automation, robotics, and power transmission end markets.
- GPC's Automotive and Industrial business grew +30% from 2018-2022. Technology is at the core of the GPC's business including supply chain management, sales strategy and interaction with customers. These investments along with distribution capacity and scale have driven significant share gains.
- US automotive now accounts for 56% of total revenue. After NAPA generated double-digit annual growth rates by entering New Zealand and Australia, the company entered Europe in 2017. The company has been growing the European division since, including the recent acquisitions of two of the largest players in Spain. The benefits of being in Europe are significant. The maturing electric vehicle (EV) market in Europe provides insights into change and growth in other regions. Further, the company is able to drive gross profit via penetration of the NAPA brand. Given GPC's growth in Europe and at under 1.5x net debt/EBITDA, M&A remains an option in both the automotive and industrial segments.
- GPC sells non-discretionary parts. During periods of softening consumer demand, GPC should continue to grow as vehicle owners cannot defer failure-related work or maintenance for extended periods. Despite slowing in the UK and Germany economies, GPC has seen double-digit sales growth YoY.
- GPC has expanded EBIT margin by +100 bps to ~10.0% over the last two years despite double-digit cost inflation. The industry has experienced rational pricing, passing through price increases. While 2H2023 has seen fewer YoY pricing benefits, there is no historical precedence of price reductions during periods of moderating inflation.
- Not only has GPC been able to push through price during periods of rising inflation, but there are 290 million vehicles on the road driven by increasing complexity that also support price. Electric vehicles and vehicle complexity sits at the core of GPC's value proposition in terms of providing parts, especially in the Industrial segment. The aftermarket's jobs is to ensure technicians have the training to keep pace.
- The industrial segment has seen incredible broad based strength, breaking correlation with the PMI. GPC has more exposure to automation, robotics, and conveyance relative to previous cycles, which has driven outsized growth. KDG, Motion's \$1.3 billion 2022 acquisition, has doubled the segment's automation business. GPC believes that factories will continue to look at companies like Motion to identify more solutions. Further, near shoring remains a medium-term opportunity for the end segment.
- GPC continues to see inventory opportunities that drive working capital efficiencies. While interest rates remain high, suppliers continue to participate in aftermarket financing programs, which provide beneficial rates.



Monro, Inc. (MNRO - \$28.65 - NASDAQ)

Transition Drives Growth

COMPANY OVERVIEW

Monro, Inc. headquartered in Rochester, NY, is the largest chain of company-operated undercar care facilities in the United States, operating 1,297 stores in thirty-two states. The company operates in the \$287 billion “Do-It-For-Me” (DIFM) segment of the \$329 billion U.S. Automotive aftermarket industry.

HIGHLIGHTS

- Partnerships will be key in both tire and service. The company divested its wholesale distribution business, which generated cash and simplified the business. By building stronger relationships with wholesalers, MNRO now has more available SKUs in closer proximity to stores. Going forward, MNRO will focus on preferred partnerships to better meet required fill-rates for customers and to improve costs through scale.
- The company experienced the same double-digit hyperinflation as the rest of the aftermarket. However, during this same period MNRO chose to invest in paying appropriate wages to higher trained technicians, while limiting the inflation passed on to the end customer. The end customer makes less than 100,000 per year and is a first time car owner. By limiting price increases on the customer, MNRO believes they drove customer lifetime value. As costs moderate, margin pressures should alleviate. Further, post the 2008 deferral cycle, MNRO saw outsized growth from 2009-2011 which they believe will occur during this cycle and are already seeing in opening price point categories.
- Going forward, MNRO has multiple strategic initiatives to drive growth. The company has a long-term plan to drive double-digit growth in the bottom 300 (25%) underperforming stores along with improvements in customer experience.
- MNRO generated ~\$175 million in free cash flow in FY2023. The company has driven strong working capital efficiencies that have supported free cash flow generation. There are more working capital opportunities to generate free cash flow growth. While the company had previously targeted 10% in annualized M&A growth, MNRO is now looking to invest in internal growth and execution, which will make MNRO a better acquirer going forward. The company plans to invest ~\$40 million in capital expenditures with the remaining allocated towards dividend and the \$53 million share repurchase authorization.
- MNRO’s sweet spot are those vehicles aged 6-12 years old with a 50% mix of tire to service revenue. The average ticket is \$250. The sweet spot has been growing due to the aging car parc and the higher price tags of both used and new vehicles. Customers will choose to maintain their vehicle over buying a new vehicle at these price points.
- Hiring and maintaining technicians has been extremely competitive. MNRO’s strategy has placed them in a strong competitive position for the future. Further, vehicle complexity and the penetration of electric vehicles should drive growth in MNRO’s core categories; tires, brakes and suspension due to the weight and torque of electric vehicles.



