SOHRA PEAK
CAPITAL PARTNERS

Memo: Auto Partner SA (APR.WA)
October 27, 2022

Introduction to Auto Partner

Auto Partner SA ("Auto Partner") is a USD ~$385MM market capitalization small-cap company listed on the Warsaw Stock Exchange. Since 2013, its earliest set of publicly available financials, Auto Partner has compounded its sales at a +26% CAGR and its net income at a +30% CAGR, and has consistently earned double-digit returns on its invested capital.[2] The company currently trades at a trailing P/E of 8.7x. For many reasons, I believe Auto Partner has a durable competitive position and is likely to continue growing sales and profits at high rates for many years.

Auto Partner is Poland's second-largest distributor of aftermarket auto parts. The company was founded in 1993, shortly after Poland's fall of communism, by President, Chairman, and 46% shareholder Aleksander Górecki.[4] In the company's early days, Mr. Górecki ran the business out of his 90 m^2 apartment. He showcased auto parts out of his building's hallways and delivered the auto parts to customers himself. The following 29 years have since seen the company expand organically into its current form with USD $500MM in annual sales, 110 domestic branches, and a distribution network to over 30 European countries.

Auto Partner Headquarters in Bieruń, Poland
Pictured, in order from left to right:
Andrzej Manowski, Vice President of the Management Board
Jonathan A. Cukierwar, Principal of the GP at Sohra Peak Capital Partners
Aleksander Górecki, Founder & President at Auto Partner
Piotr Janta, Vice President of the Management Board

To fully grasp Auto Partner's business model, it is important to understand how the aftermarket auto parts ecosystem in Poland and Europe are quite different from that of America. In the U.S., if your car repair is light or moderate enough, rather than taking your car to a professional mechanic it is common to visit an aftermarket

(1) Source: Estimates, thoughts, opinions, and research of Sohra Peak Partnership LLC.
(2) Source: Auto Partner SA, Financial Statements.
(3) Data as of August 2, 2022.
(4) Includes common shares held by Katarzyna Górecki, Aleksander Górecki's wife.
(5) Source: CarParts.com, *More Car Owners Shifting to DIY Auto Repair*, https://www.carparts.com/blog/covid-19-car-ownership-survey.

auto parts retailer such as AutoZone or O'Reilly Automotive. The do-it-yourself (DIY) market in the U.S. is strong, with 58% of surveyed U.S. car owners pre-pandemic opting to conduct DIY repairs compared to 42% opting to visit mechanics.[5]

In contrast, in Poland, when a person needs a vehicle repair, over 90% opt to visit professional mechanics, with less than 10% opting for DIY repairs. This is also the general situation in most, if not all, European countries. One main reason behind this difference is that European cars and their parts are significantly less homogenous and more complex than many non-European cars that one would find in America, and therefore the auto part SKU catalog a European store-based retailer would need to carry to serve a reasonable percentage of its customer base's car repairs is significantly higher than in America. Another reason is because the proportion of Poles living in apartments, 44%, is higher than the percentage of Americans, 20%, implying that the average Pole is less likely to have the necessary space in a driveway or otherwise to perform a DIY repair.[6,7]

Amongst professional mechanic shops, of the 90%+ of repairs that take place at mechanic shops, approximately 70% occur at independent mechanic shops as opposed to 30% at authorized service outlets (ASOs), with the former almost always offering noticeably lower prices and the latter usually being a more sensible option for cars still under warranty.[8] In recent years, market share has shifted slightly from the ASOs to the independents as the average car age in Poland has increased as a result of people holding on to their cars for longer.[9] Among Poland's 70% independent mechanic market, ~99% are mom and pop owned and ~1% are part of larger chains, which has presented a favorable backdrop for the auto parts distributors who serve a stable customer base with low bargaining power. Despite a steady population, the TAM for auto parts continues to grow, too, as vehicle repairs have become increasingly complex and as the number of cars per 1,000 Polish inhabitants has increased from 451 to 656 over the past decade, a function of the population's rising affluence.[10]

Worth mentioning, the high proportion of Polish consumer aftermarket auto part spending that occurs at the mechanic level and the generally low affluence nature of Poles suggest that aftermarket auto parts in Poland are much closer to being a consumer staple product than a consumer discretionary product.[1]

