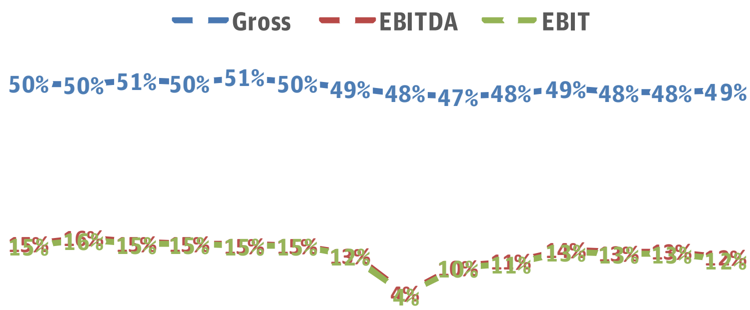
# SINGULAR DILIGENCE

## America's Car-Mart (CRMT)

# America's Car-Mart (NASDAQ: CRMT)
# Stock Price: $38.37




| | EV/Sales | EV/Gross Profit | EV/EBITDA | EV/EBIT | EV/Owner Earnings |
|---|---|---|---|---|---|
| EZCORP | 0.80 | 1.26 | 4.63 | 5.73 | 5.53 |
| Cash America International | 0.97 | 1.69 | 6.15 | 8.27 | 8.27 |
| First Cash Financial Services | 2.32 | 4.15 | 11.06 | 12.44 | 12.44 |
| Nicholas Financials | 3.87 | NMF | 8.38 | 8.44 | 8.44 |
| Credit Acceptance | 6.61 | NMF | 12.45 | 12.92 | 12.64 |
| | | | | | |
| Minimum | 0.80 | 1.26 | 4.63 | 5.73 | 5.53 |
| Maximum | 6.61 | 4.15 | 12.45 | 12.92 | 12.64 |
| Median | 2.32 | 1.69 | 8.38 | 8.44 | 8.44 |
| Mean | 2.91 | 2.37 | 8.53 | 9.56 | 9.46 |
| STDEV | 2.41 | 1.56 | 3.27 | 3.05 | 3.04 |
| CV | 83% | 66% | 38% | 32% | 32% |
| | | | | | |
| Car-Mart | 0.92 | 1.90 | 7.61 | 8.01 | 7.22 |

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | Min | Max | Median | Mean | Standard | Variation |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Sales | 91 | 107 | 128 | 155 | 176 | 205 | 234 | 240 | 275 | 299 | 339 | 379 | 430 | 465 | 91 | 465 | 237 | 252 | 119 | 47% |
| Gross Profit | 46 | 53 | 65 | 78 | 91 | 103 | 115 | 115 | 130 | 143 | 166 | 183 | 207 | 226 | 46 | 226 | 115 | 123 | 56 | 46% |
| EBITDA | 14 | 17 | 19 | 23 | 26 | 30 | 30 | 10 | 28 | 33 | 46 | 50 | 57 | 56 | 10 | 57 | 29 | 32 | 15 | 49% |
| EBIT | 13 | 17 | 19 | 23 | 26 | 30 | 29 | 9 | 27 | 32 | 45 | 48 | 55 | 54 | 9 | 55 | 28 | 31 | 15 | 48% |
| | | | | | | | | | | | | | | | | | | | | |
| Receivables | | | 69 | 83 | 98 | 113 | 136 | 144 | 151 | 173 | 194 | 214 | 237 | 270 | 69 | 270 | 148 | 157 | 63 | 40% |
| Inventory | | | 3 | 4 | 5 | 7 | 9 | 12 | 14 | 15 | 18 | 22 | 25 | 30 | 3 | 30 | 13 | 14 | 9 | 64% |
| PP&E | | | 3 | 4 | 5 | 8 | 13 | 16 | 18 | 19 | 21 | 24 | 27 | 29 | 3 | 29 | 17 | 16 | 9 | 57% |
| Working Liabilities | | | 5 | 6 | 6 | 6 | 7 | 7 | 10 | 16 | 19 | 22 | 25 | 28 | 5 | 28 | 9 | 13 | 8 | 64% |
| Net Tangible Assets | | | 70 | 84 | 101 | 123 | 152 | 166 | 172 | 190 | 213 | 238 | 264 | 300 | 70 | 300 | 169 | 173 | 72 | 42% |
| | | | | | | | | | | | | | | | | | | | | |
| MARGINS | | | | | | | | | | | | | | | | | | | | |
| Gross Profit/Sales | 50% | 50% | 51% | 50% | 51% | 50% | 49% | 48% | 47% | 48% | 49% | 48% | 48% | 49% | 47% | 51% | 49% | 49% | 1% | 0.03 |
| EBITDA/Sales | 15% | 16% | 15% | 15% | 15% | 15% | 13% | 4% | 10% | 11% | 14% | 13% | 13% | 12% | 4% | 16% | 14% | 13% | 3% | 0.23 |
| EBIT/Sales | 15% | 16% | 15% | 15% | 15% | 15% | 12% | 4% | 10% | 11% | 13% | 13% | 13% | 12% | 4% | 16% | 13% | 13% | 3% | 0.24 |
| | | | | | | | | | | | | | | | | | | | | |
| TURNS | | | | | | | | | | | | | | | | | | | | |
| Sales/Receivables | | | 1.87 | 1.86 | 1.81 | 1.81 | 1.72 | 1.67 | 1.82 | 1.73 | 1.75 | 1.77 | 1.82 | 1.72 | 1.67 | 1.87 | 1.79 | 1.78 | 0.06 | 3% |
| Sales/Inventory | | | 39.04 | 40.78 | 35.13 | 29.34 | 24.77 | 19.54 | 20.18 | 20.61 | 18.91 | 17.25 | 16.92 | 15.47 | 15.47 | 40.78 | 20.40 | 24.83 | 9.01 | 36% |
| Sales/PPE | | | 37.29 | 43.59 | 35.11 | 24.29 | 17.52 | 14.87 | 15.68 | 15.95 | 16.11 | 15.72 | 16.21 | 16.10 | 14.87 | 43.59 | 16.16 | 22.37 | 10.29 | 46% |
| Sales/NTA | | | 1.83 | 1.84 | 1.74 | 1.67 | 1.54 | 1.45 | 1.59 | 1.57 | 1.59 | 1.60 | 1.63 | 1.55 | 1.45 | 1.84 | 1.60 | 1.63 | 0.12 | 7% |
| | | | | | | | | | | | | | | | | | | | | |
| RETURNS | | | | | | | | | | | | | | | | | | | | |
| Gross Profit/NTA | | | 93% | 92% | 90% | 84% | 75% | 69% | 76% | 75% | 78% | 77% | 78% | 75% | 69% | 93% | 77% | 80% | 8% | 0.09 |
| EBITDA/NTA | | | 28% | 28% | 26% | 25% | 20% | 6% | 16% | 18% | 22% | 21% | 22% | 19% | 6% | 28% | 21% | 21% | 6% | 0.29 |
| EBIT/NTA | | | 27% | 28% | 26% | 24% | 19% | 6% | 15% | 17% | 21% | 20% | 21% | 18% | 6% | 28% | 21% | 20% | 6% | 0.30 |
| | | | | | | | | | | | | | | | | | | | | |
| GROWTH | | | | | | | | | | | | | | | | | | | | |
| Sales | | 17% | 20% | 21% | 14% | 16% | 14% | 3% | 14% | 9% | 13% | 12% | 13% | 8% | 3% | 21% | 14% | 13% | 5% | 0.37 |
| Gross Profit | | 17% | 22% | 20% | 17% | 14% | 11% | 0% | 13% | 10% | 16% | 11% | 13% | 9% | 0% | 22% | 13% | 13% | 5% | 0.41 |
| EBITDA | | 26% | 12% | 21% | 12% | 15% | -1% | -65% | 167% | 20% | 39% | 8% | 15% | -2% | -65% | 167% | 15% | 20% | 50% | 2.47 |
| EBIT | | 26% | 14% | 21% | 12% | 15% | -2% | -68% | 183% | 20% | 40% | 8% | 14% | -3% | -68% | 183% | 14% | 21% | 55% | 2.55 |
| | | | | | | | | | | | | | | | | | | | | |
| Receivables | | | 21% | 22% | 13% | 19% | 21% | -7% | 17% | 11% | 13% | 8% | 13% | 15% | -7% | 22% | 14% | 14% | 8% | 0.56 |
| Inventory | | | 17% | 15% | 47% | 34% | 37% | 25% | -1% | 14% | 32% | 16% | 15% | 21% | -1% | 47% | 19% | 23% | 13% | 0.57 |
| PP&E | | | -38% | 71% | 24% | 103% | 37% | 9% | 7% | 7% | 17% | 12% | 8% | 10% | -38% | 103% | 11% | 22% | 36% | 1.59 |
| Working Liabilities | | | 13% | 23% | -18% | 19% | 9% | -15% | 126% | 23% | 20% | 14% | 10% | 16% | -18% | 126% | 15% | 20% | 36% | 1.79 |
| | | | | | | | | | | | | | | | | | | | | |
| Net Tangible Assets | | | 18% | 23% | 18% | 24% | 24% | -3% | 11% | 10% | 14% | 9% | 13% | 15% | -3% | 24% | 14% | 15% | 8% | 0.52 |

# SINGULAR DILIGENCE

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America's Car-Mart (NASDAQ: CRMT) is the Biggest Lender to the Poorest Borrowers in the Smallest Cities

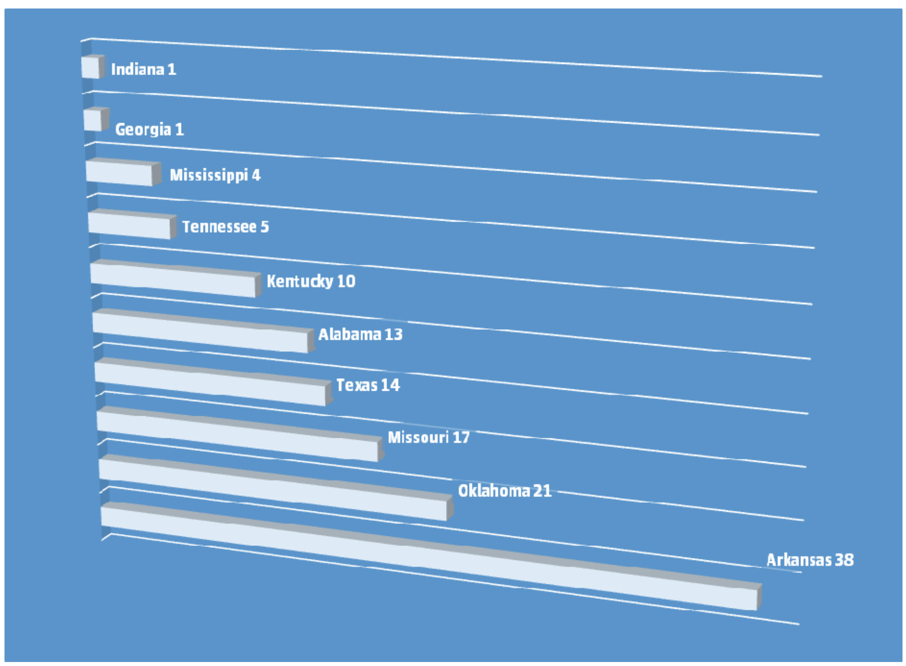
## OVERVIEW

America's Car-Mart is a "buy here pay here" car dealer. The Buy Here Pay Here industry started in the 1970s during the savings and loan crisis. Credit was hard to get. Unemployment was rising. And some Americans who needed basic transportation did not have access to the kind of credit most Americans bought cars with. Eventually, car dealers started related finance companies that approved the loans on vehicles and required customers to make regular cash payments.

