TheStreet Transcript

Carmax (KMX) Earnings Report: Q3 2015 Conference Call Transcript

The following Carmax conference call took place on December 19, 2014, 09:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Katharine Kenny; CarMax; VP - IR
- Tom Folliard; CarMax; President, CEO
- Tom Reedy; CarMax; EVP, CFO

Other Participants

- Matt Nemer; Wells Fargo Securities; Analyst
- Brian Nagel; Oppenheimer & Co. ; Analyst
- John Murphy; Bank of America Merrill Lynch; Analyst
- Brett Hoselton; KeyBanc Capital Markets; Analyst
- Scot Ciccarelli; RBC Capital Markets; Analyst
- Craig Kennison; Robert W. Baird; Analyst
- Matthew Fassler; Goldman Sachs; Analyst
- Rod Lache; Deutsche Bank; Analyst
- Paresh Jain; Morgan Stanley; Analyst
- Rick Nelson; Stephens; Analyst
- Bill Armstrong; CL King & Associates; Analyst
- David Whiston; Morningstar; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Good morning, ladies and gentlemen. My name is Aaron and I will be your operator today. At this time I would like to welcome everyone to the FY 2015 and third-quarter earnings call.

(Operator Instructions)

I would like to turn the call over to Ms. Katharine Kenny, Vice President of Investor Relations. Ms. Kenny, you may begin.

Katharine Kenny (VP - IR):

Thank you, Aaron, and good morning. Thank you, everyone, for joining our fiscal 2015 third-quarter earnings conference call.

As always, on the call with me today are Tom Folliard, our President and Chief Executive Officer, and Tom Reedy, our Executive Vice President and CFO.

Before we begin let me remind you that our statements today regarding the Company's future business plans, prospects, and financial performance are forward-looking statements that we make pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on management's current knowledge and assumptions about future events that involve risks and uncertainties

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

that could cause actual results to differ materially from our expectations.

In providing projections and other forward-looking statements the Company disclaims any intent or obligation to update them. For additional information on important factors that could affect these expectations, please see the Company's annual report on Form 10-K for the fiscal year ended February 28, 2014, filed with the SEC.

Before I turn the call over to Tom I would like to mention that we have a few spots available for our next regular analyst day, which will take place on January 20 here in warm Richmond. If you are interested in attending, please let us know. And as always, I hope you will remember to ask just one question and a follow-up before getting back in queue.

Thank you and turn it over to Tom.

Tom Folliard (President, CEO):

Thanks, Katharine. Good morning, everyone. Thank you for joining us today.

As you saw, we had a great third quarter. Total revenues grew 16% to $3.4 billion, net earnings grew 22% to $130 million, and earnings per share increased almost 28% to $0.60. Used unit comps grew by 7.4% for the quarter and total used units rose by 14%. Gross profit per used unit increased $23 compared to last year to $2,172.

Total wholesale units up 10% and gross profit per wholesale unit up $40 to 927.

Other sales and revenue rose by over 30%, partially due to an increase of $13 million in extended protection plan revenues. This expansion reflected the growth in unit sales offset by a somewhat lower penetration rate. Also impacting October sales and revenues growth was a $2.5 million improvement in third-party finance fees.

CAF income grew 7% to approximately $90 million, and I will turn it over to Tom to give you some more details.

Tom Reedy (EVP, CFO):

Thanks, Tom. Good morning, everybody. In Q3 CAF income grew 7% compared to the third quarter of fiscal 2014 and average managed receivables grew 18% to $8 billion. CAF's weighted average contract rate -- that is the rate charged to customers -- was flat to last year's third quarter at 7% and this rate has been relatively stable for the past eight quarters.

The allowance for loan losses grew to $80 million, which represents 1% of managed receivables and is consistent with last year. At 41.8%, CAF net penetration was up slightly compared to last year's third quarter, in part due to our subprime test which was not in place last year.

Net loan dollars originated in the quarter rose 20% to $1.2 billion due to a combination of the retail unit growth, higher penetration, and an increase in the average amount financed.

