Classic Value Investors, LLC
www.classicvalueinvestors.com

America's CAR-MART Drive Easy.

Ticker Symbol – CRMT

December 1, 2015

America's Car-Mart – Not Like the Other Players

INVESTMENT SUMMARY

America's Car-Mart has had an impeccable financial record during the last seven years. The revenues and the bottom line have increased pretty much on a straight line. Even though the company has plenty of growth left, the stock is trading attractively in relation to its earning power. The company is definitely worth a look.

COMPANY DESCRIPTION

I was very happy researching America's Car-Mart because I own a car that now has more than 300,000 miles.

Consequently, I keep thinking about the day that my car will need to be replaced. Amazingly, it never had any major repairs yet. Hondas are built to last.

America's Car-Mart is in the business of selling used cars. Obviously, we have all heard comments about used car salesmen as being deceptive and sleazy. This is exactly what I was expecting when I first looked at this company. However, I was pleasantly surprised to learn otherwise. America's Car-Mart is definitely not like the stereotype of used car dealerships.

The company was started by Bill Fleeman in 1981 with one dealership in Rogers, Arkansas.

1981

He built the company on great customer service and honesty. Surprisingly, he had a policy of not hiring car salesmen for the lot jobs or management positions. He didn't want employees that had been tainted by the used-car sales industry. He wanted honest people that could be trained properly. He was not in the car business but in the people business. For the management positions, he promoted from within. Only recently, to accommodate growth prospects did the company open up management positions to outsiders.

Hank Henderson

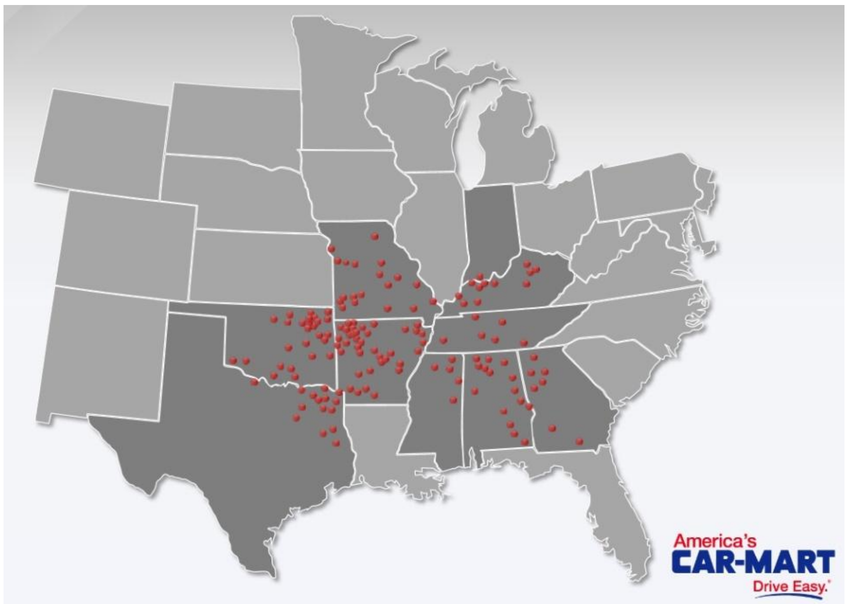
In 1999, Fleeman sold the company to Crown Group. In 2002, Crown Group divested it and America's Car-Mart became a publicly traded company. In 2007, Hank Henderson, the current CEO, took over the top leadership position.

Before I describe the company's business in more detail, let's first talk about how used-car dealerships make money.

You might say, "Well, they make money by selling cars for more than what they pay for them." Yes, this is true, but there is more to it. They also make money on the financing. It is no coincidence that you see so many used-car dealerships willing to financing your car purchase. They might charge you an interest rate of 10 percent and turn around and sell the paper to a bank or investor at 8 percent. To get the inventory, they buy cars from individuals, other dealers, or wholesale auctions.

America's Car-Mart makes money in similar ways. The company obtains cars from various sources and sells them for more than the cost. Generally, the company purchases vehicles between 6 and 12 years of age with 90,000 to 140,000 miles and pays between $3,000 and $7,000 per vehicle.

Then, it sells them to credit-challenged customers through its dealerships.

