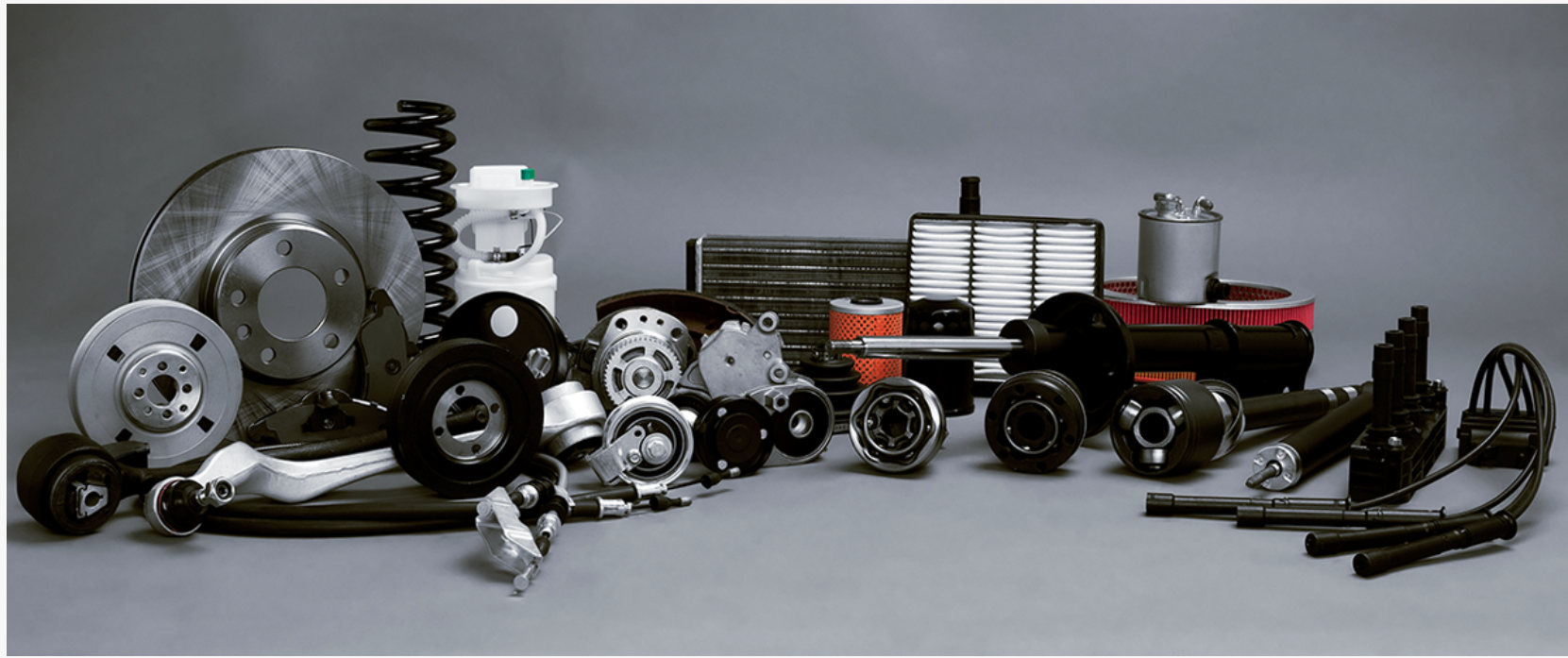


Beneath the bonnet

JASON SPILKIN JUNE 2024

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The retail and distribution of automotive aftermarket parts seems to be a dull and mature industry from the outside. However, when you look “beneath the bonnet”, there is a long run, profitable consolidation story, which is veritably exciting.