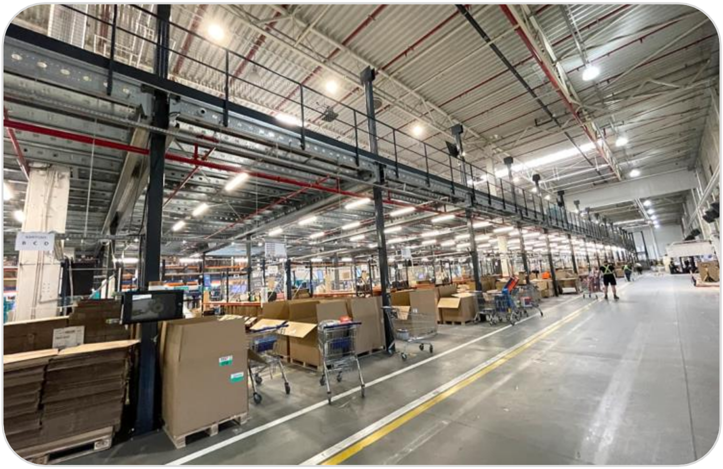
Typical Transaction Sequence

In the typical transaction sequence, a person needs their car repaired. They bring their car to a local mechanic, who then tells the customer to come back in either hours or days, depending on the complexity of the repair and the mechanic's car backlog. The mechanic's incentive here is to receive the part as quickly as possible to begin the repair, because faster repair times lead to happier customers and free up work space for quicker turns on repair jobs. To receive the part, the mechanic either calls or, in the case of Auto Partner

(6) Source: Statista, *Distribution of the population in Poland as of 2015, by dwelling type.*
(7) Source: U.S. Census Bureau, *American Community Survey*, 2014.
(8) Source: The Boston Consulting Group, *Returning to Growth: A Look at the European Automotive Aftermarket*
(9) Source: Polish Automotive Industry Association (PZPM), https://www.pzpm.org.pl/en/Publications/Reports.
(10) Source: GUS, Central Statistical Office of Poland, https://stat.gov.pl/en/search/search.html.

and other leading distributors with IT systems, submits an online order for the specific part(s) they need from their distributor's local branch, waits for the distributor to confirm whether that SKU is in stock, and waits for delivery.

From Auto Partner's point of view, auto parts first arrive at their central warehouses from suppliers where the parts are sorted. Auto Partner constantly monitors branch inventory levels and sends deliveries from the warehouses to their 110 domestic branches to replenish local inventory. At the branch level, once a customer order is received, the parts are added to a basket and loaded onto a last-mile vehicle to be delivered during that day's next scheduled delivery trip.



Auto Partner's central warehouse in Bieruń, Poland
(Source: Photo taken by Jonathan A. Cukierwar)

Competitive Advantage

Based on feedback from various industry sources, I have surmised that in order for a distributor to deliver a leading value proposition to its mechanic customers, a distributor must win or be competitive in three areas, listed in order of importance:

1. Selection and ready-to-deliver availability of any given auto part SKU, of which there are 100,000s.
2. Speed of delivery time, preferably within hours, or sooner, of placing an order.
3. Competitive prices.

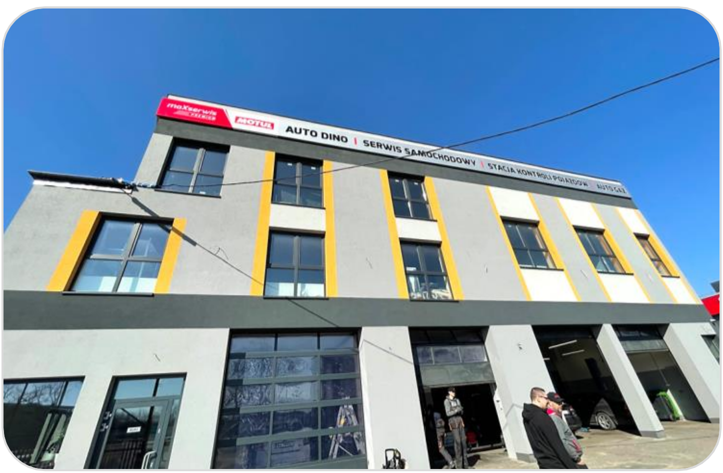
Auto Partner wins over its smaller, more fragmented distribution competitors by having higher SKU selection and availability, delivering parts frequently, and offering competitive or lower prices.[1]

