Vickie Judy, America's Car-Mart CFO

Thank you. Welcome to America's Car-Mart second quarter 2024 earnings call. Joining me today is Doug Campbell, who took over as our company's CEO on October 1, 2023.

We've issued our news release earlier this morning and it is available on our website. We have updated our reporting format with a simplified look, providing an efficient and easy comparison of important metrics against the prior corresponding quarter and commentary about our results. In addition, we will post the transcript of our prepared remarks following this call and we also will post some slides – supplemental material -- to our website to further illustrate many of our talking points that we'll cover later in the call. The Q&A session will be available through the webcast after the call. We believe that this process will help enhance how we share our quarterly results with you, and we welcome your feedback.

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, 2023, and our current and quarterly reports furnished to or filed with the Securities Exchange Commission on Forms 8-K and 10-Q.

I will turn it over to Doug now for his introductory comments about our second quarter.

<u>Doug Campbell, President & CEO</u>

Opening:

Good morning and tthank you for joining us and for your interest in our Company. First, I'd like to thank our associates for their relentless focus on keeping our customers on the road. I also appreciate the many messages I've received on my appointment as CEO. It means a lot so thanks for that.

I also want to take a moment to recognize the passing of Hank Henderson, one of our board members and CEO prior to Jeff Williams. His contributions here at the Company, in the community, and to his family will leave an indelible mark. He was valued as a board member and long-time shareholder. His pointed advice to me about the opportunity as CEO has a different meaning today, so thank you Hank. During the quarter we identified someone with a similar profile that has a long-term view of the business. As such we've recently added Jonathan Buba from Nantahala Capital Management to our board. He brings many years of experience within specialty finance, including subprime installment lending, pawn lending, and lease-to-own retail. He is a shareholder as well, and we are excited to have him join our board.

Now, I'd like to address the quarter. If I'm on the other end of this call, I'd have a lot of questions about the results and particularly credit losses. I'd also ask you to bring into context that GAAP accounting requires us to report our results as a retailer with an accounts receivable balance of almost $1.5B originated over the last 4 years. As the business grows, the impact of reserve and credit adjustments on a portfolio originated over a 4-year period becomes even larger in relation to the quarterly results. The way we measure our business is the cash we collect over time relative to the money we put on the street, and if you look over time, we have never had a pool of loans in which we earn cumulative cash returns of less than 50% in excess of the cash outlay over the life of the contracts. What's changed is that it takes longer to recognize it, but 10 years ago we'd put a dollar on the street and get approximately $1.60 back over time, and that's still the case.

Let me start by telling you why I came to Car-Mart. Over the last 5-6 fiscal years, this business has generated almost $600MM in Free Cash Flow. The Company's repurchased over $156MM in shares, grown the net AR balance by $739MM, funded various capital expenditures of almost

$78MM while funding increased inventory of $79MM in a growing business. They've been able to do this because the underlying pools of receivables that the Company has originated have consistently produced cash flows in excess of the costs to operate the business over time. This remains the case. Additionally, this segment in automotive is large and a growing part of our industry. The ability to really help consumers who have little to no access to credit from an industry leader with a great track record and an abundance of opportunity made it attractive. Especially when you consider the opportunity to feather in my skillset and industry best practices with Car-Mart's unique culture, it has the power to take the business to the next level and that's just what I'm focused on.

Revenue/Sales:

Today, we reported a revenue increase of 2.8% that was primarily driven from a 23% increase in interest income.

Sales volumes were down 4.6%, but sales revenue only saw a decline of 0.4%. The muted sales revenue was a product of a 5.6% increase in the quarterly average selling price moving from $18,025 to $19,035 YoY. Approximately 40% of this increase was related to the vehicle selling price but 60% was related to increased revenue for ancillary products. Sequentially the quarterly average selling price was relatively flat.

As for sales volumes, we finished the quarter with 15,162 units vs. 15,885 units sold last year. August and September had respectable volumes and collectively posted a gain in sales YOY, but October sales results were down. Several items contributed to the sales decline witnessed in October. And I'll talk about that here. Web traffic was consistent and still posted gains YoY, and OCAs for the quarter were also positive by 19% yet there was a decrease in showroom traffic. Additionally, launching several states onto our new Loan Origination System or LOS was also a contributing factor I'll speak to more in a minute. Overall, we're trying to balance sales volume with our new system, onboarding new stores, and introducing new underwriting guidelines.

