The Case of Avis Budget Group

(or how to get rich with lower share prices)

by Loke Wen Wei, June 2017

As you may have noticed, a new top stock was introduced into the Fund in May 2017, so I thought it would be helpful for investors to understand why Avis is so attractive.

Avis (which also owns Budget and Zipcar), is one of the largest car rental companies in the world with operations primarily in the United States. It competes with 2 other competitors in the U.S., Hertz and Enterprise, and collectively these 3 players control >95% of the car rental market. At a $25 share price, Avis has a market cap of slightly over $2bn.

1. Avis generates large amounts of free cash flow and is trading cheaply

	2012	2013	2014	2015	2016	2017E
Free Cash Flow ($m)	518	460	456	525	472	> 400

Source: Avis Budget Group

Over the last 5 years, Avis has generated free cash flow[1] in excess of **$400m** per year and this is expected to remain stable going forward.

Buying this business at **$2bn** gives investors a *sustainable* free cash flow yield of around **20%**. That, in and of itself, makes this an attractive investment.

2. Management is using most of that free cash to buy back shares

	2016	2017E	2018E	2019E	2020E	2021E
Avg. Share Price	31.7	25.0	25.0	25.0	25.0	25.0
# Shares Outstanding (m)	97.3	85.0	72.2	59.4	46.6	33.8
Free Cash Flow ($m)	472	400	400	400	400	400
80% Share Buybacks ($m)	390	320	320	320	320	320
FCF Yield (%)	**15%**	**19%**	**22%**	**27%**	**34%**	**47%**

Source: Author's forecast calculations, Avis Budget Group historicals.

In addition, management has been using the bulk of their free cash to buy back shares[2] at low prices. In 2016 itself, management bought back $390m worth of shares at $31.7, reducing the outstanding share count by about 13% - and I expect them to continue buying back whilst the free cash flow yield remains above 10%.

As illustrated above, if management uses 80% of free cash flow to buy back shares at today's share price, in 5 years, the company will be throwing off free cash flow of $12 per share, giving a free cash flow yield on cost of almost 50%. *In essence, management is helping shareholders invest their money (tax free) in a product that increases its own high rate of return over time.*

Unfortunately, at some point along the journey, it is likely the market will take notice of the free cash flow profile of the company and bid its share price up to levels which are no longer attractive for buybacks, removing the opportunity for shareholders to participate in high and rising rates of return.

[1] **Free cash flow** is cash available to equity holders, after working capital, vehicle related purchases/sales, interest, cash taxes and capital expenditures but before acquisitions, debt repayments and share buybacks.
[2] **Share buybacks** occur when management uses the company's cash to buy its own shares in the open market, and then cancels the shares, reducing the number of shares outstanding.

3. With buybacks, a declining share price greatly increases the returns of shareholders

50% decline in share price

	2016	2017E	2018E	2019E	2020E
Avg. Share Price	31.7	25.0	12.5	12.5	12.5
# Shares Outstanding (m)	97.3	85.0	72.2	46.6	21.0
Free Cash Flow ($m)	472	400	400	400	400
80% Share Buybacks ($m)	390	320	320	320	320
FCF Yield (%)	**15%**	**19%**	**44%**	**69%**	**152%**

Source: Author's forecast calculations, Avis Budget Group historicals.

Thus, investors would much prefer that Avis experience a significant decline in share price as soon as possible. If its share price can drop by 50% over 2018, the free cash flow yield for existing shareholders would increase to a highly attractive 44%, greatly enriching existing shareholders in a much shorter time frame than if share prices remain at $25.

4. Even if free cash flow were to decline materially, the investment remains attractive

50% decline in share price

50% decline in FCF

	2016	2017E	2018E	2019E	2020E	2021E
Avg. Share Price	31.7	25.0	12.5	12.5	12.5	12.5
# Shares Outstanding (m)	97.3	85.0	72.2	59.4	46.6	33.8
Free Cash Flow ($m)	472	400	200	200	200	200
80% Share Buybacks ($m)	390	320	160	160	160	160
FCF Yield (%)	**15%**	**19%**	**22%**	**27%**	**34%**	**47%**

Source: Author's forecast calculations, Avis Budget Group historicals.

