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Calling all cars

Evan Lorenz writes:

Which will it be in the wake of Covid-19, inflation or deflation? In the case of the far-flung auto industry, the correct answer is "both." Now on deck is an overview of the pandemic-addled market for cars and light trucks. It's preface to bearish analyses of CarMax, Inc. (KMX) and Carvana Co. (CVNA; both on the New York Stock Exchange).

The Manheim Index of used-vehicle prices plunged by 12.3% between March and April, the sharpest decline in the series' history. But the same index leapt by 18.7% between May and June, the steepest rise in the series' history. It sits today at an all-time high.

Many factors drove the sell-off. For one, around half of the nation's auto dealers shut their doors and pared inventory "to enhance our liquidity position," as CarMax described its own approach to the lockdown.

In the depths of the panic, auto manufacturers enticed their homebound clientele with various incentives. Zero-percent loans closed 25.8% of new-car transactions in April, up from just 3.6% in February (*Grant's*, May 15). And since used cars compete for the same wallet as new vehicles, used-car prices buckled.

While new-auto sales plummeted to an 8.6 million annualized rate in April, from 16.8 million in February, they snapped back to 13.1 million in June. A faster-than-anticipated rebound in sales, plus supply disruptions due to the virus, depleted new-vehicle inventory.

Responding to the supply situation, OEMs pulled incentives, and average sales prices ticked higher. Lower incentives on new cars, in turn, lifted used-car prices.

"Used-car prices stabilized while half of the dealer network was still closed," Daniel Ruiz, the founder of Blinders Off, LLC, an automotive-research boutique, tells me. "Used inventory had dropped so low that despite the fact that half of the dealer network was still closed, dealers that were open had to go back to the auctions to replenish." And as the rest of the country reopened for business, pent-up demand greeted the formerly shuttered dealers, producing a further draw on used-vehicle supply. "We are 30% down on used-car retail inventory year-over-year," says Ruiz.

Cory Armand, a partner at Rice Voelker, LLC, New Orleans, tells me that his office has fielded cold calls from local dealers asking if they'd care to part company with their two-year-old wheels. "We'll buy your car" is the theme of a sales push by AutoNation, Inc., America's second-largest dealer by revenue.

Banks, too, have stoked the recovery in auto sales. In the depths of March, corporate America tapped bank lines for precautionary balances, but such borrowing has receded, and auto lending has become a rare source of bank-loan growth. Between May 6 and July 22, auto credits chugged higher by 1.2%, to $458.9 billion, making that loan category the second-fastest growing one after construction and development.

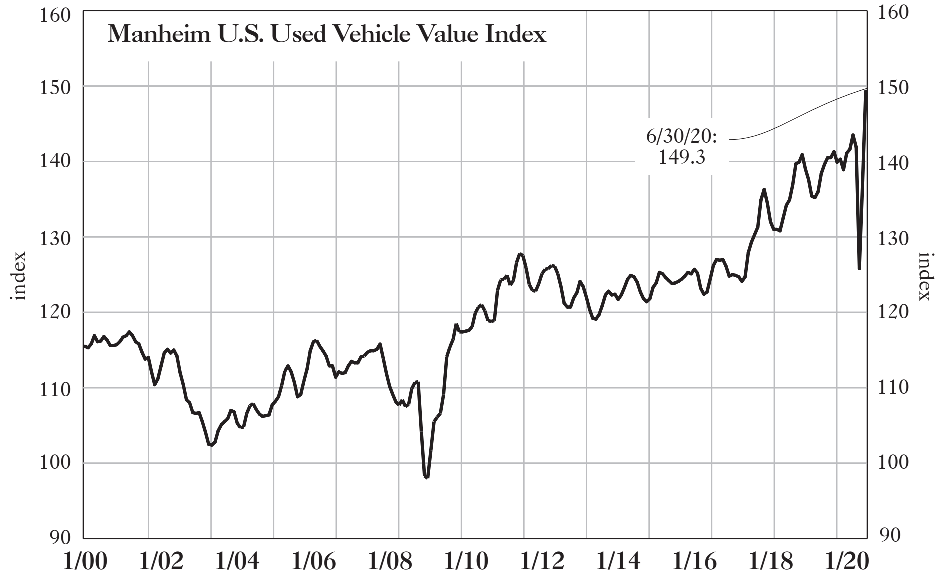
Not that auto loans have proven to be such standout balance-sheet performers. According to TransUnion, the proportion of car loans in forbearance rose to 7.2% in June from 0.6% in March. Tourism meccas have been particularly hard-hit, says Kroll Bond Rating Agency, with Nevada (19.2% of loans either 30-plus days behind schedule or in deferment), Hawaii (18.9%) and Florida (22.2%) showing the greatest levels of stress.