Over the next 40 years, credit became more widely available. So lower and lower quality borrowers were able to get traditional car loans. As a result, the buy here pay here segment focused on subprime customers. These customers fell into two groups. One group had bad credit histories and low FICO scores. The other group had no access to credit because they dealt almost entirely in a cash society. In the United States, it has become increasingly rare for most workers to be paid in cash and for most shoppers to pay for large purchases using cash. However, there are some segments of the population in very rural and low income areas – like Appalachia – where large numbers of people still use cash more frequently than cards. Some of these consumers do not have bank accounts. They do not use automatic fund transfers, they are not paid through direct deposit, and they do not shop using debit or credit cards.

This "unbanked" group of people who live in a cash society is the focus of America's Car-Mart. That group is not the focus of many other subprime car lenders. Most lenders in the buy here pay here industry deal with slightly higher income people who have some access to credit.

Based on default rates, America's Car-Mart deals in the most subprime of subprime groups. The company has a higher default rate than the rest of the buy here pay here industry. About 79% of buy here pay here customers are less than prime borrowers. Only 17% are classified as sub-prime. The majority (63%) are considered deep sub-prime. The average car sold by a buy here pay here dealer costs that dealer $6,366 and is sold for $11,121. However, the down payment is just $1,494 (13% of sticker price and 23% of the dealer's cost). The average buy here pay here loan has a length of 139 weeks (2 years and 8 months). The average weekly payment is $87. However, most customers pay once every two weeks making each payment $174. About 31% of all buy here pay here borrowers eventually default. The lender's recovery rate is usually around 32%, Excluding bad debt expense, the profit margin of buy here pay here car sales is 23%.




Car-Mart grows by moving to the next city with less than 50,000 people

However, the relationship between car prices, down payments, loan terms, and interest rates is complex. Customers have two key constraints. The first is their ability to come up with a down payment. Many buy here pay here customers have trouble coming up with $1,500 at one time. Most of America's Car-Mart's customers can't put together down payments larger than $1,500. Second, the small size of a borrower's weekly paycheck constrains the ability of the car buyer to come up with enough cash to make each payment. Therefore, the lenders must adjust the other terms of the loan (including the car price) to find the right combination of profitability for them and payment affordability for the customer. Finally, the remaining useful life of the car being bought is an additional constraint on the loan length. In almost all cases, a customer will default (simply walk away) from a loan secured by a car that no longer runs. Because borrowers are cash strapped and the cars are normally older and cheaper cars, the borrower will not put additional cash into repairing a car. Any maintenance beyond low cost repairs will lead to a default. This means that long-term loans can only be matched up with younger cars.

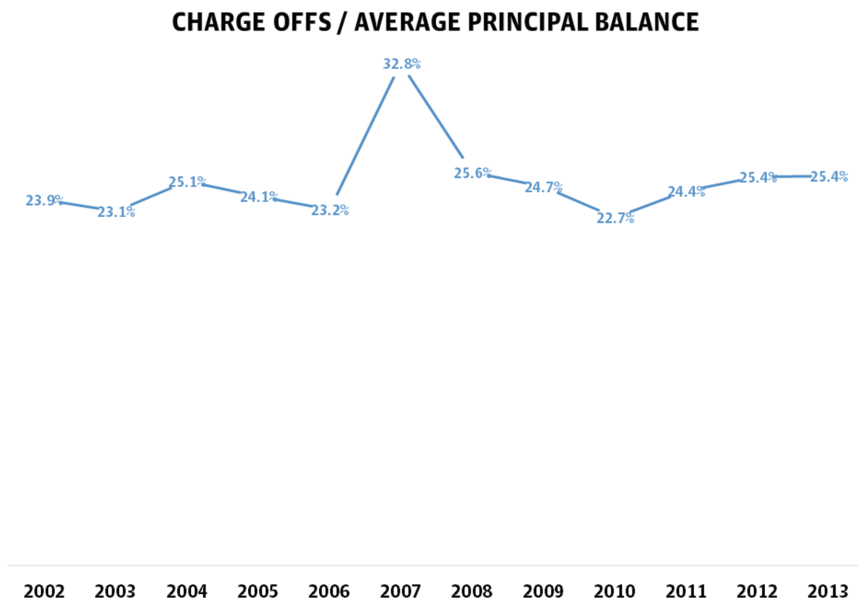
The average age of an America's Car-Mart car is 9 years. Making loans of 3 years or more on cars that are 9 years or older will lead to higher default rates as borrowers walk away from collateral they view as totaled. The lender needs the entire transaction to be profitable over the life of the deal. The borrower needs the car to have a low down payment, small enough individual payments, and a young enough to keep working throughout the entire term of the loan. To achieve this: Car-Mart adjusts the down payment and length of the loan instead of the interest rate. The company charges 15% a year in interest at all times for all customers.

America's Car-Mart started in 1981. The company was founded in Rogers, Arkansas. It later moved to the same town where Wal-Mart is headquartered, Bentonville, Arkansas. The company started out providing basic transportation in Rogers. This proved to be a good niche. Car-Mart moved out in a slow and geographically consistent way. The company targeted small towns with 20,000 to 50,000 people. The company avoided large cities (Car-Mart has dealerships in places like Little Rock, Arkansas – but does not view this as part of their overall strategy. They had problems in some larger cities. And they avoid areas like Dallas-Fort Worth). Car-Mart also avoids truly rural areas. Generally, Car-Mart targets locations with fewer than 50,000 people that are about a 30 minute drive from the next major population center. This ensures they are operating in a true niche. Small towns have several attractive characteristics for Car-Mart. Borrowers are easier to track down. There is usually no public transportation, so a car is an absolute necessity for anyone with a job. And there are enough buyers who are looking for basic transportation.

Car-Mart views its cars as commodities. And does not see itself as a car dealer. Management talks about the company primarily as a lender and especially as a collections company. In its first 15 years, Car-Mart opened roughly 2 stores a year. By 1998, it had 35 stores with a total of $65 million in revenue. Car-Mart was acquired by a company called Crown Group. However, that public company's other subsidiaries did not perform as well as Car-Mart. So, Crown group eventually sold off the other businesses and focused on America's Car-Mart. The rump public company then changed its name to Car-Mart. It also brought in a new management team. Today, Car-Mart is still a regional company. It is mostly in locations like Arkansas, Alabama, Oklahoma, and East Texas. Local competitors are usually small, often single location buy here pay here dealers. Many small dealers here rely on companies such as Nicholas Financial to provide them with financing. America's Car-Mart does not factor its receivables. The company keeps all of its loans on its own books. It services and modifies the loans itself. Because of the very low quality of the company's receivables, collections are a specialized part of the business. Underwriting and collections are the two functions where Car-Mart's management believes they have expertise in serving unbanked customers living from paycheck to paycheck. Car-Mart's employees are paid based on the performance of the actions they take. The company has 45 purchasing agents who are compensated in part on the long-term performance of the cars they buy. Store employees who make the actual loans are compensated based on the long-term performance of those loans. Base pay is modest. However, branch managers can theoretically make several times their base salary in incentive compensation. This is mostly done through originating loans that perform well. All loan decisions are made face-to-face at the store level. Headquarters monitors the risk taking of each branch and provides a scoring system for managers to analyze their underwriting. However, this is used as an after the fact risk management tool only. No loan decisions are made at headquarters. Store managers do all of the risk taking and are rewarded or punished based on the performance of the loans they make.

## **DURABILITY:** *Crisis Survivors Maintain Low Debt and Disciplined Underwriting at All Times*

The demand for Car-Mart's product is very durable. Most of the company's sales – and almost all of its sales to first time customers – are for basic transportation. These are old, used cars. Many are 9 years old. Car-Mart does not compete for higher quality borrowers or in the higher priced car markets. It focuses on low population density areas with few people and low GDP per square mile. Car-Mart's markets include Arkansas, Alabama, Oklahoma, and East Texas. These areas and especially the deep subprime customers Car-Mart focuses on in these areas are a wasteland for banks. Car-Mart's customers tend to be unbanked. The company offers free check cashing at its dealerships as a way to encourage customers to repeatedly visit the




"Collections is the focus of our business, selling cars is not" – Former CEO

dealership and stay in constant contact with the company. Most of the towns Car-Mart competes in do not offer public transportation. A car is a basic necessity for anyone who has to get to a job.

Companies in the Buy Here Pay Here industry often fail due to excessive risk taking. Weak balance sheets can lead to solvency problems. At its peak, Mercury Finance had 290 loan offices around the country and a market cap of $2.6 billion. One year later, it was in bankruptcy. Finance companies have higher debt to equity ratios than Car-Mart. AmeriCredit has a 4.6 debt to equity ratio. Credit acceptance has a 1.9 debt to equity ratio. Nicholas Financial has a 0.94 debt to equity ratio. Meanwhile, Car-Mart's debt to equity ratio is just 0.54. Management tries to ensure that there will still be money to run the business if something goes wrong.