Loan Origination System/Underwriting:

We spent the better part of last year rolling out the consumer application portal for LOS, which allows the consumer to apply faster, have a soft credit pull during the application process, and get a response via text on the status of their application, as well as centralized appointment setting.

We're now in the second phase of our LOS rollout is related to underwriting and how sales are being originated. During the quarter, we onboarded 3 additional states, bringing the total to 5 states, which accounts for 45% of our revenue at quarter end. We started out this fiscal year rolling out the dealer-facing portion of this tool. As a reference, our legacy system had limited ability to influence outcomes but served as a stable platform to originate deals and manage associated costs.

Our original intent was to roll the new system out with similar underwriting rules as our legacy system ALIS, allowing users time to learn the system over time, giving us enhanced data and visibility. However, with a backdrop of increasing credit losses, we made the strategic decision to implement new underwriting rules, which primarily sought to decrease terms and increase downpayments. The initial results were very positive.

When looking at originating term lengths, we finished at 44.1 months for the quarter. While this is up YOY, it's down sequentially by 0.6 months and is the largest decrease we've seen since July 2019. The originating terms during the quarter for our legacy system were approximately 44 months and 42 months for the new LOS. Originating terms were down in both systems, and both trended downward throughout the quarter.

Average downpayments for the quarter were 4.9% and relatively flat when viewed sequentially, but down 30 bps YoY. Yet, when comparing the two originating systems, we collected nearly a point more in downpayment on the LOS generating 5.5% down and 4.6% in ALIS. This demonstrates how effective the system is, and our teams are pushing for improved deal structures despite the seasonality we normally see with cash downpayment percentages.

The benefits of LOS are no longer theoretical; it's deployed in about half our stores already and we couldn't think of a more opportune time to be testing its capabilities. These combined results show that we can more quickly and more precisely adjust parameters. As with any new system, there are growing pains. We are projecting to have the LOS completely rolled out in the third quarter prior to tax season. Ultimately, we're striving to achieve higher volumes with better deal structures to help our consumers be more successful and we're confident the investment will have positive long-term impacts. While adding a level of sophistication to our underwriting is critical, a large part of our results is a function of our servicing efforts after the sale, which we must continue to execute at a high level.

Vehicles/Pricing:

The gross margin initiatives we are focused on continue to bear fruit and improved materially YoY. Sequentially there was a small decrease, but this was a function of the sales miss I discussed earlier.

We also continue to improve the age and mileage of the vehicles we're purchasing compared to the prior year. During the quarter, we were able to bring down the Purchase Cost Average (PCA) of vehicles, despite the UAW strike and any noise it created. If you reference slide 4 in the supplemental material on the website, I've included two charts. In the first chart I've put our purchase cost average up against Cox's MMR index which tracks price movement throughout the year on a set basket of goods. We're improving our timing here which ultimately will reduce how we own that vehicle relative to a given book value at the time of contract origination. It's evident we are moving with the market better despite us doing this with lead times of 3-4 weeks.

The second chart shows during that same period we have improved the quality of the assets by purchasing newer and lower mileage vehicles. These are material changes which lower repair costs both during initial reconditioning, and while under a service contract, contributing to better gross margins. When combined with the inventory procurement and remarketing management processes implemented last year, we're delivering operational improvements for our customers and the Company.

We've made great strides in both our procurement and remarketing capabilities and a key driver going forward will be our ability to resell more of these vehicles that are repossessed. The opportunity today is considerable and continues to grow as the newer vehicles cycle through our portfolio. We've engaged a national provider to perform reconditioning and improve vehicle quality which will in turn help drive the overall average cost down, improve gross margin, reduce credit loss, and enhance cash flow. We will launch this during the third quarter. This is also critically important to addressing the affordability headwinds for our consumers.

Net Charge-Offs:
I want to touch on the NCOs and overall credit losses. Although the macro environment has seen some cooling of inflation over the quarter, the lingering financial and psychological effects of the worst bout of inflation in four decades continues to impact our consumers. Goods and services are still far pricier than they were just three years ago, with the economic inflationary pressures on our customers now more prevalent in all areas of their lives. Things like higher energy costs, food, housing, and auto insurance just to name a few. This is the largest contributing factor that drove an increase in the frequency of losses during the quarter of 24%. The unit losses on repossessions peaked in September and came down slightly in October. Our 30-day delinquencies also improved during that time frame which are both positive signs, but we remain cautiously optimistic about this movement.

