GRANT'S
INTEREST RATE OBSERVER®
Vol. 36, No.22f Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 16, 2018

Used and abused

The point of ultra-low interest rates is to yank consumer demand into the present from the future. Evidently, that mission is accomplished, but what will become of the industries whose demand has thus been accelerated? With respect to the auto industry, we expect falling sales and lower residual values. Knock-on effects for CarMax, Inc. (KMX on the Big Board), a *Grant's* pick-not-to-click, are likewise in the cards.

At a glance, the automotive skies would appear cloudless. The 17.1 million unit annualized selling rate through October was exactly flat with the first 10 months of 2017. Auto loans and leases 30 days or more delinquent have registered a slight decline. New-car prices jumped by 3.1% in October from the year-earlier reading, according to Kelley Blue Book, while manufacturers' incentives tumbled by almost 3% in the 12 months to September, on the authority of J.D. Power.

And there's another source of uplift: Used auto prices zoomed 4.8% higher in the first 10 months of the year. Yes, that 2015 Chevrolet Cruze or 2014 Ford Fusion is worth more today than it was on New Year's Eve. Larry Dixon, senior director of valuation services at J.D. Power, says he's seen nothing like it since 2011–12.

Rising used-car values spread their cheer broadly. Because most purchases involve a trade-in, they make new vehicles more affordable. And because most purchases are financed, they embolden lenders to lend (since more collateral is better than less) and lessors to lease (since greater residual values at the end of a lease now seem reasonable).

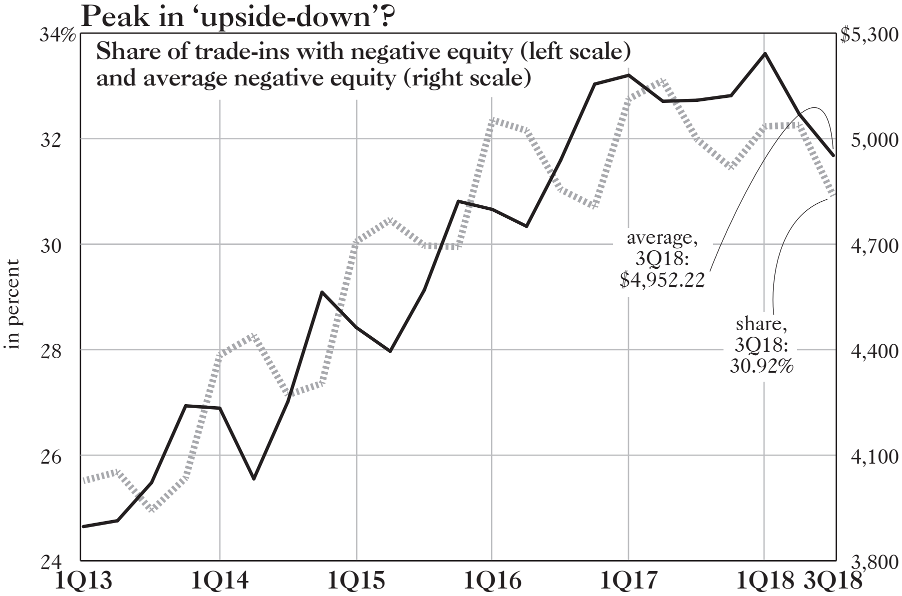
"However," relates colleague Evan Lorenz, "the pillars that propped up the car values, used and new, are buckling. Take leasing: Waves of off-lease vehicles came on the market two summers ago. Most auto leases have three-year terms. The proportion of cars financed through leasing stands at 30% today, up from 13% in 2009. This means the number of off-lease vehicles hitting the market will jump to 3.9 million in 2018 from 3.6 million in 2017. It will ratchet still higher in 2019."

As used inventory starts to pile up again—hurricanes delivered no significant demand bump this season, according to Anil Goyal, executive vice president of operations at Black Book—used-vehicle prices are under pressure. The 69 basis-point price decline registered in the final week of October was the steepest in any week this year, Goyal reports.

Meantime, new-car inventories are on the rise. As recently as June, with days inventory at 67, manufacturers had the green light to push up prices and reduce selling incentives. Now the light is amber, says Daniel Ruiz, founder of Blinders Off LLC, an automotive-research boutique, as the October inventory sighting reached 73. And he tells Lorenz, "If I use a 3% increase for the total supply of new vehicles, which is a slower growth rate than we observed in October, then we are going to be back at 78 days supply by December."

Fiat Chrysler Automobiles N.V., which sits on 100 days of inventory, is a particular worry. "The problem when you have a major manufacturer with that much in-

Peak in 'upside-down'?



source: Edmunds.com

ventory is at some point they will need to increase incentives," Ruiz goes on. "When you increase incentive spending, you impact used-car values. The other thing that happens is, when you increase incentive spending, the other manufacturers don't just sit by. Whether or not they have an inventory problem, they will follow trends."