The most important consideration to a mechanic when placing a parts order is whether a distributor has that particular SKU in stock.[1] Auto Partner over its 29-year history has built its SKU catalog to 250,000 and its supplier count to 350, and believes that its catalog offers almost 100% of customer SKUs outside of tires and body parts. This is greater or much greater than most smaller, fragmented competitors, who aren't able to source as many SKUs because they have fewer supplier relationships, less scale, and/or don't have the warehouse capacity to build such a catalog. Mechanics place high value on this element, as they want relationships with distributors who can act as reliable, convenient one-stop-shops for every order.

The second-most important consideration to a mechanic is the average speed of delivery for each order. In order to deliver to customers quickly, a distributor must have a branch present near the mechanic, which helps level the playing field for smaller distributors and mom and pops. In areas where Auto Partner has a branch presence, it is common for Auto Partner branches to make between 3-8 delivery trips per day to each mechanic customer, which is as frequent as any other distributor and allows mechanics to receive their parts within hours or sooner.[1] This also means that, when Auto Partner opens a branch in a new neighborhood, it immediately becomes competitive on speed of delivery time while retaining its advantages on SKU selection and availability as well as competitive pricing.

Third and importantly, prices must be competitive in order to win business. Large distributors such as Auto Partner have a clear advantage in this category thanks to their scale, which has allowed them to increase gross margin by ~8% since its early years as a result of increased bargaining power with suppliers over time. For branded auto part sales, this gives Auto Partner the choice of either undercutting smaller competitors on price or offering similar prices and pocketing the extra margin. Auto Partner also has a strong private label brand, MaXgear, which comprises ~20% of total sales and provides ~100% higher gross margin than branded products.[1] MaXgear prices are available to customers at a price point of ~30-40% lower than branded products while possessing product quality that is on par with branded products, as evidenced by MaXgear complaint rates being similar to those of branded products.[11] Few domestic competitors have strong private label brands.[1]

In addition to the above, Auto Partner's strong competitive position is reinforced by its customer online ordering portal and its mechanic-assistance program MaXserwis. Auto Partner's customer online ordering portal receives 62% of total mechanic customers order traffic, which has cost millions of dollars and taken years to build, which adds value to the mechanic's customer experience.[11] Most competitors, especially smaller ones, still require customers to place orders over the phone. Auto Partner also partners with mechanics through a program called MaXserwis whose purpose is to help mechanics stay current on car repair knowledge given increasing general car complexity, and also leases specialized tools to mechanics who might need them.[1] These mechanic shops in return tend to do more business with Auto Partner, brand their shops with visible MaXserwis banners, and receive the privilege of being listed on the http://maxserwis.com.pl website, an aggregator for car owners to search for high quality mechanic shops in their area. Auto Partner is selective with whom it partners with under MaXserwis, intending only to partner with those who are of high quality, and frequently turns down applications from mechanic shops wishing to join the program.[1]



Mechanic Shop near Warsaw, Poland; MaXserwis Partner
(Source: Photo taken by Jonathan A. Cukierwar)

Main Competitors

Auto Partner's main domestic competitors include **Inter Cars** (~30% market share), **Inter Team** (~9-10% market share), and **H.M. Gordon** (~7% market share).[1]

Inter Cars is a strong player whom I view as a more-scaled version of Auto Partner. Among their similarities and differences, the biggest qualitative difference in my view is leadership, specifically the change of President (CEO) at Inter Cars that occurred in 2017 when founder Krzysztof Oleksowicz passed down the CEO position to his son, Maciej, who had limited experience at Inter Cars before assuming the helm. Since the beginning of Maciej's tenure, Inter Cars has engaged in a series of seemingly growth-driven, but also seemingly scattered, initiatives such as manufacturing and selling semi-trailer trucks, opening Isuzu car dealerships, selling marine parts, and launching a rental car services start-up, each with mixed or no success to my knowledge.[1]

Meanwhile, Auto Partner is led by Founder and CEO Aleksander Górecki who is still in his 50s, with likely many years to operate ahead of him, has a proven 29-year track record, and who in my view is clearly ambitious for his business. As a sign of confirmation, I asked Maciej, CEO of Inter Cars, **"which of your Poland competitors do you respect the most,"** to which he was quick to answer, **"Auto Partner. Auto Partner is a really nice company. A rising star, even."** No other competitors were mentioned.[1]

