

# QUANTUM CAPITAL MANAGEMENT, L.L.C.

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## QUANTUM FOCUS

April 17, 2009

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### The Keys to the Kingdom

*The following is an adaptation of a letter written by John Hughes on April 15<sup>th</sup> 2009:*

It is only fitting that we illustrate our investment philosophy from time to time. Both new and existing clients will benefit from periodic review of our guiding principles and fundamental approach to investing. In this letter we will discuss owner's earnings and pricing power, conceptually and as applied to one of our long term holdings, Copart, Inc. With an early apology for this letter's length and granularity—notwithstanding the fact that many of you stop reading after the first paragraph—to those still with it, we hope you find the information useful.

On a recent spring afternoon, a friend of Quantum, the eminent analyst James Grant addressed a group of approximately four hundred professional money managers at the Plaza Hotel in Manhattan. The editor of *Grant's Interest Rate Observer* had been ahead of the curve regarding the meltdown of the credit markets and wrote for the last three years of opportunity in the purchase of naked credit default swaps (a trade that pre-dated our fund and remains outside our core competency) and the short-selling of mortgage and housing related securities. Characteristically rational in his assessment, he called an end to the trade of the millennium, thanked it for fortunes made and losses avoided and declared it time to move on. He offered in its place a new theme for these times of tumult and binary possibilities, not the least of which is the weighty probability of a latent and potentially egregious inflation. To paraphrase, the offering went something like this—"It

may not be the homerun that we just closed but capital-light companies perform well in most markets. And if the companies enjoy pricing power they should outperform those without it in an inflationary environment.”

Calling a once in a generation debt crisis in terms of magnitude and timing is certainly a tough act to follow. A fact that wasn't lost on the speaker or his audience. However, we found it a bit ironic, that what was delivered with just the slightest hint of resignation, a consolation prize wrapped unobtrusively in understatement, was to our way of thinking, the holy grail of investing—the proverbial keys to the kingdom.

Capital-light is investor-speak for companies that require little capital reinvestment into fixed expenditures like property, plant and equipment and working capital such as operating cash, accounts receivable and inventory. As a company grows revenues in real or, as a result of inflation, in nominal terms, it isn't the gravy train that one would presuppose. Many companies must continuously feed the balance sheet beast to support growth and some must feed it just to run in place. Capital intensive companies are typically constricted by balance sheets with an insatiable appetite for capital reinvestment. This mandatory reinvestment leaves little residual for the benefit of the shareholder. Capital-light infers that even during periods of growth or rising prices there remains a high ratio of retained cash or “owner's earnings” to reported earnings. It is the effective deployment of owner's earnings, whether through dividends, stock repurchases or accretive reinvestment or acquisition, that allows investment capital to compound exponentially.

Pricing power means just what it sounds like. The term refers to the strategic position of an enterprise that permits it to raise prices without a corresponding decrease in units sold. Economists refer to this as price inelasticity of demand. One should be mindful that pricing power is relative to current demand and during recessionary periods unit sales may suffer downward pressure whether the company has pricing power or not. This may provide opportunity, however, as those companies that suffer the vicissitudes of demand are often priced at market troughs as if they enjoy no competitive advantages. This is tantamount to buying a Mercedes at Hyundai prices.

Into the pricing power mix we also include companies that have the ability to resist cost increases during inflationary periods. The ability to raise prices or hold down the cost of inputs in inflationary environments allows owners earnings to grow in nominal terms and keep pace with the required reinvestment that may come at higher replacement costs or at a higher cost of capital.

The concepts of “owner’s earnings” and “pricing power” are drawn from the writings of master investor, Warren E. Buffett. As Columbia Business School professor and investor, Thomas Tryforos puts it, “I often read his letters on the subway when going to teach a class. Who knows how many times I have read them previously. But nevertheless, it is rare that I read them and do not walk away with an enhanced perspective.” Having read and re-read Buffett’s body of work, we too subscribe to the investment wisdom and the lessons contained therein. However, none of his ideas have resonated as strongly as the Charles Munger inspired concepts of “owner’s earnings” and “pricing power”. It is from this intellectual foundation that, day-in and day-out, Giri Reddy and I ply our stock in trade and the primary reason that we believe we have house advantage over a market that deems the concepts too constraining, subtle, labor-intensive and lacking the so-called quantitative rigor suggestive of modern portfolio theory. Elegant in their simplicity and powerful in their efficacy, the concepts, when thoughtfully applied, provide a low risk route to riches and form the conceptual framework that we employ to compound our precious capital.