Car-Mart does not rely on securitization of its receivables. The company keeps all of its loans on its own books. When these loans go bad, the company reports worse than normal results. If bad results in the company's own loan portfolio occur at the same time as an economy wide credit crunch, access to credit can be difficult to obtain. Companies that rely on securitization can run into this problem. Credit becomes hardest to obtain when they most need it. A good example of a bad year for Car-Mart was 2007. The company's provision for credit losses is normally between 20% and 25%. In 2007, it spiked to 32%. The charge-off rate normally runs 23% to 26%. In 2007, it hit 33%. Car-Mart has short loan terms. So, the relationship between provisions for losses and actual charge offs is usually fairly tight. Bad underwriting becomes obvious within a matter of months. Most mistakes will be off the company's books one way or another in less than 3 years. So, unlike banks, Car-Mart does not have old vintage loans in its portfolio. In 2014, the company will almost exclusively have loans made in 2012, 2013, and 2014. There is not a long lag between originating bad loans and charging off these mistakes. However, credit availability for the companies that compete with Car-Mart does cause some cyclicality in the industry. If securitization is easy and general corporate borrowing is cheap, finance companies may offer low or no down payments, lengthen loan terms, and even reduce interest rates. Car-Mart adjusts car prices, down payment requirements, and loan length in response to competitive pressure. Car-Mart does not adjust interest rates. All customers are charged a 15% interest rate.

The keys to Car-Mart's long-term survival are conservative corporate borrowing and disciplined underwriting at the dealership level. Car-Mart's debt to equity ratio, its rate of growth, and its use of free cash flow are corporate decisions. Top management is responsible for leaving the company with enough room to survive a credit crisis like the one the company experienced in 2007. However, no actual lending decisions are made at the corporate level. Ultimately, the risk in owning Car-Mart stock comes from the risks taking by these store managers.

All incentive compensation is tied to collection results. Car-Mart does not securitize loans. The company lends to some of the riskiest borrowers of any public company. Therefore, both underwriting and servicing are important parts of the business. If Car-Mart securitized its loans so that someone else serviced them, it is likely that the loans would be less valuable to the new servicer. This is because the new servicer would lack the expertise in collections and modifications that Car-Mart regularly makes for this group of ultra-high risk borrowers.

Repossessions are often the result of a lack of communication with the borrower. Once a borrower becomes uncommunicative – no longer showing up at the dealership or returning Car-Mart's calls – the borrower is much more likely to default on the loan in a way that will require repossession. Car-Mart contacts borrowers very quickly. Usually, initial contact is made within 1 to 2 days (at most) after a borrower misses a payment. This is very different from how the collection of prime and even subprime loans are handled in most industries. Car-Mart reminds the borrower that missed payments will be reported to the credit bureaus. However, many deep subprime borrowers do not care about their credit scores. Common causes for a missed payment include job loss, illness, or the car breaking down. The car breaking down will often result in repossession. This is a bad result for Car-Mart. That is why the company needs to match the remaining useful life of the car and the loan term carefully. Selling a car to a customer that will not survive the entire loan term will often result in the customer choosing to forfeit the collateral rather than attempting to keep paying the loan. According to one Car-Mart manager: "If a mechanical failure occurs, customers almost always stop paying."

Car-Mart does not hire people from the used car industry. In fact, the company generally avoids "car people". Management sees the company as being in the "collections" business and the "people" business. So, they look to hire people who are good in person judges of character. Incentive compensation is tied to collection performance.

Car-Mart is very focused on small towns. Even in the mostly rural states in which Car-Mart operates, management goes out of its way to avoiding entering the biggest cities. The company's CEO explained this policy in a 2010 investor conference: "We are located in a few bigger towns, such as Little Rock, Tulsa and such, but …we don't really have our sights set on going into Birmingham, Memphis, or Kansas City…we're focused on the small towns." This focus on small towns matches the collection focus of Car-Mart. The company communicates a lot with borrowers – who are more often behind on payments than borrowers at almost any other company – and this involves direct contact. In many cases, it may be no more than "coaching" where the borrower is staying in constant contact with the dealer explaining problems such as illness, job loss, etc. and the dealer is explaining the importance of the car as basic transportation, what missed payments will do to the customer's credit report, etc.

Collections are the key to Car-Mart's business. That is the reason Car-Mart is unlikely to securitize its receivables. This collections based approach to the worst borrowers in the smallest towns is what makes Car-Mart unique. Car-Mart's former CEO put it best in 2007: "We like to control our receivables. It allows us to deal with our customer in the way we think they should be dealt with, and that is working with these customers. If we were to sell these receivables to some third party, I'm not so sure we would still have that control over the receivables to deal with the customers. Many folks in our business have a much different view of how they deal with the customer and are quicker to repossess a customer or charge them off or deal with them in such a way that you might sell one car, but that may be the end of the relationship. And that is not the way we do business."

## **MOAT:** *Car-Mart's Niche is Collecting Debts from the Riskiest Borrowers in the Smallest Cities*

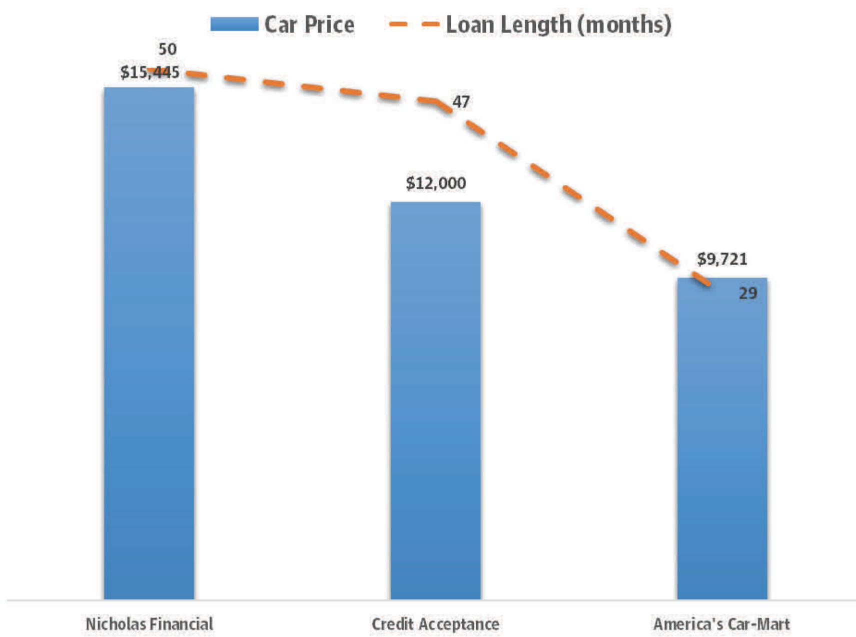
The buy here pay here industry consists of about 24,000 dealers originating $24 billion in loans each year. Most are small dealers. There are a few large chains. DriveTime Automotive has 104 dealerships in 19 states. The average age of their cars is 3 years. Byrider Systems has 147 dealers in 35 states. Their average selling price is $16,000 a car. Car-Mart is comparable in terms of locations to these two companies. It now has 131 dealerships. However, Car-Mart's dealerships are much more focused. They are almost all in towns with populations of 50,000 or fewer people. And they are mostly in just a handful of states. Car-Mart has 38 dealerships in Arkansas, 21 in Oklahoma, 17 in Missouri, 14 in Texas, 13 in Alabama, 10 in Kentucky, 5 in Tennessee, and 4 in Mississippi. Those 8 states account for more than 99% of Car-Mart's dealerships. The company's top six states account for 90% of its dealerships. The majority of Car-Mart's dealerships (58%) are in just three states: Arkansas, Oklahoma, and Missouri. These 3 states share a border. So, a map of Car-Mart's dealerships would show a narrow focus with the majority of dealerships in Arkansas or its neighboring states. The company has moved slowly out into more states. The progress has been geographically consistent. Car-Mart has not bought dealerships far from the markets it is already in. Nor has Car-Mart entered distant states. Car-Mart may eventually expand into states far from Arkansas (the company has one dealership in Indiana and one dealership in Georgia). But this expansion will be slow. And it will follow the same geographic pattern of moving outward from existing dealerships. Car-Mart's cars are much older and cheaper than those sold by DriveTime and Byrider. The average Car-Mart vehicle is 9 years old and has 100,000 miles on it. The average price is $9,721.

The buy here pay here industry is most competitive in large markets. Customers have more bargaining power in major markets. There are more customers. And the customers are much more likely to deal in electronic forms of payment. Most customers actually pay by credit card or debit card in the buy here pay here industry. Car-Mart's customers are an anomaly. About 80% of Car-Mart's customers make their regular loan payments in cash. Car-Mart provides free check cashing at their dealerships. So, customers who receive income in either cash or check form can easily pay in cash at a Car-Mart dealer. It is obvious that many Car-Mart customers are unbanked. Many must not use credit or debit cards on a regular basis. It is not just a matter of having a poor credit score. The availability and use of credit is severely restricted in these customers' lives versus the lives of most Americans. In large markets, most people with very poor credit scores still use banks. Bank use among Car-Mart's customers is very low compared to the habits of most Americans.

A lot of the competition in the buy here pay here industry is driven by special financing sources. The securitization of receivables and the providing of financing to dealers as well as general corporate borrowing by buy here pay here industry participants influences how willing they are to offer low down payments, long loan terms, low interest rates, etc. In this way, the macro economy affects buy here pay here customers primarily through making financing easier or harder for the companies that originate the loans. The easier access to capital is for the companies that originate loans, the easier the terms they will offer car buyers. With some rare exceptions (like the 2007-2009 period when there was a financial panic) the impact on the car buyer's finances are less important.

Companies like Car-Mart lend to borrowers who are in a constant personal recession. The financial circumstances of these borrowers in good economic times is much worse than the finances of the average American in even a very deep recession. Their ability to make large, regular payments is always very restricted. And their ability to make meaningful down payments is also very limited. So, the industry focuses on offering low down payments and minimizing the dollar amount per payment (for example, stretching out the loan). These are the two aspects of the loan that are the greatest competitive incentive for borrowers. They want to make low or no down payments and small regular payments. Other factors like the actual car price, interest rate, etc. are less important to the borrower. In fact, Car-Mart does not compete on interest rates at all. It charges a 15% interest rate to all customers in all economic environments. Car-Mart puts the prices and down payment amounts on the windshield of each car on the lot. The prices and down payments are not intended to vary with customers. They are based solely on the car.