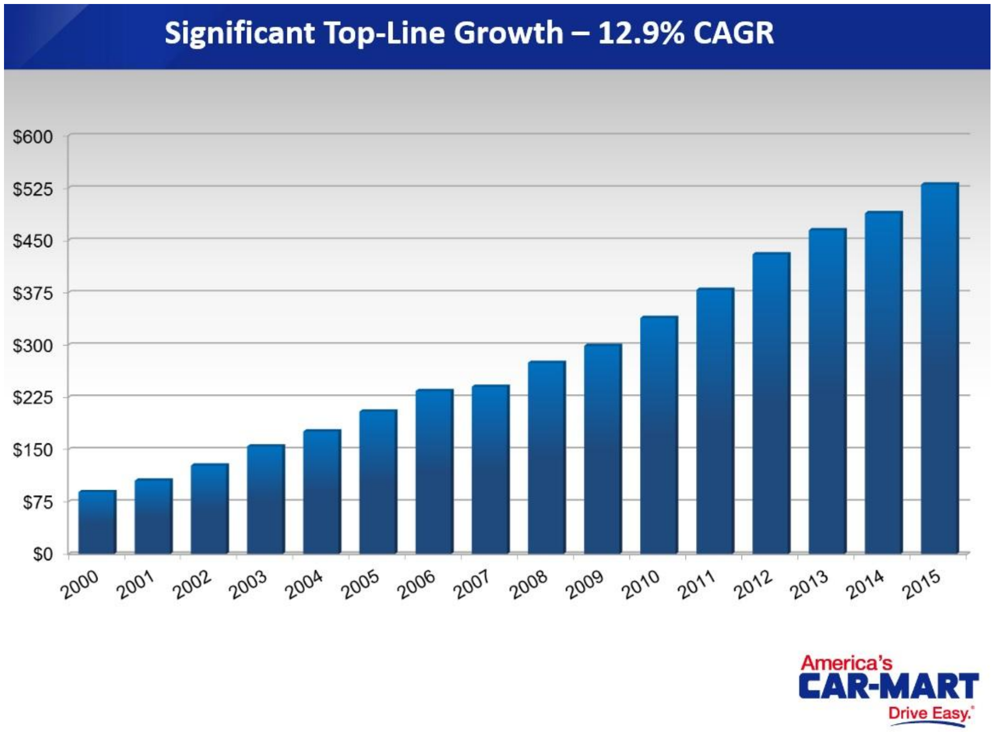


Because many of its customers would never qualify for traditional car loans, the company charges them appropriate interest rates to account for the extra risk. Lending to subprime customers might remind of you the housing crisis that started with subprime borrowers. America's Car-Mart business is completely different. Before the housing crisis, originators were giving out loans to anyone with a pulse with the intention of dumping the paper on someone else. This is referred to as securitization.

America's Car-Mart holds the loans on its books, which means that the underwriting is strict. The managers of individual dealerships are the ones that make the loan decisions and their compensation is tied to the performance of these loans. Customers either pay on a weekly or bi-weekly basis. Because many of the customers do not have bank accounts, they make their payments in person. This allows employees of individual dealerships to establish close relationships with the customers who usually become repeat customers. The majority of the company's clients are repeat customers. The ones that default on their payments usually return the cars to the dealership without the need of repossession.

Because the company holds on to the paper without securitizing it, the 2008/2009 financial crisis did not impact it that much. Others who relied on securitization either went out of business or faced liquidity problems.

By doing business in such a manner, the revenues have been on a continuous increase.



The next obvious question is determining how the company grows. As with most dealerships, the most obvious way to grow is to either make more money per car or sell more cars. The problem with such growth is that at some point the market gets saturated and there is no growth available. So, the next obvious way of growing is to open up more dealerships which is exactly what the company has been doing for years. It usually expands into neighboring cities that have enough population to support another dealership.

You might say that growing by opening up new dealerships is extremely expensive. When you look around at various dealerships, they are located in fancy and expensive buildings. Well, these are new-car dealerships. Here, we are talking about used-car dealerships.

When America's Car-Mart enters a new market, it leases the lot and usually uses an existing building on site. Because the company does not repair any vehicles, it does not need service stations that are common at new-car dealerships. All it does is fund the accounts receivable at the new branch with approximately $2 million so that there is money to lend to customers. Typically, the new dealerships are profitable and cash flow positive within the first year of operation.

VALUATION

As of the date of this report, America's Car-Mart is trading for $29 per share and the company has a market cap of $250 million.