*We look at investing very simply.*

We look at investing very simply. We classify companies into two categories—1) capital compounders—those companies with the ability and inclination to compound a high percentage of retained earnings at a rate more favorable than the market averages and 2) capital confiscators—everyone else. We invest in the former and run, as fast as we can, away from the latter. Our opportunity set is limited as many publicly traded companies fall into the capital confiscator category.

To understand the essence of a “capital compounder” one must understand the concept of owner’s earnings. Warren Buffett has described investing as “what you get for what you give”. Another way of saying that the value of an enterprise is the discounted sum total of future cash flows that emanate from the enterprise and inure to the benefit of the shareholder. Owner’s earnings should not be confused with cash flow or earnings before interest taxes and depreciation (EBITDA), in our opinion, two widely accepted measures of limited, if not dubious, value.

Cash Flow is simply GAAP net earnings plus depreciation and amortization, a number that ignores the economics of an enterprise and the ongoing maintenance capital outlays required to sustain operations.

EBITDA is a concoction only a private equity promoter can love. The measure is derived from GAAP net earnings after adding back interest expense, taxes and depreciation and amortization. The result is supposed to provide a cash flow number, useful to promoters and brokers and anyone else foolish enough to enter into a transaction based on such misleading information. The number ignores the variability of costs of capital, interest expense or “I” and its impact on current earnings or “E” and subsequent capital reinvestment. Depreciation and amortization may or may not represent the capital reinvestment required to sustain operations. However, omitting “D and A” without a corresponding charge for ongoing maintenance capital is reckless, even in the least capital intensive enterprise.

Owner’s earnings are derived from the economic earnings of an enterprise. We define economic earnings as GAAP net earnings, on a per share basis, adjusted for accounting treatment that obfuscates the true economics of the enterprise. These obfuscating items can be, but are not limited to, stock option treatment, revenue recognition, expense recognition, contingent liabilities, extraordinary items, off-balance sheet financing, gains and losses from inventory, fixed assets, and marketable securities, consolidation accounting and inventory adjustments to name a few. To economic earnings we add back non-cash charges such as depreciation and amortization. We then subtract those capital outlays that are necessary to sustain the going concern. We call all necessary capital outlay “maintenance capex”. Not all maintenance capex is created equal and many

companies with degrading business models make acquisitions and expansive capital outlays just to sustain the going concern. We classify such expenditures as maintenance capex as well. What remains are the residual cash flows available to pay out dividends, repurchase shares or make, hopefully, accretive acquisitions. These cash flows are “owner’s earnings”.

Companies with little required capital reinvestment—capital-light—and pricing power, all other things being equal, over time, even in inflationary environments, will enjoy a higher relative level of owner’s earnings. A high level of owner’s earnings, deployed effectively, will result in the exponential growth of our capital. It’s as simple as that.

*Copart, Inc and the factors that allow it to enjoy the vaunted status of a capital-light company*

Copart Inc., established in 1982, is the world’s largest provider of salvage auto disposition services. A processor of total loss vehicles (TLV) the company collects abandoned or damaged vehicles, stores, cleans and processes them internally and through the local state motor vehicle agency. It then sells them on behalf of the insurer, through an auction process, into a market of parts and vehicle recycler-resellers. Its supply of TLV is primarily US based but its distribution is growing increasingly throughout the globe. Worldwide, Copart sells one car approximately every 50 seconds. In 2007 the company acquired Universal PLC, the largest TLV processor in the UK.

We often refer to Copart as a “proprietary technology company that enjoys incumbent competitive advantage(s), such as productivity advantages, customer captivity and barriers to entry—economic and regulatory—masquerading as an auto junkyard”. These so-called incumbent competitive advantages support the company’s pricing power as well as demand for its services and the nature of the business model supports the high relative level of owner’s earnings that emanate from the firm.

There is a very strong relationship between owner’s earnings and returns on invested capital (ROI). However, not all companies with high ROI are capital compounders with sustainable owner’s

earnings. Periodically, product or industry wide supply-demand imbalances can lead to excess profits, but typically those excess profits prove ephemeral. Think of fads like CROCS, Inc., the plastic footwear company, most electronic gadgetry, which is highly susceptible to substitution and thematic or macro-driven ideas like homebuilders of just a few years ago. They can make wonderful shorting opportunities, however.