MP Materials (MP - \$16.27 - NASDAQ)

Mining For Magnets in Mountain Pass

COMPANY OVERVIEW

MP Materials is the owner and operator of the Mountain Pass Rare Earth Mining and Processing facility, the only integrated site of its kind in the Western Hemisphere. With over 200 employees, MP Materials produces approximately 15% of global rare earth materials, essential for the development of technologies such as defense systems, smartphones, drones, and electric vehicles. It operates a “green” mining and processing facility and is currently one of the lowest-cost producers of rare earth concentrate. MP plays a leadership role in advocating for a more robust and competitive rare earths industry in the U.S.

HIGHLIGHTS

- Rare earth elements are the fundamental building blocks for strong magnets needed in motors across the gamut of motors and actuators within transportation, energy (wind turbines), robotics, consumer tech and aerospace. Currently, electric vehicles represent just 25% of the global permanent magnet market.
- Further, MP sees the medium to long term growth outlook for electrified vehicles and wind energy as undeniable, with visibility on permanent magnet demand well through the 2040 timeframe.
- The three stage strategy employed by MP has enabled the company to run its upstream operation into an efficient producer of REO (Rare Earth Oxide) concentrate, giving it 15% market share the making MP the largest provider of REO outside China. This efficiency and its associated cash flow provided the runway for Stage 2 separation of materials, which has essentially just begun at Mountain Pass and produced 50 tons of material this past quarter.
- Stage 1 upstream production has been highly successful, with facilities operating at 95% uptime, 9 consecutive quarters of 10,000 metric tons of REO production, high margins and strong and stable free cash flow.
- Stage 3, in which MP plans to produce permanent magnets themselves, is scheduled to begin production in Texas with a commitment from General Motors to purchase content supplied by MP
- MP is unconcerned with headlines regarding the development of electric motors that do not require rare earth metals noting that permanent magnet (rare earth) motors should continue to be the best option in 90% of use cases. Motor decisions will ultimately come down to tradeoffs regarding weight, size, and efficiency, the latter being the measure most in favor of a magnet motor. Rivian (RIVN) was noted as an example of an OEM using permanent magnet motors given space efficiency.
- MP sees considerable opportunities to sell rare earth metals to Japanese and Korean customers, potentially reducing its exposure to China.



Myers Industries (MYE- \$17.31 - NYSE)

Transforming Moldings

COMPANY OVERVIEW

Headquartered in Akron, Ohio, MYE is a leader in the manufacturing of plastic reusable material handling containers and pallets, and plastic fuel tanks as well as the largest distributor of tools, equipment and supplies for the tire, wheel and under-vehicle service industry in the United States. MYE plastic bulk containers replace single-use packaging, reducing waste and improving sustainability. As of December 31, 2022, the Company operated seventeen manufacturing facilities, seven sales offices, nine distribution centers and three distribution branches located throughout North and Central America; and has approximately 2,500 employees. MYE reports operations in two core segments: Material Handling and Distribution. The Distribution Segment centers on the global distribution of tire repair and retread products. Material Handling and Distribution. In 2022, the Material Handling segment contributed \$648 million of revenue while the Distribution segment generated \$252 million of revenue.