AutoZone (“AZO”) was founded in the late 1970s by J.R. “Pitt” Hyde III, as a division of his family’s grocery wholesale business, Malone & Hyde (M&H). Pitt started running that business in 1968, at the tender age of 26, when his father became ill. After successfully listing on the NYSE, Pitt used his company’s stock as currency to consolidate other food distributors, thereby achieving economies of scale. That strategy worked for a while, though by the late 1970s the Federal Trade Commission (FTC) blocked several acquisitions, which led to Pitt diversifying his family’s fortunes into automotive parts, where he foresaw a longer runway for consolidation in a hitherto highly fragmented industry. AZO was spun off as a standalone listing in 1991.

Whereas traditional auto parts shops outsourced to disparate distributors or operated franchises “tied” to a single distributor, AZO “insourced” their own distribution from the outset. This made sense given M&H was already a seasoned operator in a mature industry and could bring its competitive advantages to bare. Though Pitt had no direct experience in retail, he had long been a supplier to grocers. Before the “supermarket” existed as we know it today, small grocers used to serve each individual customer, from a narrow selection of mostly non-perishable foods, stacked high behind a counter. To complete their shop, customers would then have to traipse to the greengrocer, butcher, and fishmonger for fresh produce – not very efficient. Supermarkets were revolutionary in creating a “one-stop” shop and allowing for “self-service”. This was more efficient and lowered costs, which could be passed on to customers in the form of lower prices.

As the saying goes “nobody has a monopoly on good ideas”. Pitt unashamedly pilfered many of his from successful retailers. He would have witnessed Walmart (the “Beast of Bentonville”) barnstorming over M&H’s clientele. AZO’s “one-stop” stores are uniform “boxes”, carefully configured to maximise parts availability, self-service, and profitability. They are more Home Depot than hardware store, with wide aisles, bright lighting, and uniformed workers. Stores stand alone as destinations, in convenient low-cost sites, with easy access (parking) close to customers. “Autozoners” are on hand to assist confused customers diagnose problems, provide repair information (from their own ALLDATA system) and will even loan customers the specialised tools to install the part (for a refundable deposit). Private label products were first launched way back in 1986 and today their Duralast brand comprises well over 50% of AZO’s sales and with higher profit margins. Duralast’s brand equity is to AZO, what Kirkland is to Costco. AZO has long offered warranties, some of which extend up to a lifetime. Its distribution DNA is evident when you consider that roughly 30 years ago, it was one of the first adopters of real time inventory management systems, and of software linking distribution centres to stores linked via a satellite connection.

Today, the automotive aftermarket parts industry is split roughly 45:55 between the so-called do it yourself (“DIY”) and commercial (“PRO”) channels. The DIY channel caters to weekend “wannabe” mechanics. It is consolidated with the top four players representing roughly two thirds of all retail stores. AZO is the number one player by market share and approximately 60% greater than the number two competitor. DIY is mature and growing at low single digits, though AZO continues to take market share opening new stores and crowding out lesser competitors.

In contrast, the PRO channel caters to professional workshops. It is highly fragmented, with the top four players representing just over one quarter of the market. PRO is also growing faster, with younger cohorts less inclined to get their hands dirty and newer cars becoming ever more complex. Whereas DIY represents AZO’s past, PRO represents its future.

Historically DIY and PRO were run as separate businesses, though more recently the distinction has become blurred. In the past, PRO was dominated by wholesale distributors operating a “two-step” delivery model. Because they hold inventory at huge regional distribution centres, which are far away from customers, a two-step fulfilment is most efficient. First, they deliver multiple orders from the distribution centre to local branches, packaged together (in a big truck). Second, they unpackage the individual orders at the local branch and deliver to the client (in a minivan). In contrast, DIY retailers hold a huge selection of inventory in their stores, close to DIY customers, which allows for faster fulfilment. Increasingly they are operating a one-step PRO delivery from their stores (in a minivan) using the stores as local PRO branches.