Inter Team and **H.M. Gordon** are of similar scale to Auto Partner, though each currently saddled with their own set of issues. According to both Auto Partner and Inter Cars, when Inter Team was acquired in 2018 by LKQ Corporation, a USD $15B market capitalization global auto distribution giant, LKQ mismanaged Inter Team's strategy by raising prices significantly to try and capture higher gross margins.[1] Customers left, and Inter Team in recent years has become a market share donor to Inter Cars, Auto Partner, and others.[1] This also serves as a positive data point against the threat of multinational distributors entering the country and winning market share, as LKQ apparently managed to misjudge the Polish market. H.M. Gordon only grew post-COVID revenues at +5% YoY, lagging Auto Partner's +35% and Inter Cars' +34%, supposedly the result of internal dysfunction centered around a divorce within the governing family.

Significant Growth Opportunities Ahead

There is ample opportunity ahead, I believe, for Auto Partner to continue growing profits at high rates for many years, which could occur through various avenues:

- Opportunity to 2-3x Domestic Branch Count: Auto Partner currently operates 110 branches with 10% market share while its main competitor Inter Cars operates ~300 branches, despite both having a similar value proposition with regards to SKU selection, availability, and price point. Auto Partner intends to open 10-15 branches per year for the foreseeable future.[1] The main bottleneck behind branch expansion has not been TAM, but according to management, rather the result of balancing growth with profitability.[1] Branches take ~2 years to achieve breakeven and ~4 years to mature, which implies operating profit drag by immature branches.[1] Positively, as branch count increases, the ability to accelerate branch openings while maintaining profitability increases, too.

- Launch Branch Presence in Eastern European Countries: Auto Partner has just one branch outside of Poland. Currently, the company is still enjoying strong growth in Eastern Europe through sales to middlemen auto parts shops who comprise ~30% of the market. Once that market eventually saturates, Auto Partner intends to begin building branch networks in bordering Eastern European countries to target the remaining 70% of TAM which sells to mechanics directly, as they do in Poland.[1] Main competitor Inter Cars has over 400 branches outside of Poland, most of which are in Eastern European countries, providing a precedent for business model success.

- New Warehouse(s) Domestically and Internationally: Auto Partner currently has two large warehouses located in Bieruń and Warsaw. It plans to open its third domestic warehouse this year in Poznań, and more in the future, which should increase logistics efficiency by lowering average time to delivery from warehouses to branches and ultimately to mechanics. In addition, we think there is also opportunity to eventually open automated warehouses in Western Europe, which

(11) Source: Auto Partner SA, Periodic Reports, Prospectus. https://ir.autopartner.com/en/reports/#periodic-reports.

would cut commute times down dramatically from current 8-16+ hour trips and improve the company's value proposition to large swaths of Europe's USD $260B TAM.

- Introduction of Tire Sales: Tires represent ~15% of the aftermarket auto parts TAM which Auto Partner has not carried to date, and may begin to carry in the near future.[11] Tires are among the least efficient auto parts to sell as measured by profits:m^2 required to store and transport them.[1] Now that Auto Partner has finally procured a vast catalog of SKUs for most product categories outside of tires, tires remain as one of the last categories left to carry.[1] Turning on this switch can fill part or all of this ~15% revenue gap and further increase the company's reputation as a one-stop-shop.

- Gross Margin Expansion: Sustainable gross margin could expand by an additional +2% over time as private label MaXgear adoption increases and also as domestic branch count increases. MaXgear's blended take rate is currently around 20%, which tends to be lower for newer customers and higher for more mature customers. As the company's customer base matures, blended MaXgear adoption could increase and contribute to higher company-level gross margin. Increasing domestic branch count would also place Auto Partner physically closer to the average customer which has historically increased pricing power as, for example, customers may be willing to accept +5-10% higher prices per part if the average delivery time is reduced from 3 hours to 1 hour.