I will turn things over to Vickie for more details on the financials.

Vickie Judy:

Thank you Doug.

In my commentary, the comparisons that I will cover will be second quarter of 2024 versus second quarter of 2023 unless otherwise noted.

Our revenues for the second quarter were $361.6 million, up 2.8% from last year’s prior period. The year-over-year increase is primarily due to the 23% higher interest income.

As Doug mentioned, we did have a decrease in unit volumes. Our sales volumes became more challenging as we moved throughout the quarter and most of this decline came in the last month of the quarter. Although we did have some operational challenges as we implemented our new LOS, there was also a dampening in the overall used vehicle market because of continued affordability challenges for our consumer. When combined, the softness in the market, the continued elevated vehicle prices, and onboarding stores to the LOS, we have less predictability into short-term sales volumes than we would otherwise expect to have. With that said, application volume remains robust, our LOS onboarding will be completed in the third quarter and the work we are doing to improve affordability should mitigate some of these challenges.

The gross profit dollars per retail unit sold improved by 11.5% and the gross profit percentage increased 220 bps, a result of the initiatives around inventory lifecycle efficiencies – from procurement, reconditioning, wholesaling efforts and repairs after the sale. Sequentially, gross profit dollars improved slightly by 1% and the gross margin percentage was 30 basis points lower primarily due to the lower sales volumes in October. We expect further improvements in our gross margin percentage as volumes improve and we scale and fully operationalize our initiatives.

Due to our operational efficiencies, our inventory dollars decreased $16.5 million from the prior year quarter. Quarterly inventory turns improved to 7.1 compared to 6.7 annualized.

SG&A was $44.9 million for14.9% of sales, up from the prior-year quarter at $42.9 million, but down sequentially $1.6 million from $46.5 million. The primary reduction sequentially was a $3.2 million reduction in stock-based compensation, partially offset by increased costs in collection expenses and professional fees related to the implementation of our new technologies.

Since the quarter end, we have made adjustments to our operating expense structure. First, we reduced the size of our corporate workforce by 10% through a series of strategic decisions. We’ve also limited hiring, reduced our marketing spend, and curtailed the use of some professional services. We will continue to evaluate spend at both the dealership and the corporate level. And we're committed to driving cost efficiencies in the business and implementing cost saving initiatives over the next quarter. That, when combined with technology and business investments, we expect to provide SG&A cost leveraging opportunities as we move forward.

However, we continue to serve an expanding customer base with over 104,000 customers, a 6% increase over the prior year quarter. SG&A per average account improved and was $424 compared to $439 in the prior year and $449 sequentially.

On to credit losses … Net charge-offs as a percentage of average finance receivables were 7.2% vs. 5.8%. This compares to our prior 10-year average for second quarters of 6.2%, and that includes the positive covid periods. As a comparison to pre-covid periods – our average net charge-offs for the five-year period pre-pandemic were 7.0% for second quarters. The frequency of losses accounted for over two-thirds of the credit loss increase.

Severity was also higher than usual caused by some rapid vehicle depreciation exhibited last year that made some of the originations in the calendar year of 2021 and 2022 pools experience both higher frequency and severity of loss.

Doug:

That's a great point, Vickie.

If you reference chart 1 on slide 5, we've indexed wholesale prices back to 2017 to show what happens over a 3-year period with price in a normalized environment. I specifically called out two points to illustrate what happens with price between an origination and a default as an example. In chart 1, the periods between origination and default show approximately -10% reduction in depreciation. Chart 2 reflects wholesale price movement from 2021-2023 YTD. I've shown similar timing of origination and defaults, and it clearly shows the price degrading in excess of 25%. This is why severity is more pronounced than normal. This is not a dynamic that's specific to CRMT, but an industry wide issue which most lenders will have to contend with at some point.

Vickie:

Thank you, Doug. Because of the nature of our contracts being shorter term, it's our belief that we are witnessing some of this first. Many industry metrics which measure delinquency and default rates which historically moved in tandem now show delinquencies continuing to rise without defaults moving at a similar rate. As a management team, we've decided not to deviate from our historical collection practices because of our deep experience in dealing with subprime customers. The good news is that we are through the largest percentage of losses expected from these pools. While these pools are challenging, nonetheless they produce over 50% cash on cash returns and approximately a 35% IRR.