As you know, from time to time we test additional third-party lenders, and if we determine they have sufficient incremental value, we roll them out across our system. During the quarter we moved Ally Financial out of the testing phase to become our fifth Tier 2 lender.

Finally, as you probably noticed from the press release, our treasury department has been quite busy this quarter. We closed a three-year $300 million private term loan; we added $300 million to unsecured revolver capacity, bringing it to a total of $1 billion; and added $200 million to CAF's warehouse facility for total of $2.3 billion.

Now back to Tom.

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

Tom Folliard (President, CEO):

Thank you. In regards to our mix, during the quarter, despite the decrease in oil prices, we didn't see a significant increase in our sales of SUVs and trucks compared to last year. We are starting to see some growth in sales of zero to four-year-old cars, which we have been talking about for a while, compared to last year. They are now about 75% of sales, but that percentage is about the same as what it was in the second quarter.

SG&A for the quarter increased approximately 11% to $317 million. This growth is primarily due to the addition of 20 stores since the beginning of the third quarter of last year. If you remember, in the second quarter we were on top of about 18 new stores.

On a per-unit basis, SG&A decreased $52 to $22.43 compared to $22.95 in the third quarter of fiscal 2014.

During the third quarter we opened four stores, two in new markets for CarMax , Tupelo, Mississippi, and Reno, Nevada, and two in existing markets, Portland, Oregon, and Raleigh, North Carolina. In the fourth quarter will open one more store in our new market in Cleveland, home of Katharine Kenny.

Store traffic was up once again in the quarter and our web traffic also continued to expand for the third quarter compared to last year. Average monthly web visits grew over 17% to nearly $14 million. Business to our mobile site continued to represent approximately 30% of total visits, while visits utilizing our mobile apps represented another 15% of the total.

With that, we would be happy to take your questions. Operator?

QUESTIONS & ANSWERS

Operator:

(Operator Instructions) Matt Nemer, Wells Fargo Securities.

Matt Nemer (Analyst - Wells Fargo Securities):

Good morning, everyone, and congrats on an outstanding quarter. First question I wanted to ask about is whether the AutoTrader and the Cars.com addition or relaunch is maybe one of the factors that's driving your traffic. And I'd love to hear about anything else that you think is driving the traffic in the stores and on the web. It obviously seems like it was very strong.

Tom Folliard (President, CEO):

First, Matt, a little background there. If you remember last year, throughout the whole year we had decided to no longer list our cars on Cars.com and AutoTrader.com, and we had 12% comps last year, a 17% share gain, and one of the better years we have ever had in history of the Company. The reason we stopped the first time is because we weren't making a good return on our investment.

What we've started back with the two of them is just a test and the test is determined whether or not we can make a good return on the investment. So it was a test during the quarter; I don't have a lot to report, but my guess is it had very little impact.

Matt Nemer (Analyst - Wells Fargo Securities):

Okay. Then just a quick follow-up. The gross profit per unit has been extremely consistent over the last couple of years and it ticked a little bit higher. Just wondering if you're starting to see -- if you feel like you are getting -- your ability to increase prices isn't impacting your unit sales and that's kind of why that's starting to drift

© 2014 TheStreet, Inc. All Rights Reserved

and could we see that continue. Thanks.

Tom Folliard (President, CEO):

I view $20 as flat. If we were $20 down, we would have viewed it as just as good and just as consistent a performance. It's not an exact science to manage margin across this number of sales at this price point, so I would view that as just relatively flat.

And I think it just shows that we are getting better and more analytical each and every year and each and every quarter at managing our inventory and managing to our targeted margin. And despite some depreciation that we saw in the third quarter, which I think was pretty apparent in some external sources, we were able to manage our margins pretty tightly once again and deliver a 7.5% comp.

So I am pretty proud of what we have accomplished, but we continue to work on it every year and I think we get a little better each year.

