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Clunkers, Inc.

In December, we the people saved 2.4% of our disposable personal income, one of the lowest monthly readings on record. In a related item of interest, 44% of surveyed Americans told the Federal Reserve's pollsters at the latest sounding (it pertained to 2016) that, to meet an unexpected $400 expense, they would have to borrow money or visit the pawnshop.

Such unsettling facts constitute the background music of this unfolding essay. Reiteration of our bearish view of CarMax, Inc. (KMX on the New York Stock Exchange) is the investment business at hand.

Slow loans are on the up-creep, rising wages and falling tax rates notwithstanding. Thus, mortgage delinquencies, having plummeted in a more or less straight line between the first quarter of 2010 and the second quarter of 2017—to 4.24% from 10.06%—have jumped by 93 basis points, to 5.17%, over the past six months. In the fourth quarter, past-due auto loans rose by 30 basis points, to 4.05%, and past-due credit-card loans by 41 basis points, to 7.55% (both on a year-over-year basis). They were the highest readings in 20 quarters and seven quarters, respectively.

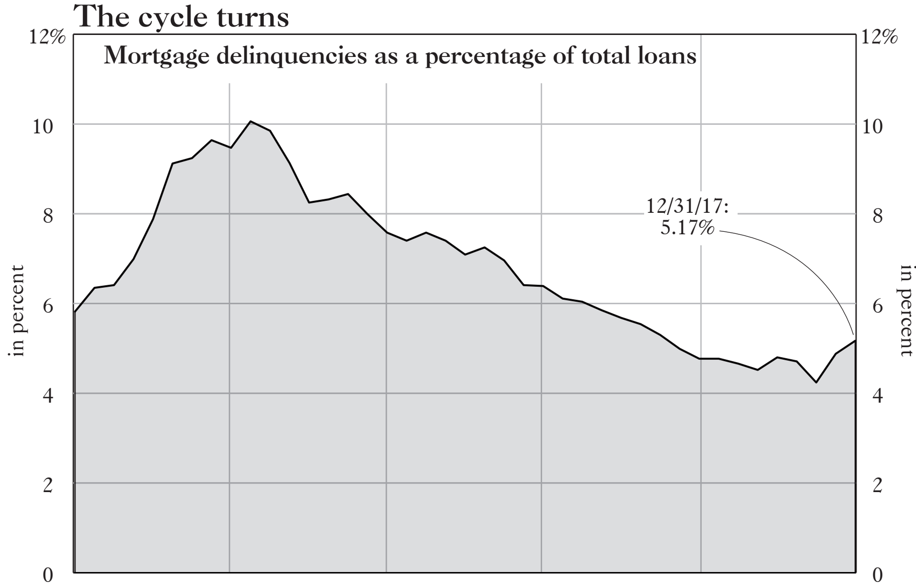
Speculative-grade consumers are leading the new slow-pay movement. You can see it, for instance, in the spurt of delinquent loans at Santander Consumer USA Holdings, Inc., the largest subprime auto lender (to 15.7% in the fourth quarter, from 15.1% on Dec. 31, 2016—see *Grant's*, March 7, 2014). Cumulative losses on a 2015 securitization by the deep subprime lender CarNow Acceptance Company have already reached 33%, uncomfortably higher than the 27% or so that Standard & Poor's expected for the lifetime of the deal.

"[A] large percentage of the population is living very close to the edge," Sean Fox, co-president of Freedom Financial Network, the No. 1 company in the flourishing American consumer-debt restructuring industry, tells colleague Evan Lorenz. Medical bills and borrowing from online lenders such as LendingClub Corp. (*Grant's*, Jan. 23, 2015) are two common threads in the stories of financially distressed consumers. "Our average client has anywhere from $25,000 to $30,000 worth of debt, and most of that is credit-card debt," Fox says. "You are talking about anywhere from five to 10 credit cards. These are consumers that were prime at one point and were able to get access to credit." Many an overextended borrower raises a final online debt-consolidation loan before succumbing to default.