- Large, Untapped Rest-of-Europe TAM: ~50% of Auto Partner's sales and profits come from its distribution of auto parts to customers outside of Poland across 30+ European countries which it refers to as its "export" segment. Auto Partner has grown this segment from PLN 59MM in 2012 to PLN 1,034MM in 2021 or a CAGR of +37%, and in its most recent trailing nine-months grew this segment by +37% YoY, indicating the Europe distribution opportunity may still be in its early innings. The company still captures just 0.1% of this estimated USD $260B TAM and believes it can capture much more. This business model is slightly different, with sales being made to middlemen auto parts shops instead of to mechanic shops directly. Given the complexity of this segment, the section to immediately follow offers a detailed breakdown.

Demystifying the Export Segment

Auto Partner's export segment comprises approximately 50% of the company's revenues and 60% of its profits. It is also growing meaningfully faster than the company's domestic segment, most recently at a rate of +40% YoY, suggesting that this business segment carries high importance to the company's valuation.[1] Understanding future outcomes for this segment is therefore crucial, which I believe I have a good grasp on and which have led me to conclude that Auto Partner should do well under a range of export outcomes.

As a refresher on how Auto Partner's export business works, this segment operates differently than the company's domestic segment. Unlike the domestic segment, the export segment possesses no physical branches. Instead of the end customer being a mechanic shop, the end customer is a middleman auto parts shop whose purpose is to re-sell these parts to mechanics who then elect to purchase some of their aftermarket parts from these shops. Reasons why a mechanic might purchase aftermarket parts from these auto shops instead of getting them delivered by local distributors include convenience, habit, being too small a business to warrant frequent deliveries from local distributors, and cultural bias.

European mechanic shops order about 70% of their aftermarket auto parts directly from local distributors and dealers such as Auto Partner, LKQ, Mobivia, etc., and purchase the remaining 30% from these middleman shops.[2] Among other reasons, one reason middleman shops exist is because of the time mechanics can save by walking down the street to pick up parts they would rather not wait hours to receive from local distributors and for which they are willing to pay a higher price. With 30% of TAM flowing through these shops, this implies a $78B USD opportunity, of which Auto Partner captures ~0.3%.[1]

Auto Partner wins new customers by deploying a salesforce across 30 EU countries. These salespeople physically visit shops and attempt to convince them to purchase parts from Auto Partner on the merits of offering an industry-standard product catalog, guaranteed next-day delivery, convenient IT solutions, and competitive or better prices. Auto Partner then delivers these products using ground transportation from their Polish warehouses all the way to the auto shop along pre-established logistics routes. Over time, Auto Partner has grown its geographies, its customer count, and average wallet share, which together have driven strong growth in sales and profits over time.[1]

Export: Auto Partner vs. Local Incumbent Distributors

In examining Auto Partner's ability to win customers in this segment, several important areas to address include how Auto Partner's product catalog can compete with the likes of industry heavyweights such as LKQ, how Auto Partner is able to deliver goods at delivery speeds competitive with local distributors, the IT-driven switching costs Auto Partner has created among its customer base, and the dynamics surrounding price competition between Auto Partner and Western European distributors.

The first area, product catalog competition or selection, is the easiest to parse. Despite being a fraction of the size of industry behemoths, Auto Partner has developed relationships with many major suppliers and now offers a competitive product assortment across nearly all major categories. This assures customers access to a wide range of aftermarket brand names and product assortments.

The second area, delivery speed, prompts a fair line of questioning. Given Auto Partner is delivering parts to shops as far as 20 hours away, how can Auto Partner possibly compete with delivery speeds of local distributors who are located just 1 hour away from these same customers? The key reason I have found is that delivery speed is simply not as important to auto shops as it is to mechanics. While mechanic shops place strong emphasis on delivery time because of the incentive to provide faster repair times for customers and free up work space for quicker turns on repair jobs, auto shops don't face such pressures, and only have to worry about maintaining inventory levels. For most parts, it is easy to keep inventory levels at 1+ days. This makes next-day delivery for orders placed by, say, 4:00 p.m. both realistic for Auto Partner to guarantee next-day delivery and often satisfactory for the auto shop.

Certain incumbent distributors in Western European countries are apparently not doing themselves any favors, either. While not evidenced, comments made by industry members suggest that many European distributors may not be as focused on customer satisfaction and growth as other more aggressive players in the industry such as Auto Partner. For instance, according to management in their latest earnings call, in France, some of Auto Partner's customers report receiving parts delivered from Auto Partner's Polish warehouses 16 hours away sooner than they receive parts delivered from local French distributors.[12]

The third area, switching costs, has helped Auto Partner win business and very possibly retain business to date as a result of two IT decisions.