And the clock is ticking on grace periods, which rarely stretch beyond 90 days. Ally Financial, Inc., General Motors Co.'s former captive lender, says that 30% of its auto deferrals expired as of June 30, that 34% more will end in July and 32% will stop in August. The level of federal stimulus and/or the pace of economic recovery will determine whether the temporarily forgiven debtors return to the good graces of their creditors. As we go to press, Congress is still debating the fate of the additional $600 per week in Coronavirus Aid, Relief and Economic Security Act unemployment benefits. "The substantial auto-loan payment deferrals expiring over the next two months, combined with reduced government benefits," Armand tells me, "will be the moment of truth for the subprime auto credit market, where the deferrals are much higher and borrowers are more vulnerable."

The nation's auto-repo men and women, idled by widespread loan-payment moratoria, will soon return to service, explains Alex Yurchenko, Black Book's senior vice president of data science. If so, they themselves will augment the supply of used vehicles.

Other sources of supply are expected to open in the second half of the year. Hertz Global Holdings, Inc., the rental-car giant that filed for bankruptcy protection on May 22, laid out a plan to sell 133,819 cars between July and December. Yurchenko says that lenders gave extensions to consumers with expiring

No deflation here



source: The Bloomberg

auto leases at the start of the pandemic, but these leased units are expected to trickle back to auctions soon.

Taking one thing with another, says Zohaib Rahim, manager of economic and industry insights at Cox Automotive, Inc., used-vehicle prices are likely peaking now: "[W]e'll see slight declines in late summer/early fall before stabilizing at year-end."

While auto manufacturers have restarted factories, it's no easy matter refilling empty dealer lots. High rates of virus-related absenteeism are stymying attempts by GM to keep a third shift running at its Wentzville, Ala. pickup-truck assembly plant. In Mexico, political protests are blocking a rail line that serves the Ford plant at Hermosillo. Workers at Volkswagen A.G.'s Puebla plant are threatening to strike this month in the absence of a 12% raise.

The virus-cum-recession will likely weigh on used-vehicle supply for a very long time, if the analysts at Bank of America Corp. are on the beam. They predict that new-car sales will languish at about 12.8 million units for 2020, down 25%, and that a return to the 16 million level may take years.

"We think that, in general, wholesale transaction volumes are going to start declining," Rahim says. (Cox Automotive is the owner of Manheim Auctions, the biggest vehicle wholesaler in the United States). "Inventory will continue to be a challenge and an important strategic priority for dealers across the country."

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CarMax, a longtime *Grant's* pick not to click (see the issue dated Nov. 16, 2018), is America's largest pure-play used-car dealer. Operating 225 dealerships in 41 states, the 27-year-old company sold 1.3 million vehicles in the fiscal year ended Feb. 29 (retail buyers took not quite two-thirds of the total, the wholesale trade, the balance). In the same 12 months, CarMax Auto Finance funded 46.7% of customer purchases, in the process generating 39% of company-wide pretax profit.

You can't help but admire the 125-point inspection to which CarMax subjects each vehicle on the corporate lot, or the fact that its prices are haggle-free or that every customer drives away with a three-month warranty and a one-week money-back guarantee.

Nor does the Street withhold its admiration. A projected tumble in earnings per share in the current (2021) fiscal year, to $3.17 from $5.33, will merely set the stage for a rebound to $5.24 in 2022, analysts predict.

To cope with the viral slump, CarMax is cutting costs and accelerating its digital transformation. On the June 16 earnings call, management touted its "omni-channel experience," meaning both online and offline sales; by the end of the August quarter, it vowed, all its dealerships will be online. The CEO is taking a 50% pay cut, share repurchases are off the table and new dealership construction is on hold.