HIGHLIGHTS

- MYE generated nearly \$900 million in TTM revenue. 70% of the business manufactures large format durable plastic moldings that are difficult to source overseas. Underlying end-markets include Industrial (26%), Vehicle (16%), Consumer (12%) and Food & Beverage (15%). A large portion of the Material Handling sales include higher capex build out of molds which cost tens of millions of dollars. This capex moat drives +20% EBITDA margins. The remaining 30% of the business distributes automotive parts to tire shops. The company is generally the #1 or #2 manufacturer in its respective categories.
- MYE expanded EBITDA margin by ~300 bps over the last 2 years. Most of the products operate within an oligopoly allowing for pricing power. New management has focused on value-based pricing. This strategy allowed MYE to drive margins despite a difficult inflationary period riddled with supply chain issues and outperform competitors. Supply chain issues have moderated which should support margin improvement in growing end-markets.
- MYE has a healthy balance sheet at 0.4x net debt/EBITDA, along with the strong cash generating distribution business, providing plenty of flexibility in driving the Horizon 2 and 3 strategic initiatives. Horizon 2 includes a focus on North American M&A, while Horizon 3 will be a +2026 focus on global M&A. Potential acquisitions include those that make their own products, have a leading market position, and tilt towards ESG. The company is slightly behind the time horizon initially expected due to rich 2020 valuations. While the company will remain cautious during the high interest rate environment, they have a strong team with a history of success that can acquire businesses at discounted multiples over the next 12-24 months.
- The aftermarket distribution segment sells everything a tire installer needs to install tires. The company distributes to over 30,000 customers nationwide across: commercial, passenger, OTR and retread. There are significant strategic execution opportunities for the segment. With nine distribution centers, Myers tire comprises ~10% of its niche market and is focused on leveraging its scale. This segment is well positioned to benefit from the aging car parc and growth in electric vehicles as electric vehicle. Electric vehicles (BEVs) remain under 3% of the car parc; however, the heavier weight and torque of a fully electric vehicle benefits MYE tire supply as tires are replaced 20% sooner than an ICE vehicle. Management believes the aftermarket will evolve to adapt to new vehicle technologies.



O'Reilly Automotive, Inc. (ORLY - \$983.59 - NASDAQ)

Driving Outperformance

COMPANY OVERVIEW

O'Reilly Automotive, Inc., headquartered in Springfield, MO, is one of the largest specialty retailers of automotive aftermarket parts, tools, supplies, equipment and accessories in the United States. The company sells to both the DIY (Do-It-Yourself) and DIFM (Do-It-For-Me) markets. As of September 30, 2023, O'Reilly operated 6,111 stores in 47 states and Mexico.