So far, such signs of distress are mere noises off; as far as the credit markets are concerned, the bullish script remains intact. Thus, a triple-B-rated tranche of a January securitization by Santander Consumer came to market 50 basis points cheaper than Santander paid in a comparable September financing. "The securitization markets continue to be open and pretty hot these days," Christopher Halmy, CFO of Ally Financial, Inc., the former captive lender to General Motors Co., attested on a Jan. 30 earnings call.

Credit being ample, lenders are competing to extend it. As for that new, reduced corporate-tax rate, it has the effect

The cycle turns



source: The Bloomberg

of allowing lenders to generate the same ROE with a lower level of pre-tax profits. And it is, for that reason, another impetus to more aggressive underwriting practices.

Still and all, interest rates are pushing higher. Thus, the average rate on a 60-month auto loan reached 4.51% in November 2017, up from 4.05% in November 2016. Ally nowadays is getting 6½% on new loans, up from an average 5.8% portfolio yield.

"Thanks to Bloomberg," Lorenz points out, "you can graph 42 years' worth of car sales against the unemployment rate. So doing, you will notice that sales peak several quarters to several years before the unemployment rate begins to rise. Since most new-car purchases are financed, rising rates mean fewer sales. The Fed began tightening in 2015. Auto sales peaked in 2016 at 17.5 million units and declined to 17.1 million units in 2017. It's par for the cyclical course."

Interest rates are one pulse point of the automotive industry. Used-vehicle prices are another (*Grant's*, Feb. 24, 2017). Elevated prices for what the trade is wont to designate "previously owned" cars and trucks constitute a richer trade-in currency for the 90% of buyers who have something to trade. Creditors, too, benefit from lofty prices, which dampen the loss in the event of default while emboldening lessors to assume greater residual values at the end of a lease.

You may recall (even if you'd rather forget) that auto sales collapsed to 10.4 million in 2009 from 16.1 million in 2007 and remained below 15 million until 2013. There was a silver lining. Fewer used cars meant stronger used-car prices. After dropping by 11% in 2008, the Manheim Used Vehicle Value Index rallied by 20% in 2009 and stayed in a tight, high range through the start of 2017. This kicked off a virtuous cycle in the automotive industry, and no segment benefited more than auto leases. New-vehicle sales financed with a lease ballooned to 30% of sales in 2016 from 13% in 2009.

Because most auto leases are structured as three-year contracts, a boom in auto leasing makes for a reciprocal bulge in the supply of off-lease vehicles; you see it 36 months later. Thus, in 2017, 3.6 million 2014-vintage autos hit the market; this year, an estimated 4 million 2015-vintage cars will go on sale. As 29.4% of new-auto sales last year were financed with leases, according to J.D. Power & Associates, this wave of fresh supply will keep rolling through at least 2020.

Trade-in values are sensitive to used-car prices and interest rates. They vary, too, with the length of auto-loan maturities. Maturities are lengthening (to 69 months from the customary 60 months), rates are rising and used-car prices are softening—three substantial negatives.

Daniel Ruiz, founder of Blinders Off LLC, a research boutique focused on the automotive sector, quantifies these variables in a concept he calls "time to equity." It means, how long till I have a positive value in my ride so that I can trade it in for a new ride?

By Ruiz's calculation, time to equity, i.e., time to positive equity, ballooned to 40 months in 2008 and shortened to 30 months in 2011. It was back to 37 months in 2017 and is expected to stretch further in 2018 as interest rates rise and used-vehicle values sag.