"Revenue growth post-pandemic is likely to convert at a higher incremental margin, given both a move toward more on-line sales and leaner cost structure," a group of analysts led by Rajat Gupta, who rates KMX a buy for J.P. Morgan Securities, LLC, proposed on June 1. "As these initiatives begin to bear fruit and the benefit to earnings trajectory beyond FY21 becomes more clear, we expect KMX's p/e multiple to gravitate higher over time, similar to other retailers that have successfully embraced on-line sales."

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Founded only eight years ago, Carvana is the used-car dealer with the trademark jumbo vending machines. It handles less than 15% of CarMax's volume but edges out its established rival in bragging rights as to points of inspection (150 to 125) and the length of its limited warranty (100 days to 90). Buyers can take delivery at their door or pick up their ride from one of the company's 24 glass-encased vending edifices. Drop a custom-made coin in the slot and, boom, you're done. It's how you bought apple pie at the automat.

Losing, at the moment, $3,501 before taxes on every vehicle it sells, CVNA targets its long-term earnings before interest, depreciation and amortization margins at 7%–11.5%. In a similar vein, *Grant's* targets long-term paid circulation greater than *The Wall Street Journal*'s, though getting there is strenuous work and the timetable is uncertain. At that, maybe Carvana is the better growth prospect, as its online-only business model could shine in this plague year. Analysts project 31% year-over-year revenue growth in 2020 with an acceleration to 42.5% in 2021. For comparison, CarMax's revenues are tipped to fall by 10.3% in the fiscal year ending next February.

"So long as fixed income investors' desire for the predictable stream of cash flows from used car loans persists, we expect equity investors to increasingly realize that a digitally native, online marketplace is the most efficient vehicle (pun intended) to drive loan origination growth and accordingly, equity value," Brad Erickson, who rates Carvana a buy for Needham & Co., LLC, playfully raved in June. "Dealers would seem to face meaningful long-term headwinds if [e]-commerce trends recently accelerated by pandemic become anything approaching a structural new normal."

But much of the good news appears to be priced into these stocks. After declining by 50% and 68%, respectively, between Dec. 31, 2019 and March 20, the shares of CarMax and Carvana have rebounded by 124% and 468%, meeting or skirting all-time highs. CarMax now trades at 27.7 times trailing earnings and 19 times the fiscal 2022 estimate. Carvana, which has yet to generate positive net income, is priced at 6.5 times enterprise value to trailing sales, a premium to the multiple of five that Amazon.com, Inc. commands.

Of the 16 analysts who rate CarMax, 13 say buy and one says sell. Carvana, perhaps owing to its higher valuation, earns only 12 buys against eight holds and two sells. Short interest amounts to 8.2% and 32%, respectively, of the KMX and CVNA equity market caps. Since March, insiders at CarMax have sold a net $59.3 million's worth of stock; at Carvana, officers and directors have stood pat.

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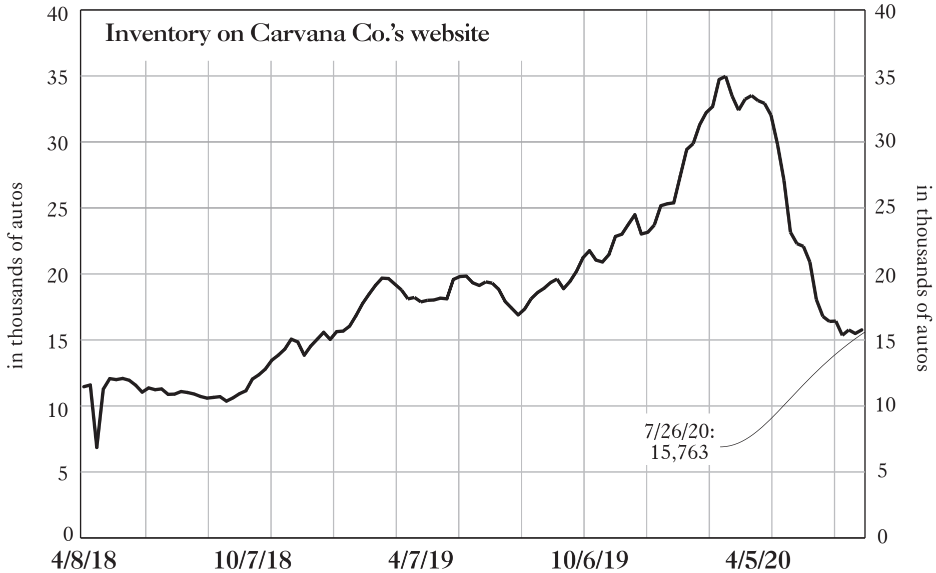
Economically sensitive businesses, CarMax and Carvana have their work cut out whatever happens to the GDP. On the one hand, if a second wave of Covid cases or a policy misstep scuttles the recovery, auto demand would weaken, a scenario for which neither stock is valued. On the other, if business activity reaccelerated, each would confront the higher-grade, but still margin-crimping, problem of inventory shortages.