Item 1. Financial Statements
Condensed Consolidated Balance Sheets
(Unaudited)
(Dollars in thousands except share and per share amounts)

America's Car-Mart, Inc.

	July 31, 2015	April 30, 2015
Assets:		
Cash and cash equivalents	$ 735	$ 790
Accrued interest on finance receivables	1,810	2,002
Finance receivables, net	332,299	324,144
Inventory	38,320	34,267
Prepaid expenses and other assets	3,842	4,195
Income taxes receivable, net	-	645
Goodwill	355	355
Property and equipment, net	34,351	33,963
Total Assets	$ 411,712	$ 400,361
Liabilities, mezzanine equity and equity:		
Liabilities:		
Accounts payable	$ 11,916	$ 11,022
Deferred revenue	26,290	25,236
Accrued liabilities	14,096	12,708
Income taxes payable, net	1,355	-
Deferred income tax liabilities, net	19,647	19,178
Revolving credit facilities	105,410	102,685
Total liabilities	178,714	170,829
Commitments and contingencies		
Mezzanine equity:		
Mandatorily redeemable preferred stock	400	400
Equity:		
Preferred stock, par value $.01 per share, 1,000,000 shares authorized; none issued or outstanding	-	-
Common stock, par value $.01 per share, 50,000,000 shares authorized; 12,708,291 and 12,688,890 issued at July 31, 2015 and April 30, 2015, respectively, of which 8,502,624 and 8,529,223 were outstanding at July 31, 2015 and April 30, 2015, respectively	127	127
Additional paid-in capital	63,598	62,428
Retained earnings	298,405	293,798
Less: Treasury stock, at cost, 4,205,667 and 4,159,667 shares at July 31, 2015 and April 30, 2015, respectively	(129,632)	(127,321)
Total stockholders' equity	232,498	229,032
Non-controlling interest	100	100
Total equity	232,598	229,132
Total Liabilities, Mezzanine Equity and Equity	$ 411,712	$ 400,361

As you can see, the main elements of the balance sheet consists of finance receivables of $324 million to extend credit to customers and $102 million of debt which came mainly from buying back shares.

From the following, you can see how the debt increased while the number of shares outstanding declined.

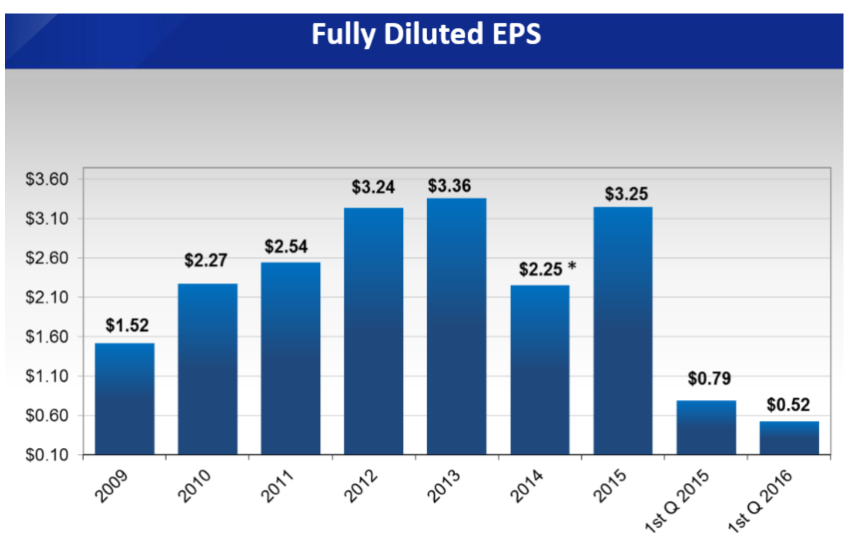
	April 30, (In thousands)				
	2015	2014	2013	2012	2011
Total assets	$ 400,361	$ 363,297	$ 358,265	$ 310,940	$ 276,409
Total debt	$ 102,685	$ 97,032	$ 99,563	$ 77,900	$ 47,539
Mandatorily redeemable preferred stock	$ 400	$ 400	$ 400	$ 400	$ 400
Total equity	$ 229,132	$ 213,006	$ 202,268	$ 184,473	$ 187,011
Shares outstanding	8,529	8,736	9,023	9,378	10,497

Also, the company has a book value of $229 million which means that stock is trading for almost one times book value.

The following is the income statement.