In each of its local markets, Car-Mart's primary competitor is usually a mom and pop operation. Competitors often have a single location. Car-Mart does not have any local competitors of sufficient size that an acquisition would add meaningfully to their corporate size. Acquisitions are usually small. Local competitors sometimes call Car-Mart when they want to sell their business. Selling to Car-Mart can speed up the exit from the business, because Car-Mart is willing to take the competitor's receivables on to their balance sheet. Operations like Car-Mart dealerships either have to sell their receivables at a very deep discount or run-off their loans over a couple years. Most financial buyers would not have the expertise



Car-Mart makes some of the smallest and shortest loans in its industry

needed to judge loans made to deep subprime and unbanked customers.

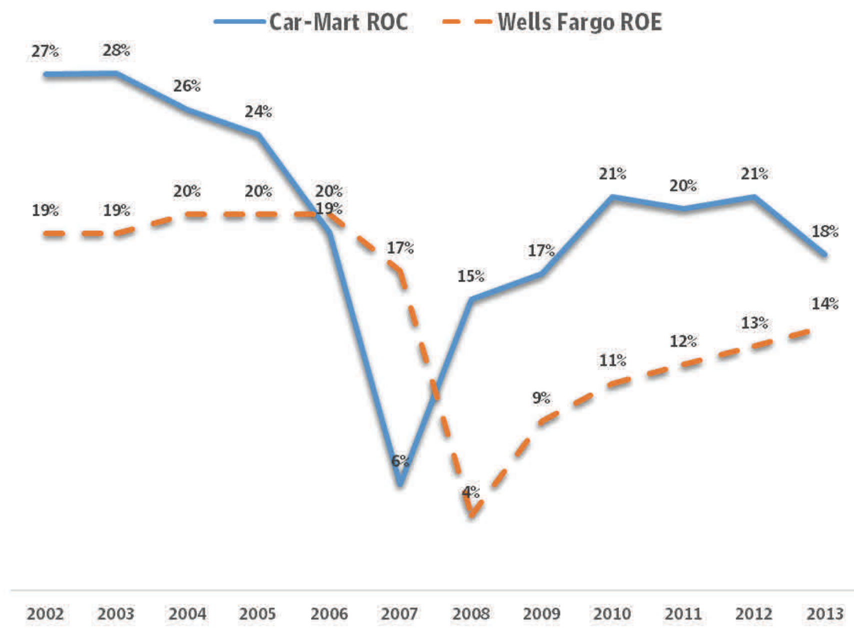
Car-Mart has some scale advantages in local markets. Advertising is very cheap in Car-Mart's markets. They spend about 1% of total sales on advertising. Much of it is TV and radio advertising that simply gets out the Car-Mart name rather than promoting specific deals. Car-Mart spent $4.1 million on ads last year. This is far more than local competitors can do.

Car-Mart also has dedicated purchasing agents. A total of 45 employees purchase cars for Car-Mart. These 45 employees buy 30,000 cars a year. They drive or inspect more than 250,000 cars. Local competitors cannot afford purchasing agents. For example, even Car-Mart has only one purchasing agent for every 3 dealerships. Since most competitors operate fewer than 3 dealerships, they are at a scale disadvantage when it comes to a specialized purchasing capability. The industry as a whole spends 2.8% on marketing expense versus 0.9% at Car-Mart. This is probably due to the markets Car-Mart operates in. They are among the lowest cost local ad markets in America.

The biggest scale advantage Car-Mart has over local competitors is its technology. Car-Mart developed its own scorecard to predict credit risk. This includes 10 or 11 different variables. Many Car-Mart dealerships have been in business for a long time. This gives an experience and reputation advantage. A dealership over the age of 5 years has an advantage over a new dealership in marketing. Generally, Car-Mart gets 33% of sales from returning customers. The number is over 40% at mature dealerships. The referral rate is 10% to 15%. So, existing customers can drive about half of all sales directly or indirectly. Mature stores have lower loss ratios than new stores. Since Car-Mart is lending in person with all risk taking decisions made at the individual dealer level, the loss expense is tied to the maturity of each dealership. Losses are 7% higher at dealerships open 5 years or less than at dealerships open 5 years or more. So, the economics of a dealership improves with age for both underwriting and marketing reasons. Car-Mart's moat is widest at the lowest end and narrowest at the high end. The low end for Car-Mart is a niche that other companies do not compete in. The high end faces competition – especially in larger markets – when there is financing available that encourages dealers to originate loans to lower quality borrowers than they would at tighter points in the credit cycle.

## **QUALITY:** *Car-Mart's Return on Capital is High – But Varies with the Financial Cycle*

Car-Mart's former CEO, Tilman Falgout, put it best when he said: "Collections is the focus of our business, selling cars is not." Car-Mart's customers are in a constant personal recession. There is some variation in sales per dealership per year along with the economy. Car-Mart sold 293 cars per dealership in 2008, 309 in 2009, 339 in 2010, and 341 in 2011. However, the company's real focus is on collections. This can be judged by actual charge-offs as a percent of average principal for the year. Charge offs were 26% in 2008, 25% in 2009, 23% in 2010, and 24% in 2011. The credit quality of Car-Mart's borrowers is very poor. However, the provision for credit losses and the actual charge offs have historically been very stable. Except for 2007 (when charge-offs spiked to 33%) Car-Mart's charge offs have ranged from just 23% to 26% in each of the last 10 years. This is a very stable range for credit losses. So, the company's loan portfolio is always very distressed but is usually predictably distressed. The industry average for charge offs has actually been consistently rising throughout this period. Car-Mart's repossession rate has also increased a bit over the last 10 years. Before 2003, Car-Mart repossessed about one of every three cars it sold. Today, Car-Mart's repossession rate is about 40%. The buy here pay here industry default rate is much lower. In 2012, it was just 31% (versus a 40% repossession rate at Car-Mart). Before the credit crisis, the buy here pay here default rate was as low as 26%. Car-Mart's repossession rate has never been that low. Car-Mart's borrowers have always defaulted at a higher rate than buy here pay here borrowers generally. About 15% to 20% of repossessions at Car-Mart are due to mechanical issues. When a car breaks down, the owner almost always chooses to stop making payments to Car-Mart (which then leads to the car being repossessed).




Car-Mart's worst 3-year ROC (13% pre-tax) was during the 2007-2009 crisis

Failure to pay accounts for the other 80% of repossessions. The 3 biggest reasons for failure to pay are: job loss, illness, and divorce.

To offset the high credit losses, Car-Mart's gross margin on its cars is very high. As a result, Car-Mart's return on invested capital is about 30% before taxes. This has allowed the company to fully fund all growth itself and buyback some stock. Car-Mart has good local scale. The company is much larger than most of its mom and pop competitors. It is focused on small towns. The company's reinvestment rate has been very high over time. The current base of 131 stores was built through retaining the company's own earnings. As a result, Car-Mart has slowly grown to a large size in its local markets. Although some other companies are of a comparable size, Car-Mart is as big as any company in its niche because other companies do not attempt to copy Car-Mart's very specific niche of focusing on the lowest quality borrowers. Car -Mart has a unique business model. No other company as big as Car-Mart focuses on the very lowest end of the borrower quality spectrum in the buy here pay here industry. Car-Mart sells to customers with the highest default rates and locates its dealerships in the smallest cities. Car-Mart sells the oldest and cheapest cars. The company focuses on basic transportation for customers who have the hardest time getting access to this transportation. It makes loans to people who are the least likely people to be able to get loans. This provides insulation from the competition seen among more mainstream credit risks in the buy here pay here industry. It means Car-Mart has a true niche. This helps the company control its own destiny. As a result, the quality of Car-Mart in the future will depend more on the quality of the organization than outside competitive forces. Car-Mart's model suggests a pre-tax return on capital of around 30%. The internal rate of return on the loans – averaged out for default and recovery experiences – is about 30% a year. However, the annual result of a financial services compounding depends on the frequency of compounding its good results. For Car-Mart to achieve a 30% return on investment, it would need instantaneous reinvestment of the loan. If the results of one loan are reinvested every 3 months, the return would be 26%. If done every 6 months, 24%. And if done once a year, 19%. This gives an indication of the possible return on capital potential. When there is constant reinvestment opportunities, returns can theoretically be as high as 30% a year. When reinvestment opportunities are sluggish, returns – on the exact same quality loans – would only result in just under 20% pre-tax returns on capital.

Reinvestment for Car-Mart comes in two forms. One is selling more cars at the same store. The other is opening new stores. There is a limit to volume per store. Physical volume of cars sold at the average store has generally trended up each year. This is a normal trend as stores mature. But, there is obviously a limit to the number of cars that can be sold at each location. So, much of the reinvestment potential has to be in building new stores. Car-Mart has also demonstrated its willingness to buy back stock. So, high returns on capital are possible through capital allocation that focuses on avoiding idle money. Each new store requires a $1.5 million to $2 million investment over 2 years. The vast majority of this investment is in the receivables of the store. The cap-ex to open the dealership is as low as $150,000. The cars on the lot at opening are also no more than about $150,000. However, the dealership will generally make enough loans to tie up $1 to $2 million in receivables during its first few years of operations. After that, it will start to throw off more cash than is needed to grow receivables. The store will then be free cash flow positive. It will be able to send cash to corporate to fund new store openings or stock buybacks. A store with $3 million in annual sales can generate $450,000 a year in free cash flow. At this rate, it would take a single store about 4 years to generate enough cash to open a second store. Car-Mart does not increase its store base at anywhere near 20% to 25% a year. So, the free cash flow from mature stores is more than enough to fund planned new store openings. The result is cash available for stock buybacks. The company was able to achieve a close to 20% annual increase in receivables balance. This is a good indication of the long-term return in the business. However, today's loans are inferior to loans made in this recent past. The average term length was 27.3 months in 2007. It has increased to 29.3 months today. Car price inflation has been at least as great as inflation generally – perhaps a percent or so higher over the last couple decades. The average Car-Mart customer has not seen an increase in their real wages during that time. As a result, loans have to be longer to keep each bi-weekly payment equally affordable. This trend is probably cyclical rather than a long-term trend. Interest rates are low. This encourages all car lenders to offer generous credit terms. This includes low down payments and longer loan terms. Car-Mart's longer loan terms are probably a result of competitive forces. Shorter loan terms and higher down payments should be considered higher quality deals as far as Car-Mart is concerned. So, there has been some erosion of the company's loan quality. But Car-Mart still occupies a niche selling to the most credit constrained borrowers of all. The company's volume has also dropped less than other buy here pay here dealers (which generally sell more expensive cars) over the last year. At Car-Mart's new stores (which sell cheaper cars than mature stores) sales were actually up 3% over last year.