As a result of the increased losses and our quarterly analysis, the Company increased the allowance for credit loss from 23.91% to 26.04% sequentially, resulting in a $28-million charge to provision expense (earnings per share loss of $3.40 after tax). The structural changes to our portfolio over recent years driven by higher vehicle costs and longer-term lengths, as well as the current economic state of our consumer, continue to drive an increase in the provision for credit losses. As our allowance represents an expectation of losses on a $1.5 billion portfolio, the result of a change can have a large impact on any period's quarterly earnings, especially based on a retail business' sales in a given quarter.

Our pools have consistently produced positive cash on cash returns and attractive IRRs. As vehicle prices have risen and terms have increased from approximately 30 months to approximately 44 months, our time to break even has been pushed out and IRRs have declined, although still at very good returns. Please refer to slides 3 and 6 on our website to see how these pools have performed over time.

Our accounts 30+ days past due were 3.6%, consistent with last year's quarter and improved from 4.4% sequentially. As a percentage of accounts receivable, our total dollars past due improved 213 basis points sequentially. That is especially important given the quarter closed on a Tuesday, which is historically the highest day of the week for delinquencies. The average originating contract term for the quarter was 44.1 months compared to 42.6 months and improved sequentially from 44.7. The lower delinquencies should result in improved losses over the next quarter.

Our weighted average contract term for the entire portfolio, including modifications, was 47.3 months compared to 44.8 for the prior year quarter and 46.9 sequentially. The weighted average age of the portfolio improved to 10.8 months. The percentage of our portfolio held by the highest credit quality customers continues to improve compared to the prior year and was flat sequentially.

You should expect us to be more aggressive on capital allocation going forward. During this quarter, we closed another location, bringing the total to 3 for the fiscal year. We will be adding a newly acquired dealership during the third quarter, moving capital from underperforming stores to higher performing assets which has cascading benefits throughout the Company. We will continue to review and monitor capital invested in each dealership and other investments to maximize returns.

Our interest expense continues to significantly impact our earnings potential. Over 60% of the increase is due to higher interest rates, with the remaining a result of an increase in average borrowings.

The Company's total securitized, non-recourse notes payable was $489 million net of $90 million in restricted cash related to these notes. We are also currently considering redeeming our first series of asset-back non-recourse notes issued in April of 2022, as we have satisfied the conditions to repurchase the securitized receivables under the terms of the notes, subject to notification to the note holders. This will free up some well-seasoned collateral.

At quarter-end, we had $4.3 million in unrestricted cash and approximately $86 million in additional availability under our revolving credit facilities based on our current borrowing base of receivables and inventory. Access to capital, with our $600 million revolving credit facility, a successful securitization program, and an active shelf registration gives us flexibility and a distinct advantage over many competitors. Many competitors may experience even more pressure in accessing capital in the future. Our non-recourse securitized notes represent the bulk of our funding, and our cost of funds fluctuates with the level of interest rates and credit spreads.

We've summarized the key drivers and their impact on EPS in the quarter on slide 7.
In conclusion, we remain committed to growth and prudent financial management. We 'refocused on delivering value to our shareholders through strategic investments, operational efficiency, and a steadfast dedication to keep our customers on the road. Thanks, and now I'll let Doug close us out.

Doug Closing:
Thanks Vickie. We continue to optimize our footprint and leverage our investments in technology and infrastructure. Our ERP implementation begins next calendar year, which will reduce the need for several manual and redundant processes.

We're excited to have Central Auto Sales as a new addition to our dealership group that we expect to close in December. We are actively evaluating several opportunities in our market geographies to acquire productive stores which offer operators an exit strategy and continue to their great work of servicing customers in their communities. This last acquisition has sales volume on par with our largest stores in the country, and we're excited to have some new partners to help us grow.

Before we take questions, I want to reiterate that our team is extremely focused on executing our strategy for the back half of fiscal 2024. Overall, we believe our keen focus on operational efficiencies, reducing costs, and prudent capital management will enhance our competitive advantages. The overall macro environment remains challenging for Car-Mart's core customers, both existing and prospective, but they need the service we provide.

While we are disappointed to show a loss during the current quarter, the underlying cash generative nature of our business continues to position us for long-term profitable growth.

Now, we’ll open up the line for questions.

Operator, please provide instructions to do so.