And not all companies with low ROI are capital confiscators with correspondingly low owner's earnings. The equity of many a great growth story has been rejected by a value investor or two because of a high P/E ratio or some other simplistic criteria. Because companies are reticent to break out much of the detail required to evaluate same-store profitability and the prospective signs of developing competitive advantage are opaque at best, it is difficult to screen electronically for these potential capital compounders. Copart's expensed research and development (the IT department has expanded from 110 employees to 210 in just two years), greenfield facility projects and its most recent acquisition in the UK, obfuscate owners earnings. GAAP earnings may be suppressed in any operation that has not reached a steady state level of productivity. The earnings, if suppressed, should be adjusted to arrive at the owner's earnings of the enterprise. The analytical work is labor intensive.

Copart's high returns on invested capital are a direct result of the company's competitive advantages. In competitive industries, price competition will drive down prices to the point where the marginal producer is indifferent about continuing in business. This will leave the low-cost producer with a favorable share of industry profits. But if no competitor enjoys a significant competitive advantage in the cost of inputs, industry profits will be barely satisfactory. A company with consistently high ROI, especially when compared to the industry in which it operates, may enjoy a competitive advantage or advantages that allow it to earn excess returns in the face of competition. These advantages may be substantial and long-lived; what Warren Buffett refers to as a "durable moat", or they may be in degradation mode and the degradation may be rapid. Companies in mature industries tend to be more susceptible to durable advantage as the slow rate of growth precludes traction among new competitors and the current price of entry may be such that new entrants, if rational, should seek to invest in them rather than compete with them.

Copart is part of an oligonomy. An oligonomy is a system with few intermediaries at the bottleneck between many suppliers—insurers in this case, and buyers—parts and auto reseller-recyclers. We often envision Copart as toll collector on a bridge. Only, in this case, the toll collector owns the bridge!

Copart's competitive advantages feed on each other. It is the rare business indeed that the more ubiquitous its product or service becomes the greater the aggregate utility realized throughout the value chain. There are input cost advantages due to proximity. Copart, because of market concentration in most of its markets, enjoys a shorter average distance from the TLV pick-up point to their facility. Since the insurer pays the transport costs of the TLV from the pick-up point to the auction site, this provides Copart with a cost advantage over its competition. Market saturation in these locations is dissuasive to new entrants who would incur higher costs of entry.

In addition Copart enjoys scale advantages in processing and contracting. Contracts with national insurance companies are nation-wide and one price. Imagine working at an insurer and having to negotiate with hundreds if not thousands of different haulers and TLV processors, with varying levels of service and prices. Although we seldom regard technology as a competitive advantage, internally generated and patented processes with substantial development cost relative to industry wide capital, can fit the bill. Copart developed a patented virtual auction process entitled VB2. Copart holds no physical auctions. The virtual auction process increases the velocity of sales (67% more sales per hour than their closest competitor) and the turnover of assets. The early adoption of the process globally, has increased the size of the auction participant pool. The number of international buyers dwarfs that of any local auction, and auction theory teaches us that the larger the auction the higher the price. These attributes, competitive cost advantages, revenue optimization and the natural tendency (or selection) of insurers to place their best cars in the Copart system lead to a positive feedback loop that reflects positively on the company as well as on our capital.

There are additional advantages, including but not limited to regulatory barriers, but we think you get the “competitive advantage as a contributor to owner’s earnings” picture.

*Copart, Inc. as a capital-light company*

In his 1983 letter to shareholders, the Oracle of Omaha wrote the following:

“For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets (“In Goods We Trust”). It doesn’t work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses. This phenomenon has been particularly evident in the communications business. That business has required little in the way of tangible investment – yet its franchises have endured. During inflation, Goodwill is the gift that keeps giving.”

Copart, Inc exemplifies the proverbial “capital-light” business. The company generates approximately \$155M per year in net income and retains nearly 100% as owner’s earnings, or cash flow available for dividends, stock repurchase or accretive acquisition and development.

