AutoZone (AZO)

Downshifting Into 2021 With the Straightaway in Sight

AutoZone (AZO) will be a familiar name to most readers – not only for its well-known slogan ("Get in the zone – AutoZone") but for its expansive retail presence. It is the largest retailer of aftermarket automotive parts in the U.S. and plans to open its landmark 6,000th store this year.

AutoZone's history began in 1979 when entrepreneur Joseph R. "Pitt" Hyde III opened its first location – then named Auto Shack. In 1984, Hyde and private equity firm KKR took Auto Shack's parent company private, and within four years had divested its sibling operations to focus on the growing auto parts chain. Rebranded as AutoZone, the business returned to public equity markets in 1991.

The aftermarket auto parts industry encompasses the direct sale of parts to consumers as well as commercial sales to auto repair shops. AutoZone holds a sub-15% share of the estimated $90-100 billion relevant parts market, similar to that of competitor O'Reilly Auto Parts. AutoZone and its three largest competitors (O'Reilly, Advance Auto Parts, and Genuine Parts) collectively claim less than half of the domestic market, and we expect them to continue to chip away at the remaining share over time.

As vehicles age, rack up miles, and lose value, they tend to pass from higher to lower-income owners. This transition often entails maintenance and repair work performed by franchised dealers for newer, especially warrantied, vehicles; do-it-for-me (DIFM) repair shops for middle-aged vehicles; and do-it-yourself (DIY) consumers for higher-mileage vehicles. Over time, as vehicles have become more technologically advanced, maintenance and repairs have become more complex in turn, spurring DIFM to grow somewhat faster than DIY – a trend we expect to continue. This trend toward DIFM is typically muted during recessions, as the ranks of the value-conscious swell and then reaccelerates in improving environments as vehicle owners begin to spend more freely on third-party services.

Among AutoZone's largest competitors, O'Reilly Auto Parts has long made its DIFM business a cultural priority. DIFM accounts for roughly 40% of O'Reilly's sales compared to a little over 20% for AutoZone. O'Reilly's commercial focus, along with more recent and impactful acquisitiveness, has served its shareholders well over the years. Commercial accounts require speedy delivery, and that means having a robust supply chain that positions inventory – even sporadically purchased items – nearer to purchasers. For the past several years, AutoZone has grown its number of hub stores, mega-hub stores, and distribution centers, resulting in a physical network that more closely resembles that of O'Reilly. AutoZone's commercial sales were already perking up pre-COVID, and we expect that the company is much better situated today to benefit from a post-recession shift from DIY back to DIFM volumes. Company management says they believe they are "in the early innings of a transformational growth story."

Still, the DIY side of the house remains AutoZone's bread and butter, and this area of the business showed particular strength during the COVID pandemic. For those who live or work outside of large urban areas, having a working vehicle is critical to maintaining one's income, especially if one's job cannot be done remotely. With stimulus payments in hand, AutoZone's customers poured more money into their vehicles than in prior recessions. This resulted in a level of DIY sales we believe AutoZone is unlikely to repeat this year.

While last year's DIY volumes may prove difficult to achieve again in 2021, we believe the medium-term prospects remain good for AutoZone's consumer-facing business. New car sales fell substantially leading up to and during 2009. Fewer new vehicles sold during that time naturally created a lack of older vehicles as the years passed. The population of older vehicles (for example, those 6-12 years old) typically addressed by AutoZone's DIY business has shrunk approximately 20% over the past decade, but it stopped declining in 2020 and we believe is likely to increase by 25% over the coming several years. A more plentiful supply of older vehicles should make them relatively cheaper in time and help shift more of them into DIY customers' hands.

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Like many companies, AutoZone held onto excess cash until the fog of COVID had largely lifted. The company entered 2021 with financial leverage well below its target. At the time of the Funds' investment, we estimated that AutoZone's near-term free cash flow and incremental borrowing (to achieve its leverage target) could fund the repurchase of approximately 20% of the company's outstanding shares.

We believe AutoZone's DIY and DIFM businesses can both perform better over the next several years than they have in the past. While the COVID-related sales windfall of 2020 may result in 2021 sales that appear weak in comparison, we expect sustained revenue growth to resume thereafter. AutoZone's improving long-term operating fundamentals should result in a continued ability to deploy substantial amounts of capital on behalf of shareholders. The expected growth 'pause' helped knock some price out of the stock and created an opportunity for us to purchase a high-quality business at an attractive price; a great example of our Quality at a Discount investing approach in action.