	2008	2009	2010	2011	2012	2013	2014	2015
Revenues:								
Sales	$250,337	$273,340	$308,756	$341,859	$386,857	$415,740	$434,504	$472,569
Interest and other income	$24,294	$25,626	$30,174	$37,392	$43,320	$48,936	$54,683	$57,752
Total revenues	$274,631	$298,966	$338,930	$379,251	$430,177	$464,676	$489,187	$530,321
Costs and expenses:								
Cost of sales, excluding depreciation	$144,537	$155,668	$173,106	$195,985	$223,392	$238,984	$251,319	$272,446
Selling, general and administrative	$47,223	$51,093	$57,207	$62,141	$67,663	$73,180	$78,591	$83,802
Provision for credit losses	$55,046	$58,807	$62,277	$70,964	$81,638	$96,035	$119,247	$120,289
Interest expense	$2,947	$4,006	$2,319	$2,625	$2,285	$2,937	$2,997	$2,903
Depreciation and amortization	$1,148	$1,395	$1,694	$1,928	$2,329	$2,826	$3,285	$3,830
Loss on disposal of property and equipment	$527	$0	$375	$562	$91	$58	$76	$17
Total costs and expenses	$251,428	$270,969	$296,978	$334,205	$377,398	$414,020	$455,515	$483,287
Income before income taxes	$23,203	$27,997	$41,952	$45,046	$52,779	$50,656	$33,672	$47,034
Provision for income taxes	$8,130	$10,051	$15,113	$16,831	$19,792	$18,491	$12,543	$17,544
Net income	$15,073	$17,946	$26,839	$28,215	$32,987	$32,165	$21,129	$29,490
Less: Dividends on mandatorily redeemable preferred stock	$40	$40	$40	$40	$40	$40	$40	$40
Net income attributable to common stockholders	$15,033	$17,906	$26,799	$28,175	$32,947	$32,125	$21,089	$29,450
Earnings per share:								
Basic	$1.27	$1.01	$2.29	$2.59	$3.36	$3.53	$2.36	$3.42
Diluted	$1.26	$1.52	$2.27	$2.54	$3.24	$3.36	$2.25	$3.25
Weighted average number of shares outstanding:								
Basic	11,825,657	17,747,183	11,681,880	10,861,403	9,793,616	9,111,851	8,930,592	8,617,864
Diluted	11,907,321	11,806,732	11,815,629	11,088,243	10,156,355	9,569,702	9,391,667	9,048,957

As you can see, diluted earnings per share were $3.25 per share in Fiscal Year 2015. Over the last seven years, they were growing almost on a straight line.



* $2.76 excluding effect from increase to the allowance for credit losses

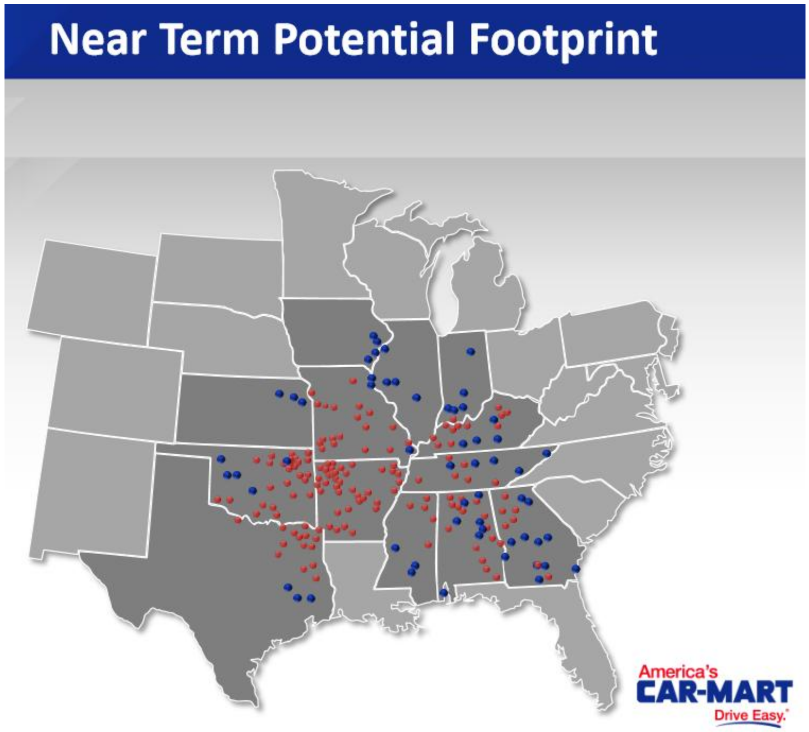
If we use EPS of $3.25 per share, the stock is trading for 9 times earnings. This is cheap considering that the company is able to grow revenues and the bottom line.