Matt Nemer (Analyst - Wells Fargo Securities):

Great, nice work and happy holidays.

Operator:

Brian Nagel, Oppenheimer.

Brian Nagel (Analyst - Oppenheimer & Co.):

Good morning. Congratulations on a really nice quarter. My first question and maybe a follow-on to Matt's question too, but there's been a lot of chatter amongst investors with respect to declines in used car pricing, what impact that could have on CarMax . You saw some of your competitors have troubles. You obviously did not.

Bigger picture, how are you thinking about as you are looking at maybe the used car market now following a more normal pricing trajectory? How is that affecting, if at all, the CarMax business model?

Tom Folliard (President, CEO):

We have been at this for a while, Brian, and the fall is a time when we always see depreciation. We have had some anomalies coming -- going into the recession and coming out of the recession, but in a normal year you expect some appreciation in the January through the spring and then we expect some depreciation throughout the rest of the year all the way through December.

You know, I think we've proven that we can manage in all kinds of different volatile environments. And this one is not as volatile as we have seen in the past, so we viewed this as -- I don't want to say it's business as usual, but it is normal depreciation that we see during the third quarter if you look at our 20-year history and say what does an average year look like. So I just think it's something that we are getting a little bit better every year, just as what I just said to Matt on the last question.

Brian Nagel (Analyst - Oppenheimer & Co.):

That's helpful. Then the second question, my follow-up question would be on the buyback it wasn't that long ago you and your Board introduced a pretty significant buyback plan for CarMax and we did see buyback activities step up somewhat here in the fourth quarter -- sorry, in the third quarter.

But any guidance you can give us how we should expect you to execute on that buyback as we go into 2015 and beyond?

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

TheStreet Transcript

Tom Folliard (President, CEO):

You know, Matt, I think the announcement that you saw from management and from our Board was really just an authorization and a further commitment to delivering capital back to shareholders with a rather lengthy expiration date on it so that it gave us the flexibility to continue to run the program that we have been running. We could go a little more aggressively if we wanted.

But it's just what it says: it's an authorization that has a two-year limit on it. But I think it's a nice show of confidence from our Board in our ability over the next few years to continue to run a good business and put ourselves in a position to keep delivering capital back to shareholders through the buyback.

Brian Nagel (Analyst - Oppenheimer & Co.):

Thanks and congrats again.

Operator:

John Murphy, Bank of America Merrill Lynch.

John Murphy (Analyst - Bank of America Merrill Lynch):

Good morning, guys. Just had a follow-up question on used car pricing or to Brian's question there.

Tom, there's a lot of concern that used car pricing might fade, yet all the data from you and the public dealers is actually positive on transaction prices. Is there the potential here that we are seeing some supply increase, but demand actually increasing faster than that supply is increasing?

We might be in an environment where pricing stays relatively stable even as supply is increasing, which is really kind of a Goldilocks scenario for your business.

Tom Folliard (President, CEO):

You know, that's impossible to tell. Our average retail was actually down in the quarter compared to the second quarter of this year by $300, so I think that reflects a little bit of depreciation.

As I have said before, we don't spend a lot of time trying to figure out what's going to happen a year from now. It's pretty irrelevant to us running our business day-to-day and we turn our inventory quick enough that I think we are able to respond to whatever volatility the market has to offer.

But I do think we've seen some improvements in the economy. We saw a nice tick up in the SAAR. We have always said whenever we see new car sales on the uptick that that shows that people are willing to get out there and buy a car and sign up for a loan, and I think that is good for us. It's good for the consumer overall in terms of their activity, but it is really difficult to predict what's going to happen in the future.

John Murphy (Analyst - Bank of America Merrill Lynch):

Okay. Then just sort of a follow-up question here on SG&A. Typically we think there's about leverage -- there is leverage in the model, about a 7.5% positive same-store sales comp. But as the store base gets larger, is it possible that that comes down over time and might get closer to 5%? I'm just trying to understand how you think about leverage on SG&A as the store base gets larger.

