CRMT Earnings Call Transcript

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Quarter: 2

Operator: Hello, and thank you for standing. Welcome to America's Car-Mart Second Quarter Fiscal 2025 Result. At this time all participants are in a listen-only mode. After the speakers' presentation there will be a question-and-answer session. [Operator Instructions] I would now like to hand the conference over to Vickie Judy. You may begin.

Vickie Judy: Good morning. I'm Vickie Judy, the company's Chief Financial Officer. Welcome to America's Car-Mart's Second Quarter Fiscal Year 2025 Earnings Call for the period ending October 31, 2024. Joining me on the call today is Doug Campbell, our company's President and CEO. We issued our earnings release earlier this morning, and it is available on our website, along with supplemental slides detailing our cash-on-cash returns and our new loan origination system performance improvements. We will post a transcript of our prepared remarks following this call and the Q&A; session will be available through the webcast. During today's call certain statements we make may be considered forward-looking and inherently involve risks and uncertainties that could cause actual results to differ materially from management's present view. These statements are made pursuant to the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. The company cannot guarantee the accuracy of any forecast or estimate nor does it undertake any obligation to update such forward-looking statements. For more information, including important cautionary notes, please see Part 1 of the company's annual report on Form 10-K for the fiscal year ended April 30, 2024. And our current and quarterly reports furnished to or filed with the Securities and Exchange Commission on Forms 8-K and 10-Q. I'll let Doug start with color on the quarter and perspective on Car-Mart's business strategies. Doug, I'll turn it to you now.

Doug Campbell: Thank you, Vickie. We had significant activity during this quarter that I want to comment on, which were designed to shape our outcomes in the future. In September, we amended our revolving credit facility. The purpose was to provide additional cushion around our financial covenants to help navigate uncertainty around the macroeconomic environment and the back half of the year. We also raised approximately $74 million of net proceeds through the issuance of new shares. It is important for me to explain the rationale for this decision. Our management team and Board of Directors gave very thoughtful consideration and review ahead of this decision given its dilutive effect on current shareholders. Our performance over the past few quarters was below our expectations, which was an important factor in our decision to bolster our balance sheet. As we've talked about in the past, we've been challenged by marketplace factors. On the sales side, we've tightened underwriting standards given the industry-wide auto loan loss pressure, evident by the performance of our own back book. Our consumer is and has been more susceptible to challenges in today's inflationary environment. We needed breathing room in our forecast to account for these factors. We did consider options that would increase additional leverage in various forms, but ultimately we felt that equity was more prudent. This decision pained us to execute. However, we felt it was the best decision for all shareholders to maintain flexibility during marketplace challenges in a higher interest rate environment. With the equity raise completed, the company is currently in discussions to extend the revolving credit facility which matures in September 2025. And we are working through potential initiatives to expand the company's funding program while also making it more robust. These initiatives include options to add warehouse capacity, a redesigned floor plan facility and a bespoke line