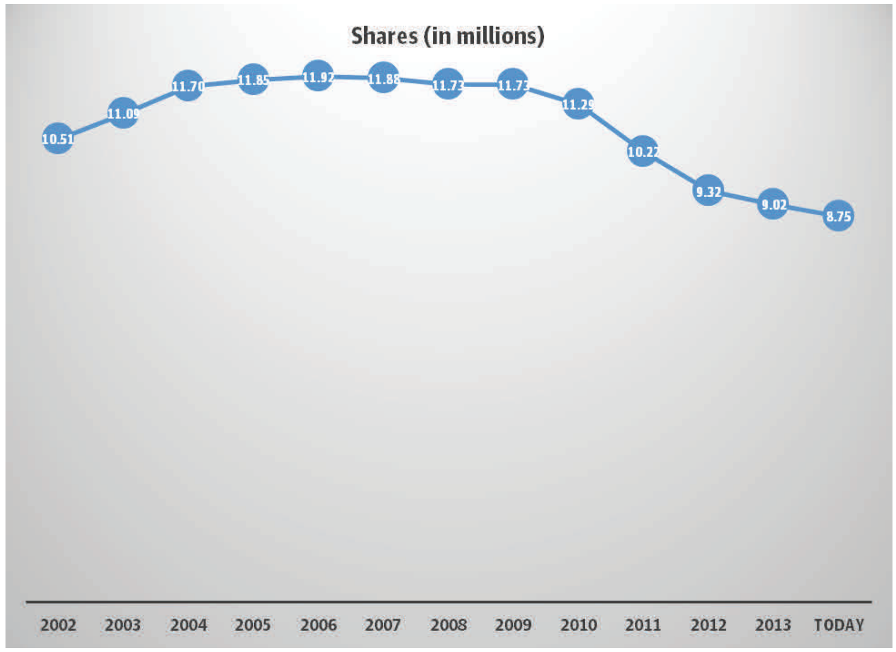
## CAPITAL ALLOCATION: *Instead of Paying a Dividend: Car-Mart Will Rapidly Reduce its Share Count*

Car-Mart is a very focused organization. This focus extends to its capital allocation. In the future, Car-Mart is likely to do just two things with its free cash flow: open new lots using a "grass fire approach" and reduce the number of shares outstanding through stock buybacks. Car-Mart is unlikely to increase its low levels of leverage. There are two reasons for this. One, Car-Mart needs to control its receivables to control the collection of those receivables and maintain the customer relationships it depends on. Two, it is not possible for someone to offer cheap money to Car-Mart in exchange for the company's receivables because the loss experience on those receivables is very special. Car-Mart is taking special risks. And like an insurer writing special kinds of coverage in a certain niche, no one else is going to be comfortable taking that book off the originator's hands at a reasonable rate. One, third parties will not believe they understand the risks as well as Car-Mart does. Two, third parties may fear that the past loss experience of Car-Mart's loan book was driven in part by the way Car-Mart serviced those loans. If someone else collects the debts in a different manner, they might get worse results. This is not a theoretical discussion of how other companies might look at taking Car-Mart's receivables off its balance sheet. Car-Mart has had discussions with companies that do just that. And whenever they had those discussions, the cost of capital ended up always being too high. Car-Mart's then CEO explained the issue in 2007: "…every time we have entertained a discussion about securitization or other methods of moving assets – receivables off the balance sheet, by the time the folks who expressed an interest in doing that understand the nature of our business and the buy here / pay here nature and the servicing aspects – they could be so difficult – the level of a discount gets to where the cost of money is just too high. We always look at it, and we're happy to entertain discussions, but we haven't found anybody yet that has figured a way to allow us to do that with the cost of funds that is anywhere near what we currently pay. Until somebody comes up with a better idea, we'll keep doing it the way we are doing it." For this reason, investors should not expect Car-Mart to change its leverage level. The only cash they should expect to be allocated in the future is free cash flow produced by the company's existing lots.

Car-Mart will use all of this free cash flow to fund growth and stock buybacks. Car-Mart does not make many acquisitions. All companies of comparable size to Car-Mart in the industry would be poor fits and would not make any sense as acquisition targets. So acquisitions will be very limited to very small deals that will not soak up much free cash flow or move the sales needle very much. Any deals Car-Mart does will be done for cash. The company does not issue shares except as employee compensation. Stock compensation is generous. Car-Mart has historically diluted its share count by 1.5% a year purely in grants to employees. Cash payments to executives is pretty low at Car-Mart. And the company seems to favor incentive compensation in the forms of large cash bonuses for store managers and stock options for executives. Option grants have caused less dilution in recent years. But investors should expect dilution to be fairly high for incentive compensation. An estimated permanent drag of 1.5% a year on the stock is a good guess. In reality, Car-Mart's share count will not increase over time. It will definitely decrease. This is because the company does not hoard cash, does not favor the idea of cash dividends, and is more constrained by how quickly it can find new managers to install in additional lots than by how quickly existing lots can produce the free cash flow needed to start up new lots.

A look at Car-Mart's lot economics in cash terms (which is how management looks at all aspects of its operations) and the potential growth that can sop up free cash flow will give some idea of how much free cash flow will need to be allocated to future share buybacks. A new lot costs $150,000 to $200,000 to build. Then Car-Mart puts about $150,000 worth of vehicles on that lot. So, the initial start-up cost is no more than $350,000. However, the new lot will then make enough loans to require an increase in receivables of $1.5 million to $2 million over the next 1.5 years to 2 years. After 2 years, the lot can become cash flow self-sufficient and grow using its own cash flow from operations. So, the best way to think of a new lot is that it costs up to $2.35 million to fund and it takes 2 years to no longer drain cash from corporate. Based on estimates of how much free cash flow a mature location produces, it could take 5 years of free cash flow at one location to fully fund a new location.

Car-Mart does not expect to grow its locations by 20% a year. In 2013, management said: "when we look out over, say, the next five-year period we have identified around 100 towns that make sense for Car-Mart locations. With our current growth rates, a 10% unit count increase per year, this will take us




In the last 5 years, Car-Mart has bought back 25% of the company

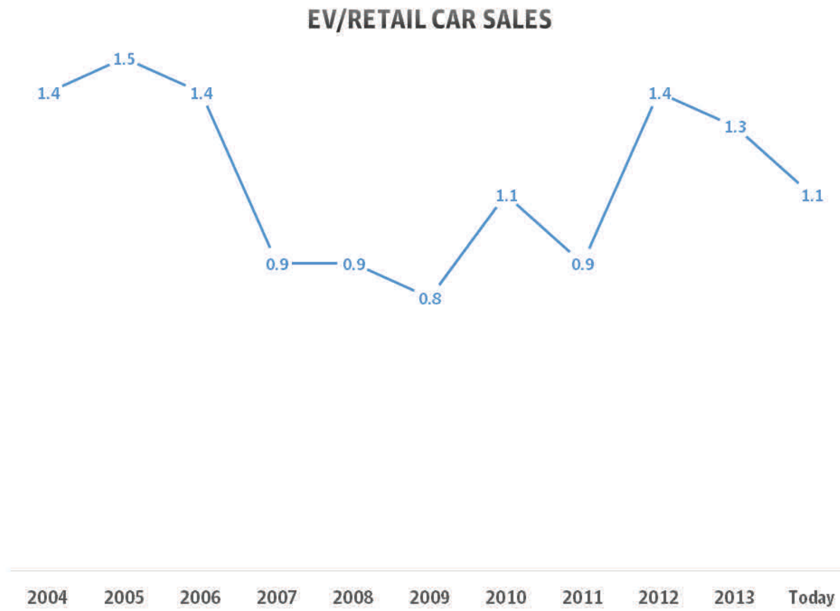
maybe beyond the next five years, but we still consider this to be our near-term potential footprint." Car-Mart can and will fund that footprint purely from free cash flow. The company's normal pre-tax free cash pre-tax flow yield is probably around 15% of sales. Sales were $465 million in 2013. So, free cash flow in the future should be at least $70 million a year on average. A 10% store count increase would be 12 stores a year. Fully funding these stores would cost about $28 million (maximum) versus something like $47 million in after-tax free cash flow. That leaves $19 million a year to buy back stock. Car-Mart has a market cap of $322 million. So, a 1.5% dilution from options would require $5 million in open market share repurchases to fully offset. That would leave $14 million a year available to reduce shares outstanding. If the share price stayed constantly at today's level, Car-Mart could lower the share count by more than 4% a year. Long-term investors would benefit from the per-share increase in Car-Mart's receivable balance (loan book) over time.

Basically, receivables per share is what drives intrinsic value. Over the last 10 years, Car-Mart grew its loan balance by 12.5% a year. Even if it slows a bit, share buybacks can keep the rate in per share loan balance growth above 10%. And the stock price will follow the per share loan balance over time. Car -Mart's commitment to stock buybacks is clear. From 2009 to today, Car-Mart bought back 25% of the company. In 2014, the CFO said: "Well, we have always felt like the best thing we can do for long term shareholders is to buy back stock. And as long as we consider it to be a good value on a long term basis, as we have the capital that we can allocate to those purposes, we consider a share repurchase to be better than a cash dividend simply because it's going to reward those folks that are there for the long-term." On the strength of this evidence, long-term investors should expect a 4% to 5% a year boost to their returns in Car-Mart from the use of free cash flow to buy back stock. Of course, this will depend on the future stock prices. The higher the stock goes, the less the buyback can contribute to future returns. And the lower it goes, the more the buyback can drive long-term returns. Buy and hold investors should hope to see Car-Mart's stock price decline.