Notwithstanding the parts purchased from retailers are more expensive, PRO customers are not price sensitive on smaller ticket items (wiper blades, brake pads, etc.), which can be charged back to the customer. Moreover, they are incentivised to keep cars moving through the workshop on fixed price jobs. Indeed, the Autocare Association estimates that almost three quarters of PRO sales go to the first call supplier. Most critical is parts availability – which leads to getting the first call. That is: consistently having the right part, in the right place, at the right time. To achieve that, AZO has steadily been increasing inventory held close to customers, building more distribution centres called “mega hubs” and “hub-stores” (mini distribution centres and large stores), to fill the gaps.

Beyond that, AZO has rolled out several, scalable, value-added services to lock in PRO customers, such as:

- electronic ordering with “in-stock” visibility;
- AZO’s ALLDATA system which diagnoses problems, looks up compatible Original Equipment Manufacturer (OEM), private label parts and OEM fitting instructions;
- shop management systems to create work orders/quotes, store CRM data and schedule jobs;
- automatic inventory restocking “push” notifications; and
- technician training.

AZO’s PRO strategy is working. Faster fulfilment speed and “soft dollar” services have grown the retailer’s PRO market share. The Autocare Association estimates that the top four share of first calls increased from approximately 44% in 2019 to 52% in 2021. Though the US market is mature, there remains a considerable consolidation opportunity.

Outside the US, AZO has a presence in Mexico and Brazil, which are faster growing due to lower automobile penetration. The opportunity is material, if one considers the combined population is similarly sized to the US, and

On and off, there have been questions as to the defensibility of AZO’s competitive “moat”. In the late twenty-teens it was the threat of online competition. However, DIY customers have not embraced the online channel. Indeed, AZO has long operated “omnichannel” and found that most of their online demand is “click and collect”. This is not surprising considering many failures require immediate fixing without which the car cannot operate, and customers benefit from the other services of a store (such as diagnosis, fitting instructions, tool loan, etc.).

More recently, there have been fears around growth in pure electric vehicles (EV) (i.e., not hybrids) which have fewer parts, since there is no engine. However, the EV transition is happening very slowly, giving the aftermarket time to adjust. Moreover, AZO’s core clientele tend to drive old “bangers”. Consumers seem hesitant over EV due to higher prices, range anxiety, charging time and fears about residual values (due to the high cost of replacing expired batteries). Despite unsustainable subsidies, EV’s currently comprise about 10% of new vehicle sales and less than 1% of the entire US fleet, which averages 12.5 years of age. Management seems sanguine about the EV threat, highlighting the “dirty little secret” of the industry that volumes have already been challenged for over 25 years due to the quality of parts having improved to such an extent that they fail much less frequently. AZO estimates the “drag” to have been between 2-4% per annum on transaction numbers, which has been offset by higher priced parts (better materials, quality, more technology, etc). Put simply, fewer EV parts does not necessarily translate to less revenue when those parts are more valuable.

Management is as shareholder friendly as they come. Their philosophy can be summed up by the then CEO, Bill Rhodes’, comment in 2013 around the time we first invested, *“our primary focus continues to be that we ensure every incremental dollar of capital that we deploy in this business provides an acceptable return, well in excess of our cost of capital. It is important to re-enforce that we will always maintain our diligence regarding capital stewardship, as the capital we invest is our shareholder’s capital”*.

The late, great Charlie Munger once quipped, “look at cannibals” by which he meant focus on companies which are “eating themselves” by aggressively buying back bucketloads of their own stock. Over the past 25 years, AZO has devoured an astonishing 88% of their shares, reducing share count by over 8% per annum. Moreover, they have done so without ballooning their balance sheet, consistently keeping leverage within their target range.

As we write this, AZO trades at a high teens P/E which is a material discount to the S&P 500 Index, despite offering superior long-term growth prospects. We aren’t complaining about their lowly rating. Paradoxically, it means more shares the company can cannibalise, all else being equal. AZO’s appetite is evidently insatiable. Hungry enough to eat the tail feathers off a low flying duck!



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