How does Copart “compound capital”? What are the opportunities? Well, from this \$155M, Copart has options and the returns on reinvestment range from zero or negative returns for ineffective reinvestment to hundreds of percent for “pushing dirt”, as CEO Willis Johnson puts it. “Pushing

“dirt” is the act of spending a little bit of capital on gravel to expand full capacity facilities. If only we could spend \$155M per annum pushing dirt. The company enjoys acquisition opportunity as well, as 40% of the industry is fairly fragmented. The company is capable of assimilating no more than 7 acquired facilities per annum according to President and COO Jason Adair. This is the case despite the fact that we have estimated steady state ROI of roughly 45% per annum on these acquisitions. The idea of limiting growth to a level where the customer experience isn't compromised, irrespective of the earnings pressure from Wall Street is—well...we are tearing up right now. After pushing dirt and managing acquisitions we estimate approximately \$120-\$130M in residual owner's earnings. The effective deployment of this residual will determine whether Copart is a great investment for our fund, or just a good one. The company spent \$120M in 2007 to acquire Universal PLC of the UK. The company has not been as transparent as we would like about the UK operations but as best as we can tell the ROI has been a substandard 5% per annum thus far. But only a fool draws conclusions looking at an unfinished business and the essence of the UK transaction was to shift the company and the UK market, where the company now controls more than 25% of transactions, to the agency model. A successful shift away from the traditional proprietorship model will reduce working capital requirements dramatically and should pave the way for the very satisfying ROI enjoyed in the US. The company always has the option to repurchase shares. In 2008, they acted aggressively, we would argue too aggressively, in acquiring 6.6M shares at an average price of \$40.70 per share. The success of a share repurchase is a direct function of the total return yield of the shares acquired. We tend to be a little stingy in that regard.

Growth at Copart has been accretive. Over the last ten years we estimate that owner's earnings as a percentage of net tangible assets have grown from ~20% to ~30%. In the last five years the company has earned \$590M in owner's earnings and has deployed \$380M for share repurchases and \$190M for acquisitions. Net earnings per share have grown 184% over the same five year period from 62 cents per share in fiscal year ended July 31, 2003 to \$1.75 per share in the fiscal year ended July 2008.

*Pricing power at Copart, Inc.*

Since Copart, for the most part earns a fee based on the sales price of the auctioned TLV, as prices rise, theoretically, so will Copart's revenues. Fees are subject to renegotiation, however, and we must look to a floor in pricing to determine pricing power. From a revenue standpoint, subject to demand, the floor on pricing is the price that Copart's next most effective competitor must charge to pay its cost of operations and earn its cost of capital. Is there a built in price increase in Copart's pricing scheme? The truth of the matter is we cannot know for sure. We do know, however, that within the industry, Copart's pricing is very competitive. They raised prices in the third quarter of 2008 without any pushback. In an inflationary period, given Copart's sales velocity advantage, we believe that as costs per unit rise, the competition will blink first and Copart will raise prices in sympathy.

From a cost of input standpoint, as indicated above, Copart is the low cost producer in the industry. An attribute that is useful in all environments but especially periods of high inflation. The way economics works—eventually—is that in competitive industries, cost push inflation will cause a rise in the cost of goods produced. Coupled with slowing demand the marginal producer will suffer margin contraction and may earn a return on invested capital that is dissuasive to the continued pursuit of the business. Consolidation, divestiture or bankruptcy will be the default as the company tries to rationalize its costs to a level equal to or less than the industry participants with the lowest costs of production. If competitors are allowed to fail, the low cost producer should enjoy margin expansion and the optionality of accretive acquisition.

Copart generates the majority of its revenues as the seller's agent. In the US the company doesn't take title to the TLV. In the UK, the company has converted half of its business to the agency model and away from the ownership model that has traditionally prevailed. Companies with rising input costs that cannot be passed on to customers suffer as described above. However, Copart receives a fee based on the gross value of the auctioned TLV. In inflationary periods, although selling, general and administrative expenses may rise with the average selling price of the auctioned vehicles, the largest expense, the cost of the TLV itself is of no consequence, as the

company serves as a broker only. At Copart, if demand holds, cost-push inflation should have an immaterial effect on owner's earnings.

*In closing*

Our hope is that you have gained some insight into our process and preferences. We are in the business of owning great businesses. We have built a portfolio of companies that, as Warren Buffett has often said, we would be happy owning if they closed the stock market for five years tomorrow.

Copart exhibits many of the attributes that we look for in a business. It is a great business. And we don't need too many companies like it in order to compound capital at a very satisfying rate for a long time to come.

Best regards,

John J. Hughes

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