Even in the unlikely scenario where free cash flow declines by 50% in the next year, followed by a 50% decline in share price, with free cash flow per share of $3, the free cash flow yield of the business is still well above 20%, giving investors at today's share price a 10% free cash flow yield, with re-investment (via buybacks) happening at > 20% free cash flow yield.

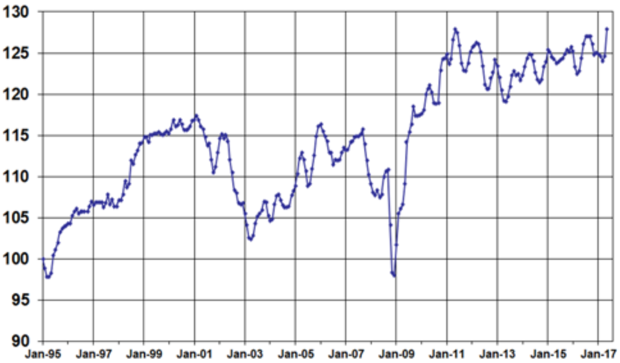
5. A material decline in free cash flow is unlikely

For the sake of argument, what would have to happen for free cash flow to decline by 50%? It would take rather extreme scenarios – e.g. U.S. average rental rates decline below the lowest levels seen in the last 10 years or average car costs rise to levels last seen in the global financial crisis (as residuals collapsed). Both these situations (or any combination of material decline in earnings) are very unlikely, for the reasons below:

Pricing competition is rational, and supply adjustments are quick. Avis operates in a highly consolidated industry, where 3 competitors control 95% of the market and nobody has an incentive to start a price war. Further, supply is variable, since cars are turned over every 14 months or so – any oversupply situation can be corrected very quickly. In addition, troubled #2 player Hertz has been de-fleeting to contain costs and improve profitability, which is already reducing the supply of rental cars.

If airlines in the U.S. can get their act together, odds are good that 3 car rental companies can keep industry pricing stable, and should arguably be able to exert pricing power.

Manheim Used Vehicle Value Index (Wholesale)



Source: Manheim Consulting, as of May 2017.

Used car pricing in the car rental segment remains healthy. Whilst there have been concerns around residuals for older cars in the U.S., this has not materially impacted the segment for car rental companies (typically 1 to 2-year-old cars), as can be seen from the Manheim Used Car Index above.

Even if used car prices decline, as long as new car prices decline as well, the car rental industry will be in good shape. Because car rental companies buy new cars and sell them after about 1 year, the cost to a car rental company is essentially the gap between the price of a new car and the price of a 1 -year old car. If that 'gap' remains approximately the same, car costs will remain quite stable – although there may be a year of lag before lower new car costs work their way into earnings, should there be a 'shock' decline in used car prices.

Management is targeting operational improvements, and expects to deliver 3-5% increased EBITDA margins over the next few years. Current management has a long history of delivering steady revenue and cost improvements, as can be seen in rising ancillary income at the top line, and Avis Europe's significant margin improvement during the current CEO's tenure as head of Avis Europe. Any earnings decline will be buffered by management efforts to drive revenue and cost efficiency.

Any significant industry downturn would result in financial trouble for Hertz, leaving Avis and Enterprise as the only two profitable players. Should there be an unexpected decline in the industry, the weakest player, Hertz, will likely face a restructuring or bankruptcy, removing significant capacity from the industry and/or greatly improving Avis and Enterprise's competitive positions.

6. The lower the share price for longer, the richer existing shareholders become

Thus, the preferred outcome is for the share price to drop as quickly and as much as possible, and stay there for as long as possible, even though this would look 'bad' in terms of short term performance. Rest assured that in this case, over the Fund's long-term horizon, you are getting richer every time the share price drops.