## **VALUE:** *Car-Mart is Worth 1.8 times Sales*

Car-Mart should be valued based on its sales. The company's total sales figure reported in its 10-K includes both retail and wholesale transactions. Since Car-Mart is not trying to make money as a car dealer but rather trying to make money as a car lender it is only sales that are tied to loans the company believes will earn an adequate return that matter. In Car-Mart's business, these loan originations are synonymous with retail sales. Excluding wholesale sales, Car-Mart had $396 million in retail sales. This $396 million in retail sales includes the actual sale prices of the used cars, the service plan sales, and the payment protection plan sales. The distinction between these 3 forms of revenue – although reported separately in the company's revenue recognition note to its 10-K – is unimportant from an economic perspective. Almost 100% of customers end up taking the service contract and the debt waiver. And both the customers and the company really think of the sale price of the car as the entire transaction entered into at the dealership. Throughout this issue, no attempt is made to separate the economics of the service agreement and other "plans" sold with a car from the sale of the car itself. The reason for using retail sales as a gauge of Car-Mart's value is not to look at the revenue recognized or the earnings reported. It is to look at the "steady state" of loans in the Car -Mart system given a certain sales level. In this sense, Car-Mart may be valuable for its receivables but can be valued based on its retail sales in much the same way that an insurer can be valuable because of its float but be valued by first looking at premium volume.

The $396 million in car sales that Car-Mart made in 2013 is what determines the company's receivable balance for the next couple years. Using retail sales as a yardstick against which free cash flow can be compared provides an opportunity to construct an owner earnings margin for Car-Mart. This is also helpful because receivable balance increases that come from sources other than additional sales – basically longer loan terms – are not desirable from Car-Mart's perspective. Car-Mart's owner earnings decrease versus sales when loan terms increase. Over time, Car-Mart (along with everyone else in the buy here pay here industry) has tended to increase the length of its loans. The two per share figures investors should focus on when trying to gauge Car-Mart's intrinsic value are retail sales per share and receivables per share. It is sales and receivables that produce future cash flow at Car-Mart. Because Car-Mart uses debt, it is best to value the company on an enterprise value basis. Historically, Car-Mart has had a very high rate of growth. Sales grew 14% from 1998 through 2012. Receivables grew 15%. That rate is something management has talked about consistently as a possible target. For example, in 2012 the company's CFO said: "Over the past 14 years, since Car-Mart became a public company, our compound annual growth rate at the topline has been over 14%. As we've discussed for some time now, our plans for the future are to continue to grow the business at levels we've experienced in the past." Back in 2005, Car-Mart's then CEO said: "Again, our historical growth, top and bottom line, in the last eight fiscal years has been at about 19%. You won't see us grow it to 30%, but I don't believe you will see us grow 4% either…if an investor likes steady performers that year in and year out perform and grow in excess of 15%, we are a candidate for that person's portfolio." Over the last 10 years, Car-Mart grew its store count by 7% a year and its retail price by 4% a year. As stores mature, they also increase the number of cars sold. So, the combination of store count growth, unit volume per store growth, and price per unit growth is higher than this suggests. The company's loan balance grew 12.5% a year over the last 10 years. The length of the loan term has increased over that time. So, the true growth rate in terms of new loans is a bit lower than 12.5%. However, Car-Mart did achieve a record of 10% to 12% growth that still left room for free cash flow to buy back stock.



From 2004 to 2013, Car-Mart's EV/Sales stayed in a low range of 0.8 to 1.5

This last point is important. Over the last 5 years, Car-Mart bought back close to 5% of the company per year. Car-Mart is capable of buying similar amounts of stock in the future. As a result, the per share growth rate in the company's sales and receivables will be higher than the numbers discussed above. Car-Mart is a financial services company. And it is capable of growing its loans – and therefore owner earnings – by double-digit percentages per share. A company that can grow earnings per share by 10% a year or faster for the next

10 years is usually given a high multiple. Based on Car-Mart's growth rate and return on capital record since it went public, the company should be valued at no less than 12 times pre-tax earnings. The quality of the company means the stock should be able to support a price to after-tax owner earnings (free cash flow) of around 20. The easiest way to think of this is to imagine what the free cash flow yield plus growth of the company would be. If Car-Mart can grow 10% a year and still buy back 4% of its stock, then the company is clearly priced too low. To be priced fairly, a stock's combination of free cash flow (available to pay dividends, buy back stock, make acquisitions, and pay down debt) and its organic growth should only add up to the expected level of annual returns in the stock market generally. The S&P 500 will not return anywhere near 14% a year. Car-Mart has been persistently undervalued throughout most of its time as a public company. This is obvious from the stock's performance.

Over the last 15 years, Car-Mart's stock has returned 16% a year versus the S&P 500's 4% a year return. It sounds strange to propose a stock is cheap when it is at "normal" levels for a typical stock and within the range of multiples it has traded for in the past. However, Car-Mart's past returns are very high compared to most stocks. In other words, the "normal" historical range of multiples that Car-Mart traded at was simply too low.

Car-Mart should trade at 12 times pre -tax earnings. At a pre-tax owner earnings margin of 15% (that is, assuming Car-Mart will earn 15 cents pre-tax on each $1 of cars it sells at retail) a price of 12 times pre-tax earnings translates into an enterprise value to sales ratio of 1.8. Last year, Car-Mart sold $396 million of cars at retail. At a 15% margin, this would be $59 million in normal pre-tax owner earnings. At an appraisal of 1.8 times retail sales, Car-Mart would have a business value of $713 million. Because financial services stocks are cyclical in their profitability, it makes sense to apply the same enterprise value to sales ratio at all times to value the stock instead of using the pre-tax earnings in any one year. So, Car-Mart should be valued at 1.8 times sales (retail only) instead of 12 times EBIT. This approach of valuing Car-Mart based on sales is similar to valuing a bank on its book value regardless of the cost of its deposits and the yield on its loans at this particular moment in the cycle. Today, Car-Mart trades at 1.1 times retail sales. In the past, the company's enterprise value has ranged from 0.8 times retail sales to 1.5 times retail sales. This constant undervaluation is what has caused the stock to outperform the S&P 500 by more than 10 percentage points per year since it went public

## GROWTH: *From Now till 2025: Car-Mart Can Grow Receivables Per Share 14% a Year*

Car-Mart can grow its intrinsic value per share 14% a year from now till 2025. This is a bold assumption. But it is supported by the facts. Really, Car-Mart's future growth can be divided into 3 or 4 factors: 1) store count growth 2) same store sales growth 3) share count decreases. The more complex – 4 part – way of breaking down future growth is to divide same store sales growth into unit growth and price growth. This is more complicated. And the division favors Car-Mart. Stores open less than 5 years sell 294 cars a year. Stores open 5-10 years sell 325 cars a year. And stores open more than 10 years sell 356 cars a year. Therefore unit growth between ages 0 and 10 – which cannot be exactly calculated using the above numbers probably runs close to 2% a year. Historically, Car-Mart's price per unit sold has increased 4% a year. This is slightly – only very slightly – greater than car price inflation on new cars. Car price inflation is a tricky subject. Officially, there is very little inflation recorded by the Consumer Price Index because car price increases over the last 30 years have been attributable to improvements to the cars. Today's cars are simply better – they have more safety features, more electronics, more improvements of all sorts – than they were in the past. However, a car is a necessary purchase for workers outside of cities. And the cost of living for those workers increases with the price of the car regardless of whether or not the car improves. In other words, people get better cars over time but they also give up more and more share of wallet for these cars. That has been happening for 30 years or more in both new cars and used cars.

Since 2004, America's Car-Mart has increased its average retail price of a car by 4% a year. The price of a new car has increased 3.6% a year from 1983 through 2013. It is safe to assume price increases at America's Car-Mart will be at least 3% a year. Car price increases tend to run higher than 3% a year. And America's Car-Mart's own prices have grown 4% a year. Furthermore, prices at mature locations are always higher than prices at new locations. This is because some mature locations get 50% of their sales from repeat customers and repeat customers generally buy more expensive cars each time they return to the lot. Past experience at locations as they matured has probably been closer to 6% annual same store growth as a result of a 4% annual price increase, 2% annual unit sales growth per lot, and a continual shift to more repeat customers buying more expensive cars. Instead of using this approach, the more conservative assumption of 3% annual same store sales growth will be made.

The biggest part of Car-Mart's growth between now and 2025 will come from opening new stores. Car-Mart is currently targeting 10% annual new store growth or adding about 10 stores a year. From 2004 to 2013, Car-Mart only grew new stores by 7% a year. This period included the financial crisis and the Great Recession that followed. During this period, Car-Mart slowed its new store growth. The store count actually declined 1% in 2008, grew just 2% in 2009, and then just 4% in 2010. Basically, Car-Mart took 3 years (2007-2009) off from planning for additional new stores in the next year. Excluding those years, Car-Mart grew its store count by at least 8% a year in every other year from 2004 through 2013. All years except one (2006) saw 8% to 9% store count increases.

Car-Mart could reach about 290 stores by 2025. The company does not provide footprint expectations that far out. They only say they can double the current store footprint and they can grow 10% a year over the next 5 years. Here is a 2013 example: "So when we look out over, say, the next five-year period, we have identified around 100 towns that make sense for Car-Mart locations. With our current growth rates, a 10% unit count increase per year, this will take us maybe beyond the next five years, but we still consider this to be our near-term potential footprint...You can see that basically doubling the size of the company from a unit count standpoint. We're only adding two states, Georgia and Southern Illinois, so beyond this footprint we have significant opportunities in addition to what we are seeing here." There is no reason Car-Mart cannot eventually have 300 locations. It would take Car Mart a little beyond 2025 to pass 300 lots if it grew at 7% a year. A 10-year growth estimate of 7% a year in store count seems reasonable. Car Mart plans to grow 10% a year for the next 5 years. A simpler assumption is to assume a 7% annual growth rate for a full 10 years.