Tom Folliard (President, CEO):

Yes, that's possible. We've never given a precise number because we're not sure what that number is. You never know what kind of incremental investments you might make at any given point in time.

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

This is the most stores, the most new stores, so stores that are the most SG&A-inefficient, that we have ever carried, which is 20, during the third quarter. And we were still able to leverage by $50 on a per unit basis our total SG&A with a 7.5% comp. So there's a combination of factors that are going to allow us to either leverage or not.

It happened to work out this quarter. I couldn't give you an exact number, but it does make sense logically that unless we dramatically accelerated our growth rate that we would be able to leverage a little bit better as the base gets bigger.

John Murphy (Analyst - Bank of America Merrill Lynch):

Thanks a lot, great execution.

Operator:

Brett Hoselton, KeyBanc.

Brett Hoselton (Analyst - KeyBanc Capital Markets):

Good morning. I was hoping you could talk a little bit about CAF profitability specifically. How do we think about a rising interest rate environment negatively impacting CAF profitability? How do you think about your cost of funds? What might be the best representative rate that you use or something like that?

Is there any way to you can kind of say, look, if we saw a 100 basis point increase in that cost of funds, that would represent some sort of a dollar amount headwind to that $90 million that you made in the third quarter. How can we quantify that?

Tom Reedy (EVP, CFO):

First off, I got to remind everybody we're going to run a market business and our APRs are going to be driven by competition and our cost of funds are going to be driven by what we can achieve in the marketplace. As far as what to look at for cost of funds, you can look at our securitization deals and the benchmarks in those and that gives you kind of a good estimate of where we are locking down long-term financing.

As far as profitability, we believe over time we can manage to a reasonable profit, at least to a market profit. In fact, if you look back at 2007, early 2008 to our securitization we did back then, we were running at a very similar spread between APR and cost of funds then as we are today and interest rates were 400 to 500 basis points higher than they are today. So we don't believe a higher interest rate market precludes the finance company from making the kind of returns that we've been making recently.

However, as you migrate towards higher interest rates, you know APRs are typically sticky upward and downward and there might be a little bit of lag time for the market to adjust to rates rising. So you might see some compression as things are moving. We've benefited from that when rates have fallen. We've felt the pressure as rates are rising, but overall I think we can manage a market rate of return for the business.

Brett Hoselton (Analyst - KeyBanc Capital Markets):

Okay. And then -- I apologize, Kathryn, I'm just getting a lot of questions rising used vehicle -- or declining used vehicle prices.

Obviously they haven't declined recently, but the general expectation is that used vehicle prices are going to decline, so getting a lot of questions from investors as to is that a net positive or a net negative for your firm? I think that we believe that it's a net positive for you, but can you explain why you see that as a net positive because I think you believe that as well?

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

Tom Folliard (President, CEO):

I've answered that a couple of times, which is whatever the market delivers we have done a pretty decent job of navigating through it. I am always a believer lower prices are better for the consumer and we turn our inventory quick enough that we can manage margins in a declining environment.

But I'm also not a believer we're going to see this giant decline in car prices because there's some tidal wave of supply coming our way. I think things tend to find a way to equal out, so --.

Brett Hoselton (Analyst - KeyBanc Capital Markets):

Fair enough. Thank you very much.

Operator:

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli (Analyst - RBC Capital Markets):

Good morning, guys. I was looking for a clarification real quick. Did you say Ally was added to the Tier 2 or Tier 3?

Tom Reedy (EVP, CFO):

Tier 2, Scot.

Scot Ciccarelli (Analyst - RBC Capital Markets):

Obviously subprime bounced back, subprime penetration bounced back sequentially from what we saw last quarter. Can you help us understand a little bit more about that? Because obviously we had seen some deterioration in that trend over the prior last few quarters.

Is that just a function of guys like Santander becoming more aggressive? Was there any other changes that might have happened on the subprime side, just to help us think about what happens in the future?

Tom Reedy (EVP, CFO):

I