For the accelerator of the post-crisis auto boom, look no further than extended lending terms and low interest rates. Consider that, at $37,007, the average new-car price is the equivalent of 60% of 2017 median annual household income. To move metal, then, lenders stretch terms. Thus, according to Experian, 33.2% of new-car loans ran longer than 73 months in the second quarter while only 19.4% ran for 60 months or less.

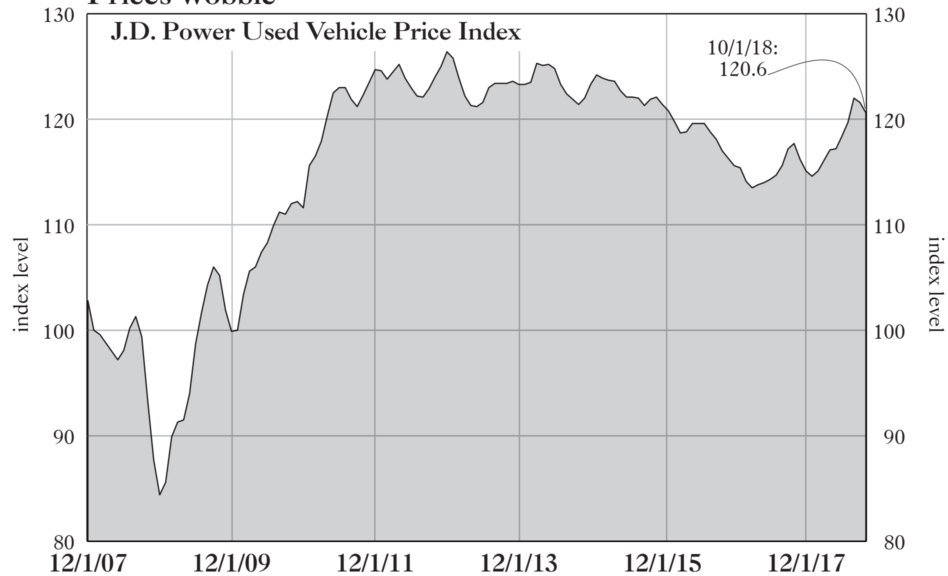
The securitizations of Santander Consumer U.S.A. Holdings, Inc., America's largest subprime auto lender, shine a light on this great stretch. Thus, the average loan in Santander's first securitization in 2007 bore an original term of 62 months. In the latest 2018 securitization, the average loan runs for 71 months.

Americans may trade in their cars every two to three years (Ally Financial, Inc. says it turns over its auto-loan book every two to two-and-a-half years), but that doesn't mean they borrow for two or three years. Longer terms reduce the size of monthly payments.

"Increasing a loan term by a year has a bigger impact on affordability than cutting interest rates by a whole point," Lorenz points out. "In the second quarter, the average prime customer paid 4.45% to finance a new car. On a 60-month term, financing $37,007 would require a $689.08 monthly payment. Cut the borrowing cost to $3.45%, and you'd be looking at a $672.39 monthly payment. But extend the term of a 4.45%, 60-month loan to 72 months, and you reduce the monthly payment to $586.60."

Naturally, the longer one takes to pay, the longer one waits to build equity. At the three-year mark, a customer in a 60-month loan will have paid off 56% of his balance. At the identical three-year milestone, a customer with a 72-month loan will have paid off just 45% of his balance. According to Edmunds.com, 30.9% of buyers in the third quarter had negative equity on a trade-in—meaning, they owed $4,952 more than they owned, on average. That was up from a $4,022 deficit in the third quarter of 2013.

Prices wobble



source: J.D. Power

Creditors finally do learn, and what they learned after 2015–16 is not to extend subprime auto loans to FICO-score-challenged customers at loan-to-value readings of 110%. And if Santander, for one, continues to extend subprime credit at LTVs in excess of 100%, it at least has tightened FICO standards (to 623 at last report, from 595 in 2015) and desisted from extending maturities beyond 71 months. Perhaps this less loose approach to loan origination has something to do with the finding of Edmunds.com that average negative equity peaked at $5,242 per vehicle in the first quarter of 2018 and has subsequently declined.

Stingier lending hits aspirational buyers hardest. "The percent of subprime loan originations on new vehicles has fallen off fairly significantly," Dixon tells Lorenz. "I think that also speaks to the appetite for risk that lenders have even in the face of a market where defaults and delinquencies are near historic lows. Lenders are showing less appetite for risk. That is cutting out a certain portion of the market in terms of new vehicles." For one reason or another—the post-2016 rise in interest rates is an obvious culprit—auto loans outstanding grew by 4% in the second quarter, less than half the 8.8% annual rate registered between 2011 and 2017.