(12) Source: Estimates, thoughts, and opinions of Auto Partner SA management.

The first was an early decision to build its digital product catalog using the Microsoft Dynamics AX ERP system. Auto shops can easily integrate data from Microsoft Dynamics AX to their industry-standard software, which is important because auto shops use these software religiously to view and compare catalogs and prices among multiple distributors. If you are a distributor looking to win new business with an auto shop and your digital catalog is not accessible by their software, you are apparently at an automatic disadvantage because you are asking the auto shop manager to open up their own software, and then a second software or portal just to view your catalog alongside which has its own unique layout. It is easy to see why shop managers would appear much more likely to prefer one software, especially when they already have existing supplier catalogs integrated with their software. As a real example of this advantage, according to Inter Cars' former head of exports, as of 2021 Inter Cars had not yet created an integration-friendly version of its digital catalog, which the former employee cited as a chief reason why Inter Cars' export business efforts had stalled so far and why Auto Partner's efforts are meaningfully ahead.[1]

The second IT decision was the building of Auto Partner's "mother and child" online ordering portal. As Auto Partner describes it, the auto shop is considered the "mother," and their end mechanic customers are considered the "children." Using this portal, a mechanic places an online order, which gets routed directly to its auto shop supplier who is notified, which then gets routed directly to Auto Partner's warehouses. These parts are then delivered next-day. This adds value to both the mechanic shop and the auto shop. It creates order visibility for the auto shop with minimal effort, it offers the mechanic a convenient ordering solution, and it possibly creates an element of switching cost for auto shops who may take this value into consideration when weighing any future decisions to stop doing business with Auto Partner. According to management, approximately 50% of Auto Partner's "mother" export customers use this portal.[14]

Export: Pricing Corridors and Price Harmonization

The final area, price, is arguably the most important consideration and also the most complex, and provides a great deal of clarity around the export segment. To date, I have spoken with a variety of European-based experts on the subject of European export including former employees at major aftermarket auto parts manufacturers, major European aftermarket auto parts distributors, and major competitors.

These experts have conveyed that, across European countries, most major aftermarket auto part manufacturers sell parts to distributors in most or all countries across the EU. However, as a distributor, depending on which country you are domiciled, the manufacturer will quote you a different price depending on each country's general level of affluence and affordability. For instance, the same specific air filter offered to a distributor in Germany might be quoted at €40, but the same exact SKU offered to a distributor in Slovenia might be quoted €36.[1]

Among these experts, it was the unanimous view that while differences in pricing, or price corridors, do exist among EU countries, the maximum price difference between the highest and lowest quoted countries is ~15-20%. Poland is near the low-end of this spectrum, which gives Polish distributors such as Auto Partner the ability to purchase aftermarket auto parts from manufacturers at what I estimate to be a ~15% average discount relative to their Western European peers.[1]

While this gives Auto Partner an advantage at cost, Auto Partner incurs several disadvantages which result in similar margins between Auto Partner and Western European distributors. An inter-country exporter such as Auto Partner faces much higher transportation costs to deliver that same part than a local distributor. Auto Partner also receives smaller volume rebates from suppliers than its largest competitors, who may receive rebates anywhere from 3-7% greater than Auto Partner for a given manufacturer.[1] Finally, Auto

Partner faces modest FX headwinds, given they pay most suppliers in Euro denomination which incrementally appreciates against the złoty. Taken together, based on my estimates, the net cost difference for an auto part exported by Auto Partner versus sold by a local distributor likely still favors Auto Partner but at a much narrower difference than 15%.