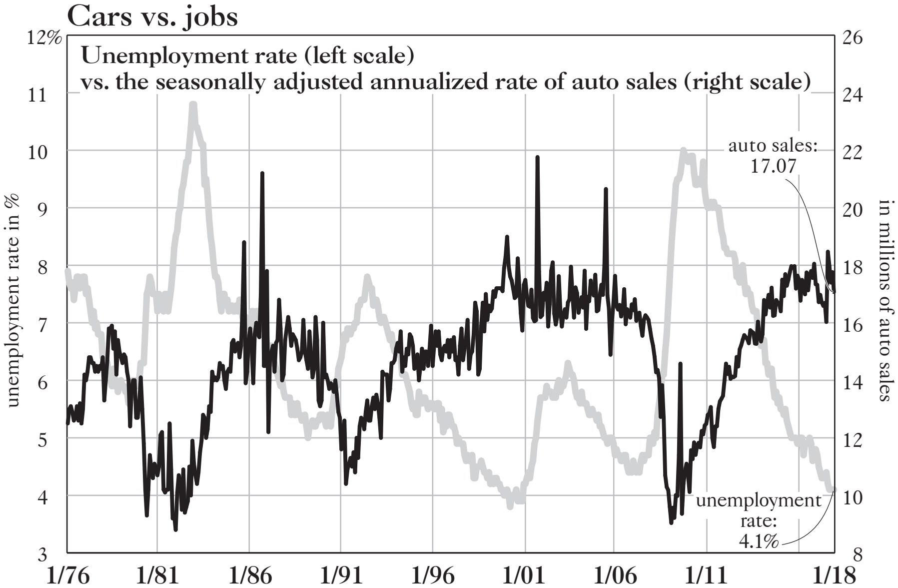
If you can't produce $400 on the spot, you are most assuredly a candidate for an auto loan. According to Kelley Blue Book, the average price of a new vehicle was $36,270 in January. That represents 61% of the most recently calculated median household income of $59,039.

"You've kind of seen that movie play out in small and compact cars over the past two or three years because that was where the leasing was initially concentrated," Brian Foran, a partner at Autonomous Research LLP who covers U.S. banks, tells Lorenz. "That's where you got the off-rental pressure as well. Everyone quotes used-auto prices in aggregate, but the reality is that you've had trucks and SUVs do pretty well and you've had traditional sedans being a little bit of a disaster over the past couple of years."

At the start of 2017, it appeared that the deluge of off-lease vehicles was set to disrupt the auto industry. According to the J.D. Power Used Vehicle Price Index, second-hand car prices declined at a 4% to 5% annual rate through spring and early summer. Then came a succession of car-wrecking floods, hurricanes and wildfires. Lo and behold, from May through October, used-vehicle prices rallied by 3.2%.

Then they stopped rallying and resumed falling—between October and January, by 2.6%, or at a 10.1% annualized rate. The mix of off-lease vehicles in 2018 is expected to shift away from compact cars. (It was in 2015 that consumers began buying trucks, SUVs and crossovers in greater numbers.) This appears to be showing up in the composition of used-car prices. "At the top of the depreciation scale, luxury mid-size car prices fell by an average of 3.1%," relates the J.D. Power used-car report for February. "Losses for this segment were driven primarily by an influx of 3-year-old 2015 model year units return[ing] to the market. . . . On the mainstream side of the market, declines were led by large pickup and utility segments. While large pickup prices continue to be strong, the segment is showing signs of losing momentum."

Cars vs. jobs



source: The Bloomberg

As trade-in values drift lower and interest rates climb higher, OEMs are having to offer more discounts to keep the iron moving. Incentives for new sales went up by 8%, to $3,740 per vehicle, in January according to Autodata Group. Subvention, auto-market lingo for OEMs paying their captive finance units to furnish below-market lease rates, increased to $5,791 per lease in 2017 from $5,535 in 2016 according to J.D. Power. This exacerbates the pressure on used-car prices as, all things being equal, consumers prefer that new-car smell.