of credit for receivables originated by our acquired dealers. The objectives of these facilities are to increase overall availability, optionality on when we enter the ABS market and to build a level of redundancy and conservatism in our funding structure. We appreciate the support of our ABL partners, and they will continue to be a critical part of our capital structure. They have been supportive for many years, and we appreciate their consideration in navigating near-term challenges to date. We will share more with you on our progress on these initiatives in the coming quarters. We completed our fifth ABS transaction in October. This transaction was $300 million in size and well oversubscribed, generating over $1.5 billion in demand. We believe improved demand was for loans underwritten by LOS which represented approximately 70% of the receivables in this transaction. Ultimately, this enabled us to have the tightest spreads we've had to-date, which when combined with lower benchmark rates, resulted in an overall coupon of 7.44%, a nearly 2-point improvement over our January transaction. This platform is important for us given its material improvement in the advance rate relative to the ABL and the access to additional capital for a growing portfolio. Also in October, we welcomed our new Chief Operating Officer, Jamie Fisher, to our leadership team. Last quarter I mentioned how important existing and new talent will be in rounding out our leadership team. Her skill sets will complement and accelerate our growth, and she's already proven to be a great fit within the organization. Before turning it over to Vickie, I want to comment on our continued improvements in underwriting. Back in June, I spoke about the LOS results relative to the loans generated in our legacy system during the LOS rollout. At the time, we noted that it was still early, but we were optimistic that the results that we were seeing showed a 20% improvement in cumulative net losses through May. An update through October is now showing this at a 21% improvement in cumulative net losses. On the surface, it is very difficult to see where such nominal changes to down payments, originating term lengths, payment-to-income ratios and overall amounts financed could represent such an improvement to cumulative net losses. But our focus has been on the cohorts of customers with the most risk within our customer rankings. We rank our customers 1 through 6 with 6 having the very best credit and ranked customers holding the most risk. Approximately 40% of our sales come from ranks 1 through 4 consumers, and that has been where most of our focus has been for us on improving loan structures and allowing more flexibility to 5 and 6 rank customers. On these lower cohorts, we systematically now can hold more control over these structures when compared to our legacy system. This has resulted in a 15% improvement in down payments, allowing us to carry smaller loan sizes of $400 to $800 less depending on the customer rank and curtail originating terms by three months on average in addition to lower pay-to-income ratios. Looking at the bottom quartile of stores, those results are even more pronounced. The LOS receivables within the portfolio at quarter end represent almost 50% of the portfolio dollars. In terms of the number of contracts, it is about 38%, it's why we're starting to see an improvement sequentially in the severity of loss, but the volume of contracts originated in the legacy system are still driving the frequency of loss. We were able to take another reduction in our loan loss reserve percentage based on the LOS improved performance and the increasing size of the portfolio impacted by it. We expect a crossover point at the end of the fiscal year where the LOS will start to be a larger driver on both frequency and severity. With that overview, let's turn to the second quarter financial results. Vickie?

Vickie Judy: Thanks, Doug. Before I get started on the details, I want to cover an accounting adjustment that we made in the quarter related to our service contracts. Our longer-term service contracts that we rolled out in 2021 have now been through a full cycle. And based on a detailed performance analysis, we found that customers reached the mileage portion of their service contract earlier than their contract term. Because of this, we reduced our revenue recognition period to better match the time of usage by the consumer. This resulted in an acceleration of deferred service contract revenue of $13.2 million during this quarter and will result in a 25% quicker recognition of revenue on both existing contracts and any new contracts originated going forward. This started in the second quarter and is expected to improve gross margin of approximately 1% on a go-forward basis, absent any other variances to gross margin. In my remaining commentary, the comparisons that I will cover will be the second quarter of fiscal 2025 versus the second quarter of fiscal 2024 unless otherwise noted. Total revenues decreased $12.5 million or 3.5%, largely due to a 9.1% decline in retail units sold. This was partially offset by a 3.6% increase in interest income and the $13.2 million service contract benefit.