As evidence of a much narrower cost difference, auto shops observe very narrow price differences for identical SKUs sold by Auto Partner and other major distributors. Auto Partner prices its SKUs on average just 2-3% cheaper than Western distributors, and according to management never cheaper than 5%. This carries a couple of key implications:

- If Auto Partner net cost advantage were truly close to 15%, then they would either be pressing it, which it appears they aren't, or theoretically they could be pricing their SKUs at slight discounts and pocketing gargantuan extra margins, which also seems cannot be true. Auto Partner's export segment operating margins of 9-12% are not astronomically higher than those of competitors, many of whom are also earning operating margins in a similar range, suggesting any extra margin is nowhere to be found. Thought otherwise, if a tremendous cost advantage were truly available, then Western distributors would have long been incentivized to purchase subsidiaries in Poland or other low-cost countries, use those subsidiaries to purchase aftermarket auto parts at large net discounts, export them to intended sales destinations, and earn 25% operating margins, but they aren't.[1]
- Perhaps more importantly, the fact that Auto Partner's prices are only slightly lower than competitors suggests that lower prices have not been the only force behind Auto Partner's explosive growth in the export segment. Other elements already discussed, including a competitive catalog, a satisfactory delivery time, value-added IT solutions, and an aggressive sales force, appear likely to have played significant roles as well in Auto Partner's wins to date.

The most uncertain future variable behind these pricing dynamics, according to those familiar with the industry, is the potential for forced price harmonization, or the narrowing of these country-by-country price differences offered by the manufacturers that does not occur as the natural result of a country's increasing or decreasing level of affluence. The general thought is that, as exporters with price advantages such as Auto Partner win noticeable market share in Western European countries, Western distributors may begin to complain to manufacturers that the situation is unfair, which could lead manufacturers to side with their Western European customers and take action against Auto Partner and other exporters.

Price harmonization cannot be ruled out and is therefore a risk, but after considering the incentives of all parties involved in the ecosystem, I believe any eventual price harmonization would take years to transpire, would occur piecemeal, and would not threaten Auto Partner's profits from its private label auto parts which comprise a significant portion of the company's export profits.

Given EU law mandates open inter-country trade such as auto part exports, any changes would almost certainly occur at the free enterprise level.[2] From a manufacturer's point of view, if large distribution customers were to complain about CEE exporters stealing their market share, the manufacturer has two high-level options to help level the playing field for Western distributors. It can either raise prices in the low-priced countries to match those of the high-priced countries, or it can lower prices in the high-priced countries to match those of the low-priced countries. For several reasons, I believe both outcomes work firmly against the manufacturer's interests.

A manufacturer raising prices in the low-priced countries to match those of the high-priced countries appears irrational because they likely face a high threat of substitution from competitors. While specific brand names offer competitive advantages in specific geographies, by and large there are dozens of manufacturers with commoditized product catalogs at competitive prices. If a manufacturer were to approach Auto Partner and attempt to raise prices by 10% or ration product quantities sold to Auto Partner, Auto Partner would in all likelihood replace that manufacturer with one or more manufacturers.

A manufacturer lowering prices in the high-priced countries to match those of the low-priced countries also appears irrational because it would likely represent a monumental profit loss for manufacturers. Manufacturers already operate with single-digit net margins, which in all likelihood is not a workable cushion to absorb price cuts of any kind, let alone 10-20%. In addition, the typical manufacturer in this industry already produces 70% of its goods in low-cost CEE countries, which suggests there is not much room for them to cut costs by relocating manufacturing facilities from high-cost to low-cost countries.

As an added measure in Auto Partner's favor, the TAM for aftermarket auto parts across Europe available for capture by distributors is €260B.[2] Auto Partner's export segment captures just 0.1% of this TAM.1 Auto Partner is also apparently among the largest CEE auto parts exporters, which implies the export industry as a whole captures a narrow slice of a large pie. This is important because, whether the CEE export market share penetration threshold before upsetting Western distributors is 1%, 5%, or 10%, any of those thresholds would imply room for Auto Partner to expand its export business multiples ahead of what it is today before becoming a target. According to one former manager from a leading European aftermarket auto parts manufacturer, his soonest estimate of when any such stir might occur would be 2030, which seemed to be his way of expressing doubt that change would occur anytime soon.[1]

For these reasons, I think any meaningful change to current export price dynamics would be slow to occur, and would occur piecemeal, whether by manufacturer or by region, rather than all at once. In the event manufacturers were to find a way to sustainably harmonize prices, there would be real downside risk to Auto Partner's export profits. If manufacturers were to harmonize prices by 5%, all else equal, I estimate Auto Partner's export profits would decline by 40%. In a more extreme example, if manufacturers were to harmonize prices by 10%, I estimate Auto Partner's export profits would decline by 80%, which would be close to a worst case scenario.