HIGHLIGHTS

- ORLY has driven significant growth since the company's inception in 1957. The focus has always been on robust distribution and parts availability. Given its history, ORLY's distribution model is based on data targeted at local markets. Proprietary systems focus on individual store locations that hold 27-28,000 SKUs and have access to millions of parts across the network. This tiered distribution network of 28 distribution centers (average 154,000 SKUs), 383 hubs, and over 5,900 stores provide competitive advantages that meet customer needs of immediacy and availability.
- Operating within a \$147 billion industry, ORLY has significant room to drive share gains. While DIY (55% of revenues) is more consolidated, DIFM (45% of revenues) is highly fragmented. ORLY generated an 8.7% comp for its 3Q2023 driving 3-year SSS growth of 23%. Throughout the supply chain crisis and the last 2-3 years of aftermarket volatility, ORLY has been able to pick up share by providing superior inventory and availability. This share appears to be sticky and driving ORLY's outperformance over smaller WDs and its larger public peers.
- Regional growth opportunities will augment ORLY's current organic growth path. The company recently opened a large distribution center in Guadalajara to drive growth in Mexico while they also opened up a distribution center in Virginia, which can service 350 stores in the area. This provides ORLY further opportunity to grow within its domestic whitespace of the Northeast and Mid-Atlantic regions.
- Despite +10% inflation in costs over the last two years, ORLY has been able to maintain gross profit margin of +51% while pushing through price. ORLY's customer needs to get a car back on the road to get to work, take kids to school, etc. The success of ORLY's commercial customer, the shop, is based on having the right parts at the right time. The value proposition is not price. This allows ORLY to take price during periods of inflation. Only a small part of ORLY's business would be considered discretionary.
- The vehicle is becoming more complex which is boosting price and the underlying value of the parts ORLY sells. The evolution of the vehicle and cost per component is a potential tailwind for ORLY.
- ORLY has typically performed well in "recessionary" type environments where there are periods of uncertainty as depicted by a 1.5% and 4.6% comp in 2008 and 2009 respectively. These periods of uncertainty provide more incentive to make repairs where the value proposition of maintaining over buying a vehicle is strong. Despite some uncertainty, tailwinds exist such as strong employment and wage growth along with the fact that it has been both difficult and expensive to buy a car, further expanding consumers interest in maintaining their current vehicle.
- Over the last five years, ORLY generated 23% annual earnings growth on 11% revenue growth. While the company is required to invest in a massive distribution system of inventory that only turns at 1.7x, its competitive moat has led to a 23% EBITDA margin and ~\$2 billion in free cash that is returned to shareholders via repurchases and investments in growth.



Penske Auto Group, Inc. (PAG - \$153.49 – NYSE)

Resiliency through Diversity

COMPANY OVERVIEW

Penske Automotive Group, headquartered in Bloomfield Hills, MI, is a diversified international transportation services company that operates automotive and commercial truck dealerships principally in the United States, Canada and Western Europe, and distributes commercial vehicles, diesel engines, gas engines, power systems and related parts and services principally in Australia and New Zealand.

HIGHLIGHTS

- Penske views its Racing brand (not part of PAG) success as a performance enhancer for the entirety of the company, driving cultural excellence, attention to detail, and ultimately leading to success across its operations.
- Penske continues to look to grow its presence in Commercial Truck, where capital outlays are considerably less than franchised automotive businesses and returns tend to be higher. PAG has grown this business from an initial \$500 million acquired revenue line to \$4 billion operation.
- PAG continues to see demand as solid within the new vehicle market, albeit at a lower rate than pre-pandemic levels. Pent-up demand continues to build, with upside ahead to the tune of a considerable number of vehicles not sold in the 2020-2023 time frame.
- Regarding gross profit, PAG sees automakers as more rational than at any point in its recent history. This, combined with higher transaction prices, should help keep GPUs higher than the market is giving PAG credit (or most other dealers for that matter). Further, any declines in GPU will come with SG&A offsets as a portion sales commissions are tied to gross profit.
- Used vehicles remain challenging, as a dearth of 1-5 year old vehicles create a difficult sourcing environment. The company did note some positives as the return of loaner cars for PAG customers create a high quality source of used vehicles once they are taken out of the loaner population. PAG continues to look to buy more vehicles from consumers and reducing reliance on auction (given low gross on those units).
- Leasing remains another opportunity for profitable volumes ahead. Leasing was 50-60% of pre-pandemic luxury volumes and had fallen off dramatically, hitting PAG not only within new retail but also as a great source of low mileage used units. PAG has noted a comeback in leasing in the 27% range YTD (vs. 21% in 2022), but still well below prior levels.
- PAG sees EV demand as currently being impacted by mix (vehicles too expensive) along with declining residual values causing sticker shock on the back end by increasing total cost of ownership. Charging infrastructure, range anxiety, and the exhaustion of early adoption demand all factor into near term issues as well.
- Service retention efforts continue, particularly for customer pay work, with the use of video (a practice borrowed from its commercial vehicle business). PAG has also utilized AI for service appointments to help increase service bay utilization.