While GDP collapsed at a record annualized rate of 32.9% between April and June, no equal and opposite bullish snapback is necessarily in the cards. "We have seen a drop in auto and vehicle searches nationwide," reports Peter Forbes, a data scientist at Arbor Research & Trading, LLC. "This fits in the context of a broad plateau in economic data and a retrenchment of consumers' going out searches."

The post-virus market heavily favors franchise auto dealers, like AutoNation and Penske Automotive Group, Inc., over standalone used-vehicle specialists like Carvana and CarMax. New-car dealers have the first shot at buying lease returns before OEMs move the vehicles to wholesale auctions. Most leases have a three-year term; and now that used-car prices exceed the residual values at

Cars wanted



source: YipitData

which leases were underwritten in 2017, franchise dealers have a strong incentive to buy vehicles coming off lease. Then, too, new-car dealers tend to get more recent-vintage trade-ins than their used-car competitors.

The inventory strain is already evident at Carvana. "Coming out of coronavirus, we stopped buying cars for probably 45 days, give or take," Ernie Garcia III, the co-founder, CEO and chairman of Carvana, told an audience at William Blair's 40th Annual Growth Stock Conference in June. "And, so, our inventory today is smaller than that, but we plan to build back that level and continue to build from there, and we think that's a big differentiator relative to the status quo for customers buying cars."

However, based on data sleuthing by YipitData, a boutique research firm, the number of vehicles listed on Carvana's website dwindled to 15,763 on July 26 from about 21,000 on May 31 and about 35,000 on March 1. Indeed, the late July figure may understate the drop, as only 4,975 vehicles listed on that date were available for purchase; the rest had either already been sold (7,515) or had yet to be inspected and reconditioned (3,273). Compare and contrast the situation on March 1, when 20,339 autos were for sale, or 58% of total listings versus only 32% of listings on July 26. Then, too, more and more of that posted inventory is the property of Carvana's partners rather than of Carvana itself. While Carvana does earn a fee for selling such units—481 on July 26, up from 17 at the end of March—most of the proceeds revert to the owners.

While the Street views Carvana and CarMax as having carved out insurmountable leads in online sales, the coronavirus is prodding the rest of the industry to catch up. According to Cox Automotive, 80% of franchise dealers had online storefronts operational by May. "I thought that Carvana, which was the leader, had a massive advantage over its competitors from a technological standpoint and eventually retail dealers would have to go that route, but I thought it would take years," Ruiz says. "Everything has been brought forward exponentially because of the crisis."

A margin squeeze is likewise plaguing the specialty used-car dealers. According to Black Book, wholesale used-car prices have appreciated by around 13% year-to-date, while, over the same span, retail used prices have fallen by about 4%. "Talking to dealers," recounts Yurchenko, "they're trying to push out the inventory as fast as they can. They're not raising prices because they're afraid that the market will turn quickly. So, the margin per vehicle has been shrinking since April."

With nearly a third of its float sold short, bears are well acquainted with Carvana, albeit for different reasons than we laid out above. In addition to the company's lack of profits, short sellers note that insiders control the company through super-voting shares and that it appears that related party transactions may account for a jump in the profits Carvana earned in securitizing subprime auto loans last year.

"At best, Carvana is a used car dealership masquerading as a high-growth tech business," Spruce Point Capital Management wrote in a March 1, 2019 report. "At worst, it's an uneconomical subprime auto loan originator being supported by an unknown party willing to purchase subprime auto loans at vastly off-market rates."

Looking past these concerns, Carvana's share price is capitalized for growth, a rarity in 2020. But if the dealer can't secure enough inventory to meet the Street's expectations, look out below.

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