A Reintroduction to CarMax (KMX)

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We first wrote about CarMax back in 2019, about a year after our initial purchases of shares priced in the low $60s. CarMax was then (and remains today) the largest used car dealer in the U.S. At the time, we described CarMax as authentically customer-focused, but aware that online competitors like Carvana had advanced the consumer experience ball well down the field. CarMax had responded with its first omnichannel 'bricks & clicks' market in Atlanta and was prepping a broader rollout of hybrid online and offline capabilities to its nationwide store base.

In 2019, both CarMax and Carvana already had difficult paths ahead. CarMax entered the year with an established brand and a huge volume lead but had to rebuild the digital workings of its entire business without impairing customer service. Carvana needed to manage enormous growth in the hopes of scaling before legacy retailers like CarMax could mimic its clean, purpose-built offering. In its sprint from behind, Carvana has endured years of heavy losses, plugging sustained cash flow shortfalls with debt and equity raises along the way. Then, along came COVID, asking still more difficult questions of both organizations.

In some ways, the pandemic may have helped CarMax's digital transition. If the organization lacked true unanimity around the need for a seamless digital offering coming into this period, COVID's forced store closures and occupancy restrictions focused efforts to digitize into a white-hot pinpoint. Within weeks of COVID's initial waves, CarMax's formerly in-person wholesale auctions – local sales of customer trade-ins not fit for CarMax's own lots – went 100% virtual. The already-in-motion push of omnichannel capabilities across the chain's 200+ stores accelerated.

Early 2020 brought curbside pick-up and home delivery to most buyers. In the back half of the year, CarMax enabled online car buying in all their markets and launched online instant appraisals for vehicles consumers wanted to sell. In 2021, CarMax introduced its "Love Your Car Guarantee," including new 24-hour at-home test drives and a 30-day money-back option. More recently, CarMax debuted its finance-based shopping engine, allowing consumers to filter using accurate, real-time payment data.

Consumers responded positively to this evolved offering and in 2021 rewarded CarMax with its largest single-year increase in market share ever. However, in late 2021, cracks in the used vehicle market began to appear. CarMax's shares peaked that November in the $150s and since then have underperformed the S&P 500 by about 35%.

Things were going so well, what happened?

In the several years prior to COVID, sales of new passenger cars and lightweight trucks in the U.S. averaged around seventeen million units per year. Used unit transactions averaged more than double that number over the same period. At COVID's outset, new vehicle purchases plunged below a nine million unit annual run rate, and manufacturers scrambled to cancel supply orders, including commitments for semiconductor capacity – capacity that was quickly taken up for other uses. Soon, the combination of stimulus payments and constrained spending (on things like travel and dining) resulted in a particularly flush consumer. Despite very strong demand for new vehicles, semiconductor supply constraints began throttling production volumes by mid-2021. Manufacturers have managed only about 80% of 'normal' production levels since. That unfulfilled new vehicle demand inevitably leapt its banks, flowing unabated into the used market. Used vehicle prices went parabolic throughout 2021, topping out some 70% above pre-COVID levels.

Into this already noxious brew, we have more recently poured the highest auto loan interest rates since the Great Recession, making already expensive used vehicles even less affordable. Too few vehicles costing too much money at too high financing rates have combined to crater used vehicle transactions. In the most recently reported quarter, CarMax's same-store retail unit volumes were down more than 20% from the prior year. Apart from the abrupt first quarter of COVID and the Great Recession, that is the worst volume growth quarter in our CarMax data stretching back to the year 2000.

CarMax's stock price has been volatile for several months, and the company's results in 2023 will almost certainly be terrible. Expecting sustained demand and a more normal supply environment, management got well out over their skis spending on investment initiatives. Having printed nearly $7 in earnings per share (EPS) a little over a year ago, it's not too difficult to imagine EPS in the coming year beginning with a $2 – or even $1 – handle. To be frank, we would be surprised if the stock rerated meaningfully higher before the used vehicle market begins to normalize. Currently, nearly 15% of CarMax's shares are sold short. In the very near term, we can understand the desire to bet against the stock.

So why own the stock?

The high-minded answer to that question is that we like CarMax's people, its business model, and its culture. CarMax behaves in a way that cultivates long-term, balanced relationships with its stakeholders (customers, employees, lenders, investors), and we tend to believe that kind of behavior gets rewarded. As difficult as this omnichannel transition has been for CarMax, we think it puts them in the best position to serve the most used vehicle buyers in the country. We know we want exposure to these things for a long time to come, no matter the chasm the industry currently negotiates.

The baser response to that question – Why own the stock? – is that we are eager to capture the returns we believe are in store. Today, a CarMax shareholder would need to be asleep at the switch to lack appreciation for the likely damage to near-term earnings. To our minds, 2023 is effectively baked, and our gaze has turned toward the future. With earnings in a repaired used vehicle selling environment likely significantly higher than we expect near term, whether 2023 produces EPS of $3 or even $0 has little bearing upon our ultimate outcome.

If we love a business – and if we believe several years of high returns are in store – we are highly unlikely to sell shares in the hopes of sidestepping some temporary hit that may or may not ever come. If the share price of that business falls substantially and our expectations for future returns from that lower price level consequently grow, our more likely response would be to buy more. The gravitational pull of our largely unimpacted future business value grows stronger with each passing day – with each downtick of share price.

Now, this all presumes a business that is actually worthy of love – a business that will not be taken from us nor forced to dilute our ownership share. In that regard, the debt for which CarMax itself is responsible looks entirely reasonable relative to the value of its inventory. That borrowing will likely – and reasonably – evolve along with inventories as the volume of CarMax's business itself evolves. And we are hard-pressed to think of a company more capable of managing used vehicle inventories than CarMax. The more we can grant CarMax a balance sheet positioned to withstand great agitation, the less our expected future reward seems a matter of "if" but rather "when."

As of 12/31/2022, CarMax, Inc. constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows: CarMax, Inc.: 0.0%, 4.3%, 4.3%, 2.6%, and 2.3%.

Holdings are subject to change and may not be representative of the Fund's current or future investments.