Rush Enterprises (RUSHB - \$43.83 - NASDAQ)

Share Gains to Continue

COMPANY OVERVIEW

Rush Enterprises, Inc. is a full-service, integrated retailer of commercial vehicles and related services in the U.S. and Canada. Through a nationwide network of truck centers, the company sells new – and to a lesser degree – used Class 4-8 vehicles – along with ancillary services including aftermarket parts and repair, financing, lease and rental, and insurance. We estimate the company will earn \$4.05 per share on \$7.9B of revenue and \$565M of EBITDA in 2023E.

HIGHLIGHTS

- Management continues to reiterate its threefold strategic focus for growing share: prioritize large national accounts, maintain diversity in customer end-markets, and continue to invest in the aftermarket business. As of Q3 2023, RUSH Class 8 sales accounted for 6.1% and 2.1% of the US and Canadian markets, respectively.
- Throughout the course of 2023, a meaningful tailwind for new truck sales has been the pent-up demand from years of limited production. As of Q3 2023, management noted that this pent-up demand had largely been met, but that there is continued support in order volume from customers in end-markets such as oil & gas and refuse. ACT projects US Class 8 retail sales to reach 278k in 2023, an increase of ~8% from 259k in 2022, before declining ~20% to 220k in 2024. Management is confident that they will continue to gain share into next year and perform better than the overall market. Looking out over the longer-term, regulatory changes enacted by the EPA for 2027 – as well as state-level enactments such as CARB that online even sooner – are expected to drive a material ramp up in purchase volume in both 2026 and 2027.
- The Parts and Services business has begun to slow, decelerating from multiple quarters of double-digit growth to ~3% year-over-year growth in Q3 2023. We note, however, that this is still expected to be a growth and margin driver for the company. Management is confident that even in years of lower production volumes (e.g., 2024), the Parts & Services vertical will continue to provide positive revenue growth, albeit in the low to mid-single digits. YTD Q3 2023, the company has increased the number of mobile technicians from 500 to 650 and intends for this figure to reach 1,000 in the long term. Management published 2027 targets in Q1 of this year, guiding \$3.5b in Parts and Services sales in 2027P. Our projections are roughly in-line, with aftermarket revenues growing from \$2.6b in 2023E to \$3.1b in 2027P.
- Sales of used equipment have faced considerable headwinds in 2023, as rising interest rates and the overall freight recession have disproportionately impacted smaller carriers and owner operators who tend to purchase used vehicles. Pricing continues to decline from the unusual highs that were experienced in 2022 on the back of limited supply in the era of “No Chips and No Ships.” Depreciation has slowed in recent quarters, but management expects another 10% in price declines before the market stabilizes.
- Management will continue to take a balanced approach to capital deployment and returning cash to shareholders moving forward. This includes continued investment in strategic growth – with a greater % likely steered towards the Parts and Service segment – as well as dealership M&A. RUSHB management targets 5-10% annual growth in the company’s cash dividend (\$0.68 or a 1.6% current return) as well as opportunistic share repurchases – with all in FCF returned to shareholders at 35-40% of the total generated.



Sonic Automotive, Inc. (SAH - \$52.17 - NYSE)

Quality at the Right Price

COMPANY OVERVIEW

Sonic Automotive Inc., based in Charlotte, North Carolina, is the fifth largest automotive retailer in the United States. The company has two operating segments: the “Franchised Dealerships Segment,” in which franchised dealerships sell new vehicles and buy/sell used vehicles, as well as providing maintenance and financing/insurance services; and the “EchoPark Segment,” which includes specialty retail locations for pre-owned vehicles. The company operates in 13 states with 108 stores, retailing +25 different brands of automobiles. Most dealerships sell both new and used vehicles, as well as aftermarket replacement parts. Fourteen of the dealerships also have collision repair centers.