Rising rates have altered the auto-credit landscape in surprising ways. Thus, paid-up subscriber William Grebe reports that Mercedes-Benz has written to invite him to partake of "an impressive investment opportunity designed for those who demand performance in all pursuits." The Mercedes "First Class Demand Notes" offer a 2.75% yield "on funds that are available to you on demand," a premium to the 2.6% three-month London interbank offered rate. Lacking a cheap base of deposits, the captive Mercedes-Benz financial subsidiary appears to be canvassing its customers, even those who perhaps only vaguely recall once having been a customer. Grebe tells Lorenz that he hasn't owned a Mercedes in 15 years.

"The pricier mix of off-lease vehicles returning to the market (SUVs and trucks predominate over light sedans) will result in some combination of a slower pace of sales and a greater depreciation of prices," Lorenz observes. "Slightly tighter credit, higher rates and lower used-car prices will further pressure affordability and push out the point in time when consumers build positive equity. This is especially true for the 2015–16 cohort of buyers, who saw the low in underwriting and rates and, after two to three years in their old jalopies, are pining for that new-car smell."

Such forces bear on CarMax. In the quarter ended Aug. 31, the undisputed leader in used-car merchandising sold 196,880 vehicles at retail, 120,866 at wholesale. New-store openings (there were 194 compared with 180 in the corresponding period of 2017) and a 2.1% rise in same-store unit sales were enough to lift retail unit sales by 5.8%. CarMax Auto Finance (CAF) facilitated 43.9% of those sales, issuing $1.7 billion in credit with an average loan-to-value ratio of 95.2%. As of Aug. 31, CAF's loan portfolio footed to $12.1 billion. Since we last kicked the tires (*Grant's*, Feb. 23), CarMax's shares have risen by 4.5% and the S&P 500 has fallen by 0.9%.

The CarMax way of doing business is one that the Better Business Bureau might have invented. 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.

CarMax trades at 16.2 times trailing earnings. Out of the 17 analysts who follow the company, 11 say buy, none says sell. The four largest auto dealers by market capitalization (Penske Automotive Group, Inc., AutoNation, Inc., Lithia Motors, Inc. and Asbury Automotive Group, Inc.) trade at an average of half the CarMax multiple.

With a backward glance, the disparity is obvious—CarMax has earned its supremacy. The valuation gulf is a little less obvious with a forward squint—the competition is coming on strong. For one thing, the big public dealers have an inside track on used-vehicle inventory. They get first shot at buying off-lease cars and trucks as those units are returned to the manufacturers. CarMax, in contrast, must secure its inventory through wholesale auctions and negotiated purchases from individuals. Then, too, CarMax has taught the competition the value of treating the customer like the sovereign he is. AutoNation has adopted CarMax's haggle-free approach. Penske, directly copying CarMax, is building standalone used-car megastores. On Sept. 13, Lithia invested $54 million and became the largest shareholder in Shift Technologies, Inc., an online-only car retailer. As part of the partnership with Shift, Lithia will share its physical infrastructure with the digital upstart.

Carvana Co., the online-only used-car retailer, gets top marks for imagination: It displays its wares in glass-encased vending-machine towers—you can find them in Austin, Nashville and Houston. Just drop a large silver slug into the slot and your car descends to earth. The video "My experience with a Carvana vending machine" has garnered 41,704 YouTube views.

Carvana expanded sales by a whopping 137%, to $534.9 million, in the third quarter. Impressive, too, was the surge in gross profit per unit (GPU): It climbed to $2,302 from $1,742 in the year-earlier period. CarMax, which targets GPU of around $2,200, delivered $2,179 in the quarter ended Aug. 31. Though it builds no stores, only vending towers, Carvana is nonetheless spending heavily to expand, and it's produced no operating profit.

Shares of KMX reached a low of $58.77 on April 9 following the release of fiscal fourth-quarter results that featured an 8% decline in same-store unit sales. Comparable unit sales recovered with the rally in previously-owned-vehicle prices, up 1.6% in first quarter and 2.1% in the second quarter, an upswing that would appear to be over or ending.

"The risk to CarMax from its finance subsidiary," Lorenz comments, "lies not with direct exposure to the loans it issues. After all, CAF funds itself by securitizing its loans and transferring the risk to third parties. The risk is rather that some future hiccup in the securitization markets may interrupt the lucrative flow of intra-corporate dividends. In the 12 months ended Aug. 31, the subsidiary supplied 41% to pre-tax parental profits."

Meantime, CarMax insiders are voting with their wallets. Over the past 12 months, executives have sold a net 964,739 shares for proceeds of $70.8 million. They sold when the share price dipped down to $60 in the spring, and they sold when the share price was in the upper-$70 range in the summer.

"Let's remember used-car prices have been high for so long," warned CEO Richard D. Fairbank, CEO of Capital One Financial Corp., a major auto lender, on that company's Oct. 23 earnings call. "We fear the industry forgot about where they are at some point. The only way has got to be down on some of that stuff."

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