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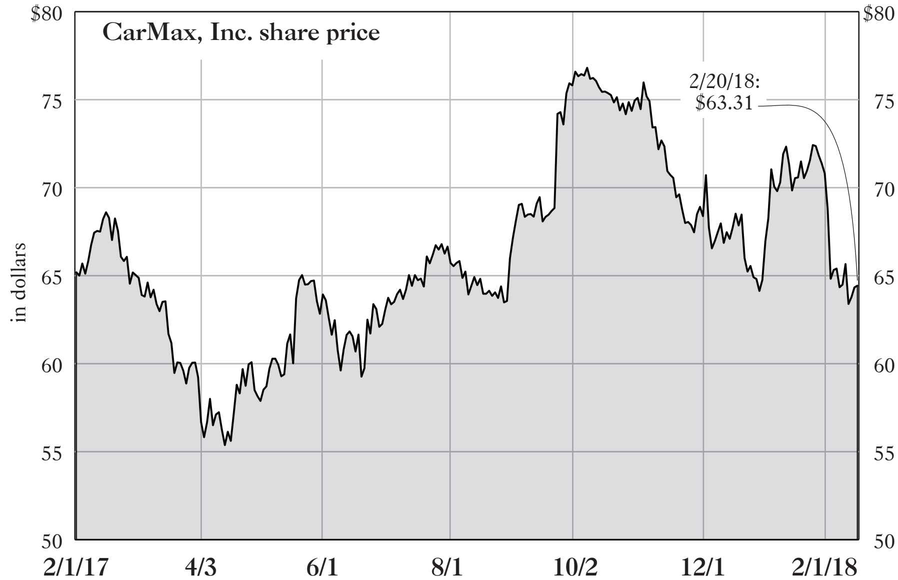
All of this portends trouble for CarMax. You might not suppose there's much to quarrel with in the results of this titan of second-hand transportation. In the three months ended Nov. 30, 2017, sales of used vehicles showed 8.2% growth (by 169,648 units) from 185 CarMax lots (9.5% more than the year before). As one of the biggest auctioneers in the United States, CarMax hammered down another 100,332 cars to the wholesale trade. CarMax Auto Finance (CAF), the captive subsidiary, financed 44% of sales last quarter, down from 45% in the quarter ended Nov. 30, 2016. CAF, which holds $11.4 billion in loans, issued $1.5 billion in new credit last quarter at an average loan-to-value ratio of 95.1% and at an average term of 65.8 months. Since our first CarMax inspection last year (see the issue dated Feb. 24, 2017), the share price has sunk by 3.8% against a 14.7% rally in the S&P 500.

The headline over this analysis is no reflection on CarMax's customer-friendly business model. Every vehicle on the corporate lot goes through a 125-point inspection, prices are haggle-free and each vehicle comes with a one-month warranty and five-day money-back guarantee.

Other dealers are busily emulating the leader. AutoNation, Inc., the top retailer of new and used vehicles, is one adoptee of the CarMax model. Carvana Co., an online-only competitor that arranges test drives and customer financing, is growing rapidly following its IPO last April.

In reverse?



source: The Bloomberg

CarLotz, a used dealer with six locations in Virginia, Florida and North Carolina, has developed a new business model that may harry CarMax. CarLotz works on the consignment model. For a flat fee, it takes vehicles from individuals and corporate fleets and prepares them for sale. "Our innovative approach helps sellers get what their car is worth without the hassle of selling it themselves," the company declares on its website, "and our buyers pay 10–20% below traditional dealership prices." This technique may be particularly attractive for managers of corporate fleets as CarLotz can sell vehicles at prices better than those typically available through wholesale auctions (in which, as noted, CarMax does an important business).

"Facebook, Inc. is likewise taking the measure of the used-car market," Lorenz reports. "In October the social-media giant created a dedicated section of its Marketplace for used cars. Dealers as well as individuals may post, and Edmunds, Cars.com and Auction123, among others, have already availed themselves of the opportunity. This is an important threat. Part of the reason why CarMax has been able to take share in the used market is that smaller dealers can't match the company's investments in technology. Facebook's entry may help to level the playing field.

"Even traditional lenders are muscling in on auctions," Lorenz proceeds. "Just the other day, Ally Financial announced plans to feature off-lease Nissan and Infiniti vehicles on its wholesale auction platform. What this might mean for CarMax can be inferred from the fact that 14.5% of CarMax's listed inventory comprises Nissans and Infinitis. An increase in competition from auto lenders would also put pressure on the CarMax finance business. In the quarter ended Nov. 30, 2017, income from CAF footed to $102.8 million, about half of the $225.2 million in profits before taxes."

CarMax trades at 16.4 times estimated earnings for the fiscal year ending Feb. 28. Wall Street is neither here nor there on the stock: 5.7% of the float is sold short, which says that bears are gnawing CarMax's tires. Of the 18 analysts who cover the stock, nine say buy, seven say hold and two say sell. Management, for its part, lines up with the shorts. Over the past 12 months, insiders have sold a net 844,787 shares for proceeds of $60.5 million.

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