HIGHLIGHTS

- SAH operates under three segments. The franchise part of the business operates 108 franchisees selling 25+ brands across 18 states. This segment also operates 16 collision repair centers. EchoPark, is the used only venture, operating 25 locations. The third and newest segment is PowerSports, which is less than 1% of revenue. The EchoPark and PowerSports segments offer differentiation relative to competitors. Both segments can grow at lower costs and provide opportunistic growth.
- As used prices normalize, volumes should return over the next 18-24 months. EchoPark sells 1-4 year old used vehicles at cost; however, drives profitability on the back end through F&I. The segment focuses on 25-30 day supply and turns inventory quickly. High turnover allows for the low prices. This model drove significant volume prior to COVID supply issues. EchoParks could sell 1,300 cars per month and were the most profitable stores in the portfolio. However, used vehicle supply has fallen as used vehicles appreciated for the first time in history and drivers did not trade-in their vehicles. Going forward, the company has started to see lease returns come back, fleets return, and new inventory coming through the pipeline, which will support used vehicle growth going forward.
- The company acquires less at the Franchisor levels than competitors with a focus on investing in technology, including AI and robotic process information. These investments create efficiencies across the 3 segments.
- SAH’s GPU is now at \$4,600 up from \$1,800 in 2019. Currently, SAH holds about 30 days supply relative to ~70 days pre-covid. The company believes this number will normalize around 40-45 days. GPU should normalize to the mid-\$3,000 range due to OEM inventory discipline and the OEM’s focus on higher margin vehicles. The company has partially used the cash generated from this higher GPU to buyback 21% of its shares since 2019.
- Parts & Service and F&I are the most stable portion of the business. Using AI to ensure that Parts & Service customer needs are met drives retention and profitability. F&I has also been growing and penetration rates are now +50%. SAH used to be last but is now 2nd to AutoNation with F&I going from \$1,899/unit to \$2,400. The company has restructured deals to better manage claims and reduce loss ratios.
- While the agency conversation continues, SAH believes you can make more as an agent than as dealer given the reduction in SG&A: CRM, floor plan and sales associates. The car is assigned to the franchised protected area and a store gets a commission rather than a margin. The store can then service those vehicles which actually drives profitability.



Standard Motor Products (SMP - \$35.38 - NYSE)

Rev Your Engines

COMPANY OVERVIEW

Standard Motor Products, Inc., located in Long Island City, NY, is a manufacturer and distributor of replacement parts for motor vehicles in the automotive aftermarket industry. The company operates in two segments, Engine Management and Temperature Control and sells its products to warehouse distributors and retail chains, primarily in the United States, Canada, and Latin America, as well as in Europe.

HIGHLIGHTS

- SMP generates over \$1.3 billion in sales. ~80% of revenue is derived from the North American aftermarket where DIFM and failure related parts (non-discretionary) are expected to drive growth. This steady, non-discretionary business generates an 11.8% EBITDA margin.
- SMP operates as a top five supplier for the majority of the large national and smaller regional distributors. Currently, SMP manufactures +60,000 part numbers to provide all of the required parts for their DIFM customers along with providing exceptional service with a strong reputation. The supplier provides all of the parts for the cars out there compared to other competitors, which cannot manage a technician's entire catalog.
- 55% of SMP's business is vehicle control, which not only manufactures engine components, but also vehicle sensors and electronics including the fast-growing ADAS, anti-lock braking, and tire sensor categories. A significant portion of the company's business is directed towards the DIFM segment, which is expected to grow due to the increasing complexity and technical nature of these vehicle parts. Vehicle complexity is a catalyst across all segments.
- ~20% of sales is the temperature control business, an engine agnostic category. SMP is committed to developing and growing parts that benefit from more advanced ICE vehicles and the introduction of EV vehicles as these vehicles require more enhanced cooling systems.
- The company recently broke out a new division, Engineered Solutions, which is ~20% of revenue. This group highlights opportunities outside of the traditional aftermarket including investments in commercial vehicle, agriculture, light vehicle and power sports. This business has doubled over the last 5 years. Specialized products have more stable technology, less competition and highly fragmented end-markets. These lines are either powertrain-neutral or focus on alternative fuel vehicles. A recent acquisition into a young Chinese company focused on electric compressors and provides entry into the Chinese and North American EV market.
- Increased factoring costs in response to higher interest rates have pressured SMP's long stable EBITDA margin; however, the company has reduced debt to under 1.0 net debt/EBITDA providing lower costs with ample opportunity to drive growth through accretive acquisitions.
- The company has grown revenues +25% since 2019 by meeting customer demand and achieving market-winning fill-rates during a difficult environment. Relative to many peers in the space who are reselling products, SMP has always been committed to manufacturing. 2/3 of SMP's supply chain resides in North America and only 15% in China. On top of M&A, good customer relationships and a reputation dedicated to long-term aftermarket commitments has enabled the company to grow with their customers.