Sales volumes were impacted by a number of factors, including the affordability of vehicles for our consumers, although we did see sequential improvement. This past quarter was also impacted by some weather events and the closing of two dealerships early in the quarter, accounting for about 15% of the sales miss to the prior year. We continue to balance the appropriate underwriting risk with sales volumes and have limited originations at a select number of dealerships to focus on collections and servicing to maximize returns. This has also contributed to lower productivity on average, but improved asset quality. I'll cover more on the portfolio statistics in a moment. The average vehicle retail sales price, excluding ancillary products, was $17,251, a reduction of $212 or 1.2% sequentially. We provided a breakout of the total average retail sales price per unit versus the ancillary sales in our earnings release this morning. This should make it easier to isolate the vehicle price movement going forward. Gross margin as a percentage of sales was 39.4% or 36.5% excluding the impact of the $13.2 million service contract revenue recognition benefit. The initiatives around procurement and our partnership with Cox continue to drive improvements to vehicle affordability and the resulting gross margin percentage. We are pleased with the continuing progress in improving the gross margin percentage, and we'll continue to be focused on driving to the 37% to 38% that we've mentioned in prior quarters. Net charge-offs as a percentage of average finance receivables for the quarter were 6.6% compared to 7.2%. Our fiscal year 2023 and earlier originations are still the primary cause of underperformance, but represent less than 30% of the portfolio dollars currently. However as Doug mentioned, the LOS originations represent approximately 50% of the portfolio dollars and are continuing to drive the improvements in the allowance for credit losses. The allowance as a percentage of finance receivables, net of deferred revenue and accident protection plan claims was 24.72% at quarter end down from 25% at July 31, 2024. Doug covered the work we've done to achieve improvements in underwriting through our LOS system. Down payments for the quarter were up 30 basis points to 5.2%, the focus of our sales teams on larger down payments, especially with higher-risk customers is benefiting the performance of fiscal 2025 pool and will benefit our customers as well. Our average originating term was 44.2 months, close to flat compared to the prior year and a slight reduction sequentially. This term flattening is improving collections and benefiting loss improvement. We continue to optimize the distribution of the term by customer score, shortening term for our highest credit risk customers and allowing additional term for our best credit scoring customers. At the end of the quarter, the weighted average total contract term for the portfolio is 48.2 months, with 35.9 months remaining. The weighted average age is 12.3 months. We continue to make progress on boosting overall collections which are up 3.3% over last year. This is also a sequential improvement from the first quarter. The monthly average total collected per active customer was $560 from $533. Delinquencies or accounts over 30 days past due improved 10 basis points to 3.5% at quarter end and was flat with the first quarter of fiscal 2025. Recency was 81.8% for the quarter. Moving to SG&A.; SG&A; expense was up $2.5 million, an increase of 5.7%. This was primarily driven by a $2.1 million increase related to the two acquisitions completed since last year. As mentioned, we measure SG&A; efficiency on a per account basis. In the short-term, these acquisitions create headwinds in our ability to leverage SG&A; on a per customer basis while they build out a portfolio of customers. These acquisitions are expected to add 5,000 or more accounts over the next 18 to 24 months. Sequentially, SG&A; increased approximately $697,000, primarily due to stock compensation increases. Interest expense increased by approximately $1.5 million or 8.8% due to the rise in rates and secondarily, an increase in debt. Sequentially, we had a decrease of approximately $270,000 in interest expense as we began to see the improvement in rates and results from the equity raise and reducing the amount of debt net of cash. As of October 31st, we had $8 million in unrestricted cash and approximately $97 million in additional availability under our revolving credit facilities calculated on our borrowing base of receivables and inventory. Now I'll turn things back to Doug.

Doug Campbell: Thanks, Vickie. We are pleased with the progress we've made on underwriting powered by our technology investments. However, last quarter I discussed the importance of unlocking more capability of the LOS system by utilizing risk-based pricing for certain customers. Our goal was to have the pilot kicked-off before the calendar year ended, and we were successful in that effort. We're currently in a few markets testing pricing structures and the results to date are good. In this pilot, we enabled risk-based pricing and the implementation of a new scorecard that adds more granularity to the

applicant pools and gives us better predictability of loss. This gives us another lever to pull to help both retain and grow the business. We believe this makes us more competitive in the upper end of our credit spectrum and will also allow us to price in appropriate returns for lower rank customers in our system. Our credit team has done a nice job of ensuring this was delivered timely and without issue. We should have a more comprehensive update by the fiscal year-end, as we get more data and results flowing through the system. Additionally we are pleased to see gross margin continue to improve and vehicle price come down sequentially. In fact, excluding the service contract benefit, this was the highest gross margin percentage on a quarterly basis in the past 10 quarters. We expect to see continued benefits in the back half of the fiscal year on affordability, and it's especially important to get this right as the tax season approaches. Our teams are critical to the company's success. Their hard work and focus on the execution of our initiatives continue to drive these improvements. We appreciate the contributions of all of our associates in serving our customers. Overall, we're focused on our stakeholders. customers, associates and shareholders. We appreciate their belief in the platform, and we believe Car-Mart is well positioned for future growth and profitability. We'll move on to the Q&A; session now. Operator, please provide instructions to ask questions.

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Kyle Joseph with Stephens.

