HollAnd Advisors

Holland Views: CarMax – Price: $82; MCap: $13bn

CarMax – Welcome to the Club

CarMax looks to us a wonderful long-term compounder offered at a great price. It is in our sweet spot of being a Scale Economy Shared model, operating in a sector unpopular with investors. Value is offered to us because the group was investing to compete better with new entrant Carvana then a large cyclical downturn in car prices and transactions occurred. The financial effect of which can be seen in the chart below. Mr Market is worried – we are excited.

> *"CarMax revolutionised the auto industry by delivering an honest, transparent and high-integrity car buying experience to its customers."*
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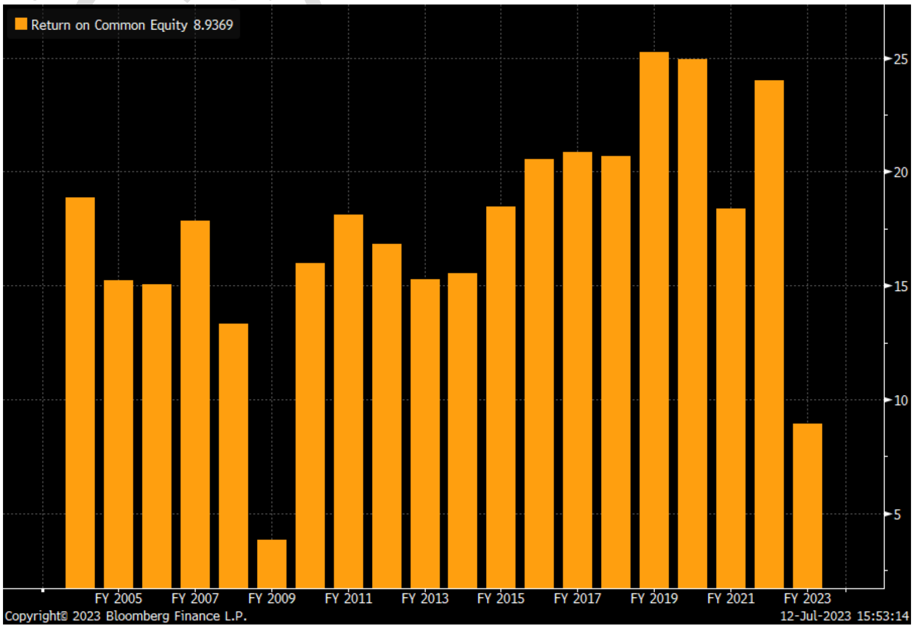
> *"For 26 years CarMax's focus has been making car buying more ethical, fair and stress free by offering a no haggle experience and an incredible selection of vehicles."*

Harvard Business Review report on CarMax, 2019

Beautiful supermodels

CarMax makes the type of returns that we find very attractive (c.20% ROEs for twenty years). Crucially they do so in a way that might not appeal to all other investors, but greatly appeals to us. By this we mean they achieve these returns from low, not high margins. These low margins come from a Scale Economy Shared, customer obsessed model. Pre-2020 this was a company making c.13% gross margins and c.6% EBIT margins. The secret sauce that makes a low margin business into one with good Returns on Equity is of course asset/turn. This coming alongside a compelling customer offer which drives the flywheel of future growth.

Fig.1: Return on Equity



Source: Bloomberg

Such low margin/higher asset turn businesses are to some investors hard to understand. For these investors brands and the like equate to pricing power and margins should be high, not low. We agree that high margin branded businesses are good. But we do not agree that, by extension, all low margin business are bad. Some may be, but a few, (Costco, Amazon, Ryanair) are outstanding.

Sorry, I don't think I know you…

Perchance you get invited to a summer drinks party, try out this little observation in social behaviour: Watch closely a person's face as an old friend comes up. Openness and warmth are immediately on display as they quickly recognise the face in front of them. Now look at the same person when someone they have forgotten, or never met comes up. Many might be guarded, some even hostile to the unknown new face.

The same is true with business models for many investors we suggest. The branded, high margin, high ROIC is like the long-lost friend that you immediately recognise and quickly want to get to know again. Low margin/high asset turn companies in odd sectors are the unknown. Few want to spend the time to get to know them fully. They are attractive to us, but that is because we have studied them in different sectors around the world and seek them out. We know the outcomes they can achieve for investors. To others they are alien.

We remind readers of our admiration for 7 Powers by Hamilton Helmer. It lists seven different business models as:

- Scale economies
- Network economies
- Counter-positioning
- Switching costs
- Branding
- Cornered resource
- Process power

All of these models (the order of which was chosen by the books author, not us!) are achieving sustainable competitive advantages (SCA's) and should result in superior ROIC/ROE. Many will do so with high margins (Branding, Cornered resource, and Network economies) and these are sought by many investors. Not all will have higher margins though. Indeed, a Scale Economy Shared business with high margins, might even be an oxymoron.

Excluding low margin businesses means some investors are effectivity looking for '5 Powers', not 7. We are agnostic as to what of the seven business models we invest in next. What we are not agnostic about is the starting price we pay for all the investments we make. This must offer us value and that 'value' is often derived from some sort of uncertainty. Uncertainty about the quality and resilience of a business (airline or car dealer). Uncertainty about trading that suddenly looks more fragile after a shock. Being clear about whether such a point of uncertainty represents real risk or is an opportunity is what our job is all about. Often we find such opportunities in business models other people understand less well. Considering the lasting power and growth runway of a good Scale Economy Shared (SES) model we are delighted if the opportunities we end up being offered are more focused here.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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