Strattec Security Corporation (STRT - \$23.35 – NYSE)

Tech to be Unlocked

COMPANY OVERVIEW

Headquartered in Milwaukee, Wisconsin, Strattec Security Corporation designs, develops, manufactures, and markets automotive access control products under the VAST Automotive Group brand primarily in North America. The company provides mechanical and electronically enhanced locks and keys, passive entry passive start systems, steering column and instrument panel ignition lock housings, latches, power sliding side door systems, power tailgate and lift gate systems, power deck lid systems, door handles, and related products. It also offers full service and aftermarket support services for its products.

HIGHLIGHTS

- Strattec sees pricing as an opportunity for profit growth going forward. OEM contracts, typically 5 years and fixed price, have not built traditionally with compromises should inflationary periods such as the one experienced over the last several years. This led to several quarters of compressed margins and reduced profitability as the company sought some relief from considerable increases in costs. Krejci was also hopeful that competition had grown wiser after entering the market at price points where sustainable profitability was not possible.
- Similar to many suppliers, Strattec sees greater value in becoming a manufacturer of vehicular systems as opposed to a simple vendor of products. With heavier software content, systems provide greater barriers to entry along with stronger pricing. An example of such a system in the portfolio would be power assist on tailgates, where acceptance rates have been considerably stronger than initially anticipated. Strattec also sees opportunities in access and security systems, including “phone as a key” where opportunities for greater pricing exist due to features.
- Strattec’s 2023 simultaneous sale of its equity position in China, India and Brazil, combined with its acquisition of the 20% of Strattec power access it did not own, enabled the company to pay down its balance sheet debt and focus more closely on priorities that impact Strattec only (vs. its partners).
- Strattec sees its owned facilities (4 in Mexico, along with Michigan and Wisconsin) as an understated asset, with 700,000 sq. ft. having been owned for over 20 years.
- Strattec noted the potential not only for M&A but also partnerships with suppliers offering technology that would be complementary to the security and access systems offered by the company. Unique in the auto industry, STRT has historically enjoyed partnerships – particularly where it has allowed for geographic expansion without an outlay of capital.
- One of the more exciting areas for Strattec over the past several years has been for multifunctional tailgates for pickup trucks, where take rates upwards of 20% have been considerably higher than what was originally anticipated. Strattec is hopeful that the safety and convenience provided by these products eventually push the OEMs to make these products standard.

Save the Date!

48th Annual

Automotive Aftermarket Symposium

Las Vegas

Attention:	Portfolio Managers/Analysts
Symposium:	Automotive Aftermarket
Place:	TBD
Dates:	2024
Contact:	Brian Sponheimer (914) 921-8336 bsponheimer@gabelli.com



Brian Sponheimer (914) 921-8336

Carolina Jolly, CFA (914) 921-7762

Guillermo Herrera, CFA (914) 921-8381

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ONE CORPORATE CENTER RYE, NY 10580 Gabelli Funds TEL (914) 921-5100

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800-422-3554 • 914-921-5000 • Fax 914-921-5098 • info@gabelli.com