Kyle Joseph: Hi, good morning. Thanks very much for taking my questions. Vickie, I just want to make sure I understand the service contract adjustment. So the big adjustment was in this quarter, but then going forward, I think you mentioned kind of a positive 100 basis point impact on the gross margin. Is that about it?

Vickie Judy: That's correct. So essentially, what we did, if you go back historically, we had a 1-year service contract. We added in 2021, we added multiple years, a one year, two year and three-year service contract. At the time we rolled those out, it was unclear on the timing of claims, the mileage driven by customers under these new contracts. And so we were conservative in our revenue recognition and recognized it just over the contract-term. As those have now completed a life cycle of our 3-year contracts or completing their third year, we began our full performance review and determined that our consumers are using up the contract in a shorter period of time than the actual contract term. So we had a onetime pull forward of the $13.2 million. And then on a go-forward basis, each contract that still sits on our books today and any sold going forward will be recognized over that shorter time period.

Kyle Joseph: Got it. Very helpful. And then I appreciate all the color you gave on the new LOS, but can you just kind of frame where you are in terms of underwriting versus when you first rolled out the LOS over that time frame? And how much that's changed under the new LOS or whether you kept that fairly consistent since the LOS was rolled out?

Doug Campbell: Great question. It's Doug. So great question. If you remember, it was this time last year we had just rolled it out and we were talking about being too tight. And certainly, we've gone back and revisited some of our assumptions, and those are mainly around our higher rank customers in terms of what we did in terms of term and down payment. We have stayed focused, and we have obviously kept the underwriting much tighter on the bottom 40% of those customers, which are one through four rank customers and continue to iterate there and focus on down payments. And so the color around there around getting more money down, that wasn't I would call it, a step change for those customers. They are sort of still living in that same environment of tightness when we initially rolled it out. I'd say it's largely unchanged. We've fiddled around with some other things in terms of PTI and originating term lengths. But for the most part, it is been -- all our focus has been around the 1 through 4 rank customers. We are trying to not deviate too far off of what we did for them because the results are really, really positive. Like I mentioned, when you're getting 15% and sometimes 20% more down on those lower rank customers, that's a really, really big difference in the portfolio, especially when you can take out a bunch of term there as well. So we like the results of what we're seeing there.

Kyle Joseph: Got it. Thank you. And then, yes, you mentioned tax refund season. I think over the last five years, call it between stimulus and inflation, the traditional tax refund season has been anything but traditional. Kind of can you give us a sense for your what your expectations are for this year's tax refund season?