Finally, there is the matter of share increases and decreases. Car Mart issues options and buys back stock. As discussed in the capital allocation section, Car Mart has no plans to pay a dividend. The company intends to devote all free cash flow not used in its expansion to the buying back of its own stock. Over the last 5 years, Car Mart reduced shares outstanding by 25%. The company may be capable – especially if it grows its store count closer to 7% a year rather than 10% a year – of buying back 5% of its shares each year. There is no need to pay down debt. So a 4% annual share count reduction is reasonable. Car Mart's management has been very committed in both words and deeds to stock buybacks. Car Mart has one

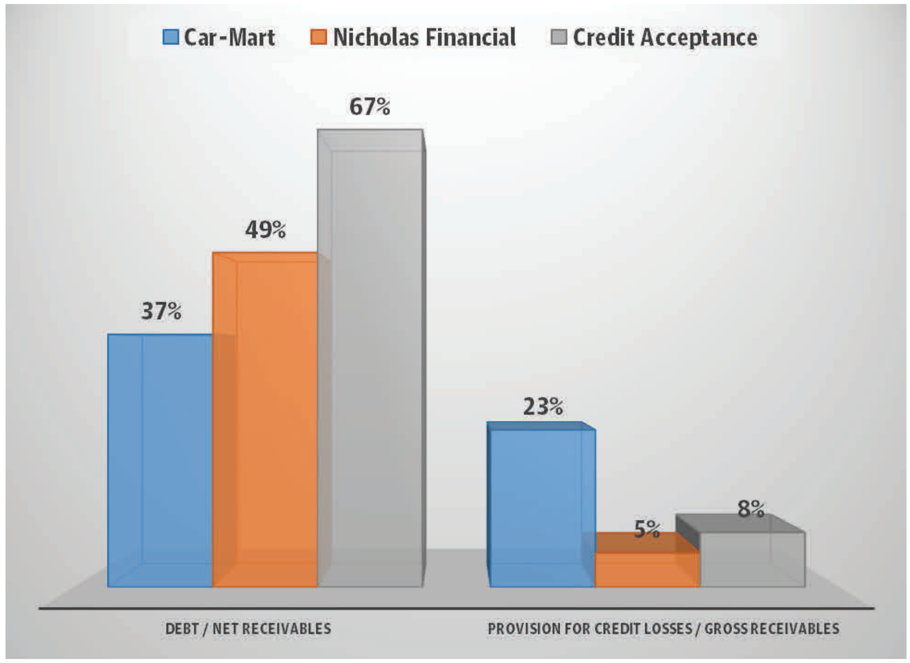

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| Retail Price | 2% | 10% | 5% | 8% | 7% | 4% | 1% | 2% | 3% | 0% |
| Store Count | 9% | 9% | 12% | 8% | -1% | 2% | 4% | 9% | 8% | 9% |
| Loan Balance | 15% | 18% | 22% | -4% | 17% | 11% | 13% | 8% | 12% | 15% |

Store count growth and same store growth will be amplified by buybacks

of the clearest capital allocation policies of any public company. These 3 factors: 1) 7% annual store count increase 2) 3% annual same store sales increase 3) 4% annual shares outstanding decrease add up to at least a 14% a year compounding of sales per share. In the long-run, Car Mart's stock price will track its sales per share. Management still talks about 14% to 15% top line growth targets. These do not include share buybacks. A safer assumption is 14% a year growth on a per share basis with all profits going to buybacks. There is also the question of whether Car-Mart should trade for a lower multiple – less than the appraisal of 1.8 times retail sales – at the end of its high growth phase. The answer is actually no. Car-Mart would still deserve an Enterprise Value to Retail Sales price of 1.8 times despite the end of its growth. The explanation is simple. Car-Mart's entire company averages a 21% loss rate. Car-Mart's stores open more than 10 years have a 17% credit loss rate. A simple way of saying this is that Car-Mart loses $12 million a year right now because of inferior underwriting at its immature lots. Car-Mart has $396 million in retail sales and probably $12 million in annual losses caused by this inferior underwriting at immature stores. In other words, immature stores currently drag Car-Mart's profitability down by 3% of sales. If the company completely stopped growing for 10 years, it would see a 300 basis point expansion in its profitability without having to do anything. Mature stores simply have lower credit losses than maturing stores. This offset means that the slower Car-Mart grows its store count the faster its profit margin will expand. As a result, the multiple contraction on an enterprise value to sales ratio basis when Car-Mart stops growing should be very minimal compared to other growth stocks. This is not true of the P/E ratio. But that is the wrong way to value Car-Mart. Car-Mart should always be valued using an EV/Sales ratio rather than the P/E ratio.

## **MISJUDGMENT**: *Car-Mart's Biggest Risks are Insufficient Loan Loss Reserves and Excessive Debt*

There are several risks of misjudging Car-Mart's future. Car-Mart is a financial services company. It is not really a car dealer. It is not in the business of selling cars. It is in the business of making and collecting deep, deep subprime loans. Car-Mart makes ultra-high risk loans (the repossession rate is 40% in normal times) car loans. By far the biggest risk to Car-Mart's future is the risk of bad underwriting. Car-Mart could make poor loan decisions. The risk of Car-Mart making bad loans and destroying its balance sheet is lower than at many financial services companies. This is because Car-Mart makes short-term loans. The shorter a loan is, the sooner it either goes bad or matures. Either way, old loans do not drag down the performance of a company that is making short loans. Car-Mart's loans are less than 3 years long. The average age of a loan at charge-off is 11 months. So, most of Car-Mart's mistakes are felt within 1 year of underwriting. The loan portfolio is very fresh with only recent vintages on the books. Car-Mart works through its loans – good and bad – within about 29 months. This means the risk takers – the store managers – pay the price (bonus cuts) for their bad decisions within about 2 years and 5 months of making their mistakes. Usually, it is a lot sooner than that.




Car-Mart has higher loan loss reserves and lower debt than its peers

The same is true of Car-Mart's purchasing department. The company tries to match the useful life of a car with the term of a loan. So, Car-Mart is often buying 9 year old cars. The employee who makes the decision to buy the car then receives a bonus for the remained of that car's time with Car-Mart. They make money (or not) based on the success or failure of the specific loan the specific car they purchased is associated with. This is important because car failure is a leading cause of default for Car-Mart's customers. If a car breaks down, the borrower stops making payment on the loans, Car-Mart repossess the car, and both the employee who made the loan and the employee who bought the car stop benefiting from the compensation tied to that transaction. The use of short terms on both the loans and cars and the incentive compensation for decision makers is insulation from "animal spirit" errors made elsewhere in Car-Mart's industry. Some companies provide financing – or buy securitized loans – for transactions they did not make. They did not sell the car. They did not write the specific loan. They never had one of their employees sit face to face with the car buyer. This approach can leave a company more vulnerable to psychological mistakes especially during good times in the financial cycle.

Other companies have longer loan terms. The receivables on Nicholas Financials balance sheet come from two sources: contracts and direct loans. Direct loans are 2% of the business. So, the company's results are all based on its contract with dealers. There are 1,412 active dealers making 12 to 72 month loans that Nicholas finances. The average "pool" from that dealer is 59 loans. Although Nicholas and Car-Mart are fairly close in balance sheet size – the scope of their business is very different. Car-Mart has just 134 sites making loans. Nicholas sources its loans from 1,412 different dealers. Car-Mart is 10 times more focused than Nicholas. Right now, Nicholas's average loan term is 50 months. Car-Mart's is 29 months. The business models of Nicholas and Credit Acceptance suggest a possible threat to Car-Mart. The company can be brought down by internal organizational failures or by competitive forces. The greatest risk of future competitive forces is securitization. If Nicholas Financial can have a great deal of long-term success buying what are essentially 1,400 pools of about 60 loans each, it might be possible to package and re-sell Car-Mart's pool of loans. If the underwriting of such loans, the servicing of such loans, and the repossessing of the collateral on such loans can all be centralized – then Car-Mart's business model would no longer be special. The organization would not be expert in anything. There would be no moat. And there would be no case for buying and holding the stock for the long-term.

The financing provided to dealers that compete with Car-Mart is what allows them to do the volume of car sales that they do. It is impossible for small time operations to put the roughly $2 million of capital (property, cars, and – overwhelmingly – receivables) needed to grow a new lot into a successful self -financing operation. Competitors do not want to put $2 million of their own money into loans they hold. So they sell their loans to companies like Credit Acceptance. Half of Credit Acceptance's 1,317 employees work in servicing loans. They need 663 people to service $2.2 billion in loans. In other words, they use one person to service $3.34 million in loans. The average loan is $15,445. So, one person is servicing something like 216 loans. This is complicated by the term length – the longer a loan is, the more loans you are servicing relative to the new volume of loans entering your system – and the amount that has been collected.

At the end of last year, Car-Mart had about $2.32 million in receivables per dealership. Some of those dealerships are not mature. A mature dealership is likely to be closer to $3 million in receivables. The average size of a Car-Mart loan is about 63% of a Credit Acceptance loan (it's actually even lower than that since Car-Mart reports is car sales price and Credit Acceptance reports the size of the loan – which is less than the cost of the car – only). This means that the same dollar volume of receivables represents at least 59% more loans using Car-Mart's business model than using Credit Acceptance's model. It is obvious that even with the kind of scale Credit Acceptance has you would need one employee dedicated to servicing the loans of one Car-Mart type branch. Basically, if you bought Car-Mart's loan portfolio, you would need something like 135 employees to service that pool. If this sounds absurd – it is – but not because the number is too high. It is clearly too low. Credit Acceptance makes it clear that the vast majority of its employees' time in the servicing department is spent on the first few days of the collections process. The volume of work done in servicing is almost wholly dependent on the number of newly delinquent loans. That number is 60% higher under Car-Mart's business model than the one Credit Acceptance (who buys much lower risk loans uses). In reality, it would require more like 220 employees dedicated to servicing a pool made of Car-Mart's loans. And that statement is still absurd. Car-Mart states that collections is their number one priority. And Car-Mart has 1,200 full-time employees at the company. The company's method of underwriting and collecting is very different from other companies its size. Car-Mart originates the loans it makes. And – unlike almost all other large buy here pay here dealers – the majority (80%) of the company's customers still pay in person at the dealership where they bought their car.

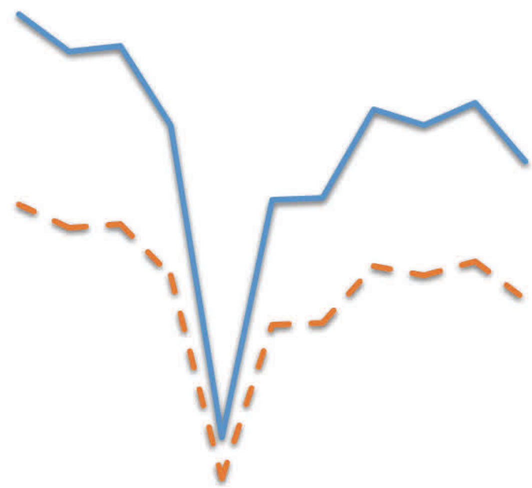
Without the approach Car-Mart uses, the loss rate on a portfolio of this quality could be much higher. In fact, Credit Acceptance has very little experience servicing loans as risky as the ones Car-Mart makes. At this moment, Car-Mart has set aside 23% of its receivables balance as a provision for credit loss. Credit Acceptance has set aside 8% of its receivables balance. Nicholas Financial has set aside 5% of its receivables balance. Although Credit Acceptance and Nicholas Financial may appear to be in the same business as Car-Mart and taking the same risks as Car-Mart – they are not. The loss experience is different. Car-Mart operates in a niche others do not yet have the experience to enter. If that niche ever becomes crowded – due to securitization – Car-Mart's moat will vanish.