Despite the serious potential downside impact, I think this risk is mitigated by several factors over the long-term. First, as discussed, price is the most important element, but not the only element that auto shops value. Auto Partner's export managers are also currently prioritizing the expansion of private label sales, which helps protect Auto Partner against the whims of manufacturers because Auto Partner is in complete control of their own private brands. Auto Partner has ample opportunity to organically grow their branch network in both Poland and nearby CEE countries which is currently shelved in lieu of pursuing the export opportunity, but if eventually Auto Partner's export opportunity becomes handicapped, they will still have room for meaningful growth.[14] Finally, as Poland becomes a more affluent nation in line with its Western European peers, Auto Partner will be better able to afford warehouses and branches in Western Europe which would reduce delivery times to customers dramatically, allow for multiple daily deliveries, and unlock the 70% of TAM belonging to mechanics that Auto Partner doesn't currently have access to. Poland eventually cementing its developed nation status should also be quite positive for its currency and become a more attractive destination for foreign equity investment.

Valuation

As of this writing, Auto Partner carries a market capitalization of PLN 1,737MM and delivered trailing annual net income of PLN 199MM, or a P/E of 8.7x.

From a valuation perspective, how should we view Auto Partner under the scenario where, in 5 years, they incur a large or complete loss of export profits? Today, Auto Partner sells for a 1,737MM zł market cap and earns ~200MM zł in net profits. I believe they can conservatively grow earnings at +20% annually for the next 5 years. This implies that, over that span, Auto Partner on a discounted basis will have earned most of its market cap alone. Then, if the export business were handicapped to zero and the branch-based business grew its earnings +15% annually from 80MM zł to 160MM zł, the company's new total profits of 160MM zł would represent a 9% yield to today's market cap. At that point, all of management's attention would likely be redirected towards expanding its CEE branch-based network, where significant double-digit growth opportunity would still almost certainly exist.

While not ideal, I view the above as not as terrible outcome for a worst case scenario. I think there is still a lot that can go right, with or without an export segment crisis. How should we view Auto Partner under the scenario where the export segment gets to keep most or all of its profits, and things elsewhere go mostly right? The company I believe could see continued annual revenue growth of 20-25% along with margin expansion, driven by three components:

1. Higher revenue growth in the export segment which carries ~3% higher absolute operating margins than the domestic segment.[1]
2. Higher private label penetration. Today private label products comprise ~20% of sales and ~35% of gross profits.[2] According to Auto Partner, mature customer cohorts see private label wallet penetration of closer to 35%. Over time, as the customer base matures, private label share should improve and bolster margins by up to 2-3%.
3. Higher rebates from suppliers as order volume increase.

Aside from export segment inputs, TTM gross margin is currently elevated by about ~1% at a level of 29.9%. In the company's latest earnings call, CEO Aleksander Górecki noted that Auto Partner's FIFO inventory tailwind to gross margin, which began in 2020 when industry prices rose quickly, has wound down to ~30% of current inventory.[14] Once this remaining inventory sells, the CEO expects to see a 1.5% downward impact on gross margin. This implies the company-wide gross margin as of 1H22 results of 30.3% should on a normalized basis be closer to 28.8%.

In estimating trailing steady state free cash flow, after taking into account normalized gross margin as well as an additional PLN +13MM due to the drag of immature domestic branches on profits, I arrive at a figure of 180MM zł or a 10.4% steady state free cash flow yield to today's share price. I believe there is a very real outcome where Auto Partner earns 500MM zł in 4-5 years or a 33% free cash flow yield to today's share price.

Macroeconomic Headwinds

In the short-term, where we may continue to incur unrealized losses is through further złoty depreciation and declining Polish equity multiples driven by further increases in Polish interest rates. The current Polish 10-year government note yield of 8.0% has dampened enthusiasm for Polish equities and helps place Auto Partner's 12.5% earnings yield in perspective. While it won't happen overnight, macroeconomic headwinds including the Ukraine conflict, high inflation, and the strong U.S. dollar should eventually subside, at which point Polish equities should rebound from their current lowest-ever valuation levels.[13]

(13) Source: Bloomberg, *Warsaw's New Stock Darlings Make Heat Pumps and Bulletproof Gear*. https://bloom.bg/3Pg8HCS.

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