Doug Campbell: Yes. So being better prepared would be one of them and just making sure we are staying on top of it. The pricing market has been somewhat volatile, a little softer in the summer than we expected. We certainly took advantage of that. But obviously, given the storms that have come through and then what I would call all the software noise and nonsense which created a bunch of turmoil in the wholesale market from a pricing standpoint, has really sort of kept pricing propped up in the back half of the year. We have sort of capitalized where we can and are in a good position here setting up for tax season. In fact, we are starting ad campaigns and all of that like right now. So we will be probably earlier in the season than we have in most cases because to your point, it has been anything but normal in the last couple of years. So we wanted to just ensure we are set up from an inventory and an advertising standpoint. Obviously, having Jamie Fisher on the team is going to go a long way. She certainly added some perspective on things we could do differently. So we're excited about this year's tax season coming up.
Kyle Joseph: Great. Thanks. And then one last one for me. Just an update on the competitive environment. And then tied to that -- just the M&A; environment as well.
Doug Campbell: Sure. There is still a lot of I would call, M&A; activity. The acquisitions, we've talked about that in the past in terms of building out a small team. There is so much that we are learning, having the opportunity to talk to a lot of owners. And the competition on the M&A; side is I'd say, small or non-existent almost. And the environment is still tough for these folks to navigate in terms of the higher interest rate and floor plan costs. And so they are really looking for help. These conversations, we have been being really, really selective on what we are looking at, but it's very fruitful what we can do out there, but we need to get the funding set up properly before we resume that. And so that will be something that we take care of here over the next quarter or so and then get back in the fight on some of those because we have clear line of sight on to several opportunities we are excited about.
Kyle Joseph: Got it. Thanks very much for answering all my questions.
Doug Campbell : You're welcome. Thanks Kyle.
Operator: Please standby for our next question. Our next question comes from the line of Vincent Caintic with BTIG. Your line is open.
Vincent Caintic: Hey, good morning. Thanks for taking my questions. It's great to see the good credit performance continue that trend. So my first question actually is on credit. So it was nice to see that trend, the LOS having the benefit the back book shrinking. And I'm just sort of wondering if we can talk about kind of how you view things once your portfolio evolution is complete. I guess, if you could compare where your portfolio is now versus what you are underwriting to. So let's say, once the back book goes to zero and the LOS originations become 100% of your portfolio, what sort of losses and allowance credit reserve rate should we be expecting in that environment?
Doug Campbell: Yes. If you go to -- we've included the first time a supplemental chart showing the LOS improvement. If you sort of buy into that, right it was -- I remember the first time we shared that we were 4 months or 5 months in. Now we're here on month 12 or 13 of the cycle and it's still holding a 21% improvement. When you're coming off years, the last two years averaging $400 million in credit loss, it would imply that business is $80 million better. We certainly believe if we didn't change anything that we could continue to hold that, but we do want to serve more customers. And I think we are still writing our story for what that looks like. And when I start talking about things like risk-based pricing, I want to make sure we give ourselves the latitude to make those decisions and go conquest some new customers, retain customers that we were losing before at the very upper end of the credit spectrum and maybe customers that we couldn't come to terms on in today's environment in terms of pricing the appropriate amount of return in on a risky customer that we have the opportunity to do that. And so I think that is still sort of a question mark. I don't obviously think we'll hold the line exactly where we are because we have this new lever that we're going to begin to pull here. We have a handful of stores now live, Vincent, and we are going to take 20% of the organization live here by the end of the year. We are going to learn quite a bit over the next couple of months. And I think that will really help shape our outcome. So I'd ask that you give me a couple of quarters to give you a better answer on that.
Vincent Caintic: Okay. Great. Sounds good. We'll ask you that in a couple of quarters. But yes it sounds like you're having a nicer control of your credit versus your sales volume opportunity. So I appreciate