The reason why the stock price is so attractive is because Fiscal Year 2016 is not looking as good as Fiscal Year 2015. The company is on track to earn only $2 per share which means that the stock is trading for almost 15 times earnings. This is ok but is not super cheap anymore.

So, now the question is why are earnings going to decline? Is it because revenues are declining or because the company is closing down dealerships? It is neither. Actually, revenues are continuing to grow as evidenced by the most recent financials.

	Three Months Ended July 31,			
		2015		2014
Revenues:				
Sales	$	127,595	$	113,459
Interest and other income		15,095		13,917
Total revenue **Growing**		142,690		127,376
Costs and expenses:				
Cost of sales, excluding depreciation		75,087		65,471
Selling, general and administrative		23,125		20,820
Provision for credit losses		35,345		27,876
Interest expense		760		675
Depreciation and amortization		1,010		918
Total costs and expenses		135,327		115,760
Income before taxes		7,363		11,616
Provision for income taxes		2,747		4,356
Net income	$	4,616	$	7,260
Less: Dividends on mandatorily redeemable preferred stock		(10)		(10)
Net income attributable to common stockholders	$	4,606	$	7,250
Earnings per share:				
Basic	$	0.54	$	0.83
Diluted	$	0.52	$	0.79
Weighted average number of shares outstanding:				
Basic		8,513,440		8,716,344
Diluted		8,909,597		9,143,062

Also, the growth prospects are still bright. Right now, the company has 141 dealerships and by 2020, the plan is to grow it to 200.



So, what is the problem? If you look back at the income statement, you will see that the biggest expense items are the cost of sales, SG&A, and provision for credit losses. The cost of sales is mainly determined by how well the company is sourcing its used cars. SG&A is determined by how well the company is controlling its expenses. The provision for credit losses is determined by how well the customers are paying off their car loans. Let's take a look at how these expense items compare to total revenues.

	2008	2009	2010	2011	2012	2013	2014	2015
Cost of sales/Total revenues	52.63%	52.07%	51.07%	51.68%	51.93%	51.43%	51.37%	51.37%
SG&A/Total revenues	17.20%	17.09%	16.88%	16.39%	15.73%	15.75%	16.07%	15.80%
Provision for credit losses/Total revenues	20.04%	19.67%	18.37%	18.71%	18.98%	20.67%	24.38%	22.68%
EBIT margin	8.45%	9.36%	12.38%	11.88%	12.27%	10.90%	6.88%	8.87%

As you can see the cost of sales as a percentage of total revenues improved from 2008 to 2015. They went from 52.63 percent to 51.37 percent. SG&A as a percentage of total revenues also improved during the same time period from 17.2 percent to 15.8 percent. However, the provision for credit losses as a percentage of total revenues deteriorated starting in 2014. They went from less than 20 percent in 2009, 2010, 2011, and 2012 to 24.38 percent in 2014. As of the most recent quarter, they are almost at 25 percent. This is the single factor that caused the EBIT margin to decline and this is what is responsible for lower earnings per share.

The reason why the provision for credit losses is increasing is because of the Federal Reserve. For years, America's Car-Mart has been catering to subprime borrowers while the other players have focused on traditional car buyers. However, cheap money is causing other dealerships to enter the subprime market. Yes, the same thing is happening to car loans that was happening to house loans prior to the 2008 financial crisis. Consequently, America's Car-Mart is forced to charge a little bit less in interest rates and offer longer maturities on car loans. Until the other dealerships or owners of securitized paper get burned by higher default rates, the bottom line for America's Car-Mart will stay depressed. It is ok for us. We can just buy the stock on depressed earnings knowing that in five to ten years, the business will be even bigger with greater earning power.

CONCLUSION

America's Car-Mart is a unique company operating in a used-car sales industry. Because of its focus on great customer service and disciplined underwriting, the company has been able to profitably grow for years. Currently, the company's bottom line is struggling because of its competitors' silly underwriting standards. Well, we know how that movie ends and when it does, America's Car-Mart will benefit.