## CONCLUSION: *Car-Mart is Worth Double its Net Receivables Per Share*

America's Car-Mart has the clearest path to growth of any stock discussed in The Avid Hog. Car-Mart's value over time should mirror its per share loan balance. This loan balance is what creates value for Car-Mart. So, it is receivables – net of the provision for credit loss – per share that will matter most to long-term investors. Today, Car-Mart has $310 million in net receivables and 8.75 million shares outstanding. That means the company has $35.42 in net receivables per share (versus a $36 stock price). Based on the assumptions made in the "Growth" section of this issue, it is reasonable to believe Car-Mart could have $884 million in receivables by the end of 2025. And based on the assumptions made in the "Capital Allocation" section of this issue, it is reasonable to believe Car-Mart could have 5.58 million shares outstanding at the end of 2025. This means the company could have $158 a share in receivables by the end of 2025. In fact, given 3 assumptions – 7% annual store growth, 3% annual same store sales growth, and a 4% a year reduction in shares outstanding – this number is certain. Car-Mart's stock should never trade for less than its net receivables per share. In the past, it has. However, the stock was badly mispriced at many times in the past. That is why the company has – over the last 15 years – returned 16% a year versus just 4% for the S&P 500. That can only happen to a stock that started the period incredibly underpriced. There is no logical reason why Car-Mart should ever have a stock price below its net receivables per share. The receivables clearly generate as much profit as the book equity at many major financial institutions – banks, insurers, etc. – that rarely trade below book value.

If a financial services company needs to reduce its leverage, then it may be appropriate for the market to anticipate this by lowering the price-to-book ratio in advance on the expectation of lower earnings versus equity. In Car-Mart's case too much leverage could force the company to reduce receivables per share because it would be unable to use as much debt – it now uses $114 million – to finance those receivables. There is no evidence that Car-Mart is overleveraged. Public company peers of Car-Mart all use more debt relative to their net receivables than Car-Mart does. This allows them to increase receivables – and thus earnings – per share by using debt instead of equity. If Car-Mart tends to earn 15% (after-tax) on net receivables, the appropriate price for Car-Mart's stock – when it has stopped growing – is probably around 1.5 times net receivables per share. The long-term return in the stock market has generally been less than 10% a year. To have a 10% annual return forever, a static business that earns 15% on its net receivables would need to trade at 1.5 times those receivables to have a dividend yield of 10%.

The best way – even better than the EV/Sales approach mentioned earlier – to value a financial services company like Car-Mart is to value the stock price against the earning assets per share at a normal and sustainable leverage level. Car-Mart sells cars to create receivables. Car-Mart does not want to make money on car sales. It wants to make money on its receivables. The intrinsic value of the stock is driven by the net receivables per share. The use



| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EBIT / Starting Net Receivables | 30.7% | 28.6% | 28.9% | 24.4% | 6.7% | 20.1% | 20.3% | 25.3% | 24.4% | 25.7% | 22.3% |
| Unleveraged After-Tax Equivalent | 19.9% | 18.6% | 18.8% | 15.9% | 4.4% | 13.1% | 13.2% | 16.4% | 15.9% | 16.7% | 14.5% |

Since 2003, Car-Mart's EBIT has averaged 23% of starting net receivables

of enterprise value per share is the best way to look at Car-Mart on a capitalization independent basis. However, the acceptable leverage level for a financial services company is not really independent of its core business. Car-Mart and its public peers like Nicholas Financial and Credit Acceptance borrow between one-third and two-thirds of the value of their net receivables (the other one to two thirds is financed with retained earnings). It is considered safe to fund 33% of receivables with bank debt. It is not considered safe to fund 100% of receivables with bank debt. For this reason, the leverage level is not independent of the business model.

Car-Mart's market cap is not backed up by the earning power of a typical non-financial company. It is backed by receivables. The most honest way of valuing Car-Mart's stock is to consider 3 factors: net receivables, debt, and shares outstanding. Car-Mart will never be debt free. Right now, the company is borrowing $114 million in revolving credit against $310 million of receivables. One way to value Car-Mart is to assume that the debt should be matched off with receivables and eliminated from the equation. This treats Car-Mart as if it could be bought and financed entirely with equity. Of course, the company could only support $196 million of receivables without using debt. This would bring net receivables per share down to $22.40. Today's stock price would be appropriate if Car-Mart suddenly had just $22.40 worth of net receivables per share. So, it is difficult to justify buying the stock if the company uses no leverage. This is almost always the case with a financial services company. Leverage is always part of the business model. If Car-Mart used no debt, today's stock price would not be especially low. The company – unleveraged – would only be able to generate about a 9% return on the current stock price. Without growth, it would not be a great investment. And it could only grow the company as fast as it could grow receivables. For this reason, the enterprise value to sales approach is somewhat dishonest when evaluating a financial services company.

In truth, the level of sales for a company that retains the loans it makes is based on the amount of leverage that company is willing to take on. Car-Mart can only use its own cash flow plus drawing additional cash on its revolving credit line to support receivables growth. Customers are not financing their own purchases. So Car-Mart cannot sell more cars without taking on more receivables.

The real question for an investor considering Car-Mart is whether 37% of net receivables is an appropriate and sustainable debt level? An investor has to be comfortable that Car-Mart will use leverage and will use it conservatively. If Car-Mart stops using leverage, the company's return on equity will be too low to justify buying the stock for the long-term. If the company abuses its use of debt, the stock will not protect the investor's principal. Car-Mart should be judged like any financial services stock. The conservatism of the organization and the balance sheet needs to be considered. And the stock needs to be valued on the basis of net receivables per share. A great price to buy into Car -Mart is 1 to 1.5. times net receivables. This should deliver a market beating 10% to 15% a year return. At today's high prices, the S&P 500 will probably return less than 7.5% a year over the next 10-15 years. Car-Mart's is capable of delivering after-tax earnings of about 15% of receivables. To promise the same future return as the S&P 500, Car-Mart would need to be priced at 2 times receivables. Today, the company has $35.42 a share in receivables. So fair value is just under $71 a share. If the stock is bought in the $35 to $53 a share range, it should return 10-15% a year over the next 10-15 years. Anywhere in the $35 to $53 a share price range (1 to 1.5 times receivables) is the perfect entry price for a buy and hold value investor who is comfortable owning a financial services stock.

Value investors who are uncomfortable with financial services stocks should skip Car-Mart. And short-term oriented investors should also pass on the stock, because Car-Mart has been consistently underpriced in its past and may continue to be underpriced in the future. There is no catalyst for double-digit returns in the next 10 to 15 months. But there is a clear path to 10-15% annual returns over the next 10-15 years.

# America's Car-Mart (NASDAQ: CRMT)
# Appraisal: $68.46

### *Margin of Safety: 36%*

| Owner Earnings | (in millions) |
|---|---|
| | |
| Pre-tax Owner Earnings | |
| Retail Car Revenue | $396 |
| * Normal EBIT margin | 15% |
| = Pre-tax Owner Earnings | $59 |
| | |
| OR | |
| | |
| Pre-tax Owner Earnings | |
| Net Receivables | $293 |
| 10-Year Average Return on Starting Receivables | 23% |
| = Pre-tax Owner Earnings | $67 |

Business Value

Car-Mart's business value is $713 million.

- Pre-tax owner earnings are $59.4 million
- Fair multiple = 12x pre-tax owner earnings
- $59.4 million * 12 = $713 million

Fair Multiple

Car-Mart's business is worth at least 12x pre-tax owner earnings

- Quan thinks: "Car-Mart can compound owner earnings 13-15% over the next 10 years. It deserves 12 times pre-tax owner earnings"
- Geoff thinks: "Car-Mart has averaged a 23% pre-tax return on starting receivables over the last 10 years. To trade at 10 times normal (next year's) pre-tax earnings, Car-Mart should trade at 2.3 times receivables."

Share Value

Car-Mart's stock is worth $68.46 a share

- Business value is $713 million
- Net debt is $114 million
  - Cash: $0.3 million
  - Debt: $114.3 million
  - $114.3 million - $0.3 million = $114 million
- Equity value is $599 million
- $713 million - $114 million = $599 million
- Equity Value = $38.02/share
  - 8.75 million outstanding shares
  - $599 million / 8.75 million = $68.46

Margin of Safety

Car-Mart stock has a 36% margin of safety.

- Business Value = $713 million
- Enterprise Value = $453 million
- Discount = $260 million ($713 million - $429 million)
- Margin of Safety = 36% ($284 million / $713 million)

| | EV/Sales | EV/Gross | EV/EBITDA | EV/EBIT | EV/Owner |
|---|---|---|---|---|---|
| EZCORP | 0.80 | 1.26 | 4.63 | 5.73 | 5.53 |
| Cash America International | 0.97 | 1.69 | 6.15 | 8.27 | 8.27 |
| First Cash Financial Services | 2.32 | 4.15 | 11.06 | 12.44 | 12.44 |
| Nicholas Financials | 3.87 | NMF | 8.38 | 8.44 | 8.44 |
| Credit Acceptance | 6.61 | NMF | 12.45 | 12.92 | 12.64 |
| | | | | | |
| Minimum | 0.80 | 1.26 | 4.63 | 5.73 | 5.53 |
| Maximum | 6.61 | 4.15 | 12.45 | 12.92 | 12.64 |
| Median | 2.32 | 1.69 | 8.38 | 8.44 | 8.44 |
| Mean | 2.91 | 2.37 | 8.53 | 9.56 | 9.46 |
| STDEV | 2.41 | 1.56 | 3.27 | 3.05 | 3.04 |
| CV | 83% | 66% | 38% | 32% | 32% |
| | | | | | |
| Car-Mart (Market) | 0.92 | 1.90 | 7.61 | 8.01 | 7.22 |
| Car-Mart (Appraisal) | 1.46 | 3.02 | 12.09 | 12.74 | 11.48 |

## ABOUT THE TEAM

### *Geoff Gannon, Writer*

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

### *Quan Hoang, Analyst*

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

### *Tobias Carlisle, Publisher*

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).