that. And then last question. So I saw the -- you sold two dealerships this quarter. And you've been selling a couple of dealerships here and there and then also adding a couple of dealerships here and there. If you can talk about your thought process with that. So when you are looking at maybe selling or shutting down dealerships, what are you looking for in the pruning of the business? And then what can you add assuming to your point earlier, you get your funding lined up, what are you looking for when you are adding business and where you're shaping the overall Car-Mart company? Thanks.
Doug Campbell: Yes. So some of the, I would say, older businesses that we have Vincent, they've been around for quite a while. Some of them need facilities, improvements, et cetera. It is really an opportunity to revisit some of that and whether we want to make some of those investments. I certainly -- given the performance of the LOS and our ability to control underwriting at a rooftop level now with sort of central oversight, it has sort of changed our mind of thinking -- our frame of thinking on what we can do there to manage what I would call originations if we are seeing a lack of performance. But there still is this sales volume part, and we still need to look at the markets and what they are bearing. And sometimes, we're in a long place for 20 or 30 years, things are different, right? Plants close, manufacturing plants close. Those things have happened, and we are trying to take action. We haven't sold any of these. These have been ones that we are closing. And so we're going to continue to look at that. I've spoken about that a couple of times about the prudent deployment of capital. And if we are not seeing the appropriate returns, even if we can manage the credit side, but there's just not healthy volume inbound, then it sort of doesn't make sense, especially when you have line of sight to opportunities and some of these new opportunities, the second part of your question, they range in size from things that look very similar to us to locations that have 5 and 6x the potential. And so we want to do that where it complements our footprint, where we can operationally manage those and certainly where we can continue to exploit and manage and leverage the Cox partnership. That's been a nice add-on that we are continuing to get the benefit of in terms of gross margin as well.
Vincent Caintic: Okay, great. Super helpful. Thanks so much.
Doug Campbell : You bet. Thanks for your question.
Operator: Please stand by for our next question. Our next question comes from the line of John Murphy with Bank of America. Your line is open.
John Murphy: Good morning everybody. Doug, I just had a first question on sort of the tightening of the credit box. And it sounds like with Elis and the scorecard that you're finding ways to kind of loosen that very responsibly at the higher-end. I'm just curious how much volume you think you may have lost and how much you may gain for that adjustment at the higher end of the credit spectrum or your rankings? And what percentage of your customers you think that is roughly?
Doug Campbell: Yes. So, good morning John. Good to hear from you. So the five and six rank customer, what we have been sort of deeming the upper end, is about on any given month, 55% to 60% of our customer base. What we've seen over the last year is sort of those customers sit on the sidelines a little bit. But over the last quarter, those -- that traffic has been pretty robust. We are excited about the opportunity. If you think about the opportunity to sort of yield up on these lower-ranked customers or potentially give away some price, get stronger down payments, incentivize these customers to work with us more, the opportunity certainly exists on the volume side. And so we are excited in terms of the pilot and where we can do that, especially where you consider we have a large density of stores in Arkansas home base, and there is a user recap there. And so our ability to go after those customers, which have some of the highest incomes in the country for us, certainly gives us volume opportunities in and around there Missouri, Texas, Oklahoma. We're certainly looking at that as an opportunity to drive and grow volume. But there are these other areas where we need customers that are customers to serve, but we just haven't been able to price in the appropriate returns. And so on the other end of the spectrum, we're excited about what we can do to still have a way to serve these customers while getting the appropriate return through all of the rising rate environment, we didn't really pass much, if any, on to our consumers because we couldn't do it sort of across the board. We had no surgical systematic way to do it, but now we do. And so we are excited about that, John.
John Murphy: And then just a second question around the confidence of your consumer because obviously, that plays a big part in getting them into the transaction. What are you seeing in traffic with your customers? And it seems like there is a little bit of a spurt that's coming in consumer confidence at

the low-end and also in some of your states that might be a little bit more red more recently in some of the readings. I mean how much of a help could that be going forward?

Doug Campbell: A huge help. Obviously, we help that lower-end consumer, and I hear what you are saying. Certainly, they have spoken and they want the help. And I think they are -- from a consumer confidence index standpoint, they are maybe feeling a little bit more confident about the future, hopeful. For us, we try to be agnostic to all that's going on in that outside environment. Our job is to stay focused on the consumer and find them every way to help. And I feel like today, where we stand, we certainly have more tools in our toolbox to be able to serve more of these customers and help them smartly. To your point earlier, it is like we want to do it and take those risks appropriately just given the backdrop of everything that's going on. And there will be a day where we'll sort of throttle volume higher, maybe return to the norm a little bit, but that's not today. Today, we want to make sure that we are setting up our future to be a very bright one.

John Murphy: And then just lastly, on the recap for the equity raise and the ABS. I mean you mentioned, obviously, it was a bit painful, but probably the right thing to do for the company in total or was the right thing, that probably was the right thing to do for the company in total. Why wouldn't you have maybe done a little bit more to get the funding to maybe get a little bit more aggressive on the acquisitions of folks that might be a little bit more motivated sellers more recently?

Doug Campbell: Yes. It is a great question. We certainly considered that as an option. But what we are banking on is a convergence of several things, right, falling interest rates, the initiatives coming into place, and we wanted this to be as least dilutive as possible. And so when we have line of sight to these things that we can do, which we'll announce here in the upcoming quarters around ways that we can help our customers in terms on the collection side, we got to get some of those things right, and we don't think we had to do it all through equity raise. There are certainly things we can do as a management team to drive some of those benefits and we have clear line of sight to that, but this certainly gave us some breathing room in doing that.

John Murphy: Thank you very much.

Doug Campbell: You’re welcome. Thank you John.

Operator: Ladies and gentlemen, I'm showing no further questions in the queue. I would now like to turn the call back to Doug for closing remarks.

Doug Campbell: Thank you operator. Thank you, guys, for your interest in America’s Car-Mart, and we’ll talk to you next quarter.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect. Thank you.