Revisiting CDK Global (CDK)

scuttlebuttinvestor.com/blog/2015/6/16/revisiting-cdk-global-cdk

June 17, 2015

I didn't plan to write a followup post to my original post on CDK Global (CDK), but I believe that today's announcements necessitate a followup post. As an outside bystander, it appears that the activist investors (Fir Tree and Sachem Head) that have been involved with the company have had success pushing for transformative changes. Kudos to them. As a result, CDK released its Transformative Plan to Strengthen the Business and Enhance Long Term Value along with a supporting presentation today. Investors liked the announcement and the stock had a big pop today.

My original thesis and model accounted for significant margin improvement in CDK's business based on benchmarks of Reynolds & Reynolds (a competitor dealership management software company) and the resulting margin improvement when it was acquired by Private Equity. However, CDK's initiatives are further reaching than I had anticipated and thus a model revision is necessary to account for these initiatives. Based on their release, CDK expects to:

- Grow revenue 4% to 5% annually on average for the next three fiscal years, and 5% to 7% thereafter;
- Target adjusted EBITDA margin for fiscal 2018 of 35% for total CDK;
- Target segment adjusted pretax margins for fiscal 2018 – 45% for Automotive Retail North America, 20% for Digital Marketing, and 25% for Automotive Retail International;
  Adjusted pretax earnings will grow more than 25% annually on average for the next three fiscal years;
- Return 70% to 80% of free cash flow to shareholders through dividends and share repurchases or other appropriate vehicles that are available.

To convey the impressive magnitude of the margin expansion that CDK is forecasting, it is worth comparing the target segment pretax margins for 2018 to actual margins in 2014 as I've done below:

- North America Automotive Retail Solutions: ~28% in 2014 -----> target of 45% in 2018
- International Automotive Retail Solutions: ~14% in 2014 -----> target of 25% in 2018
- Digital Marketing Solutions: ~7% in 2014 -----> target of 20% in 2018

This is impressive margin improvement for the business and should drive significant value for shareholders as long as CDK doesn't sacrifice its service levels, product quality and product investment in the pursuit of margin improvement. This chase for margin is a risk I highlighted in my previous post.

Taking into account the scale of margin improvement targeted by the management team and the revenue growth forecast, I believe that CDK's intrinsic value is in the neighborhood of ~$60. With the pop today, this provides minor upside of ~7%. CDK continues to be a wonderful business with durable competitive advantages. Look for dips to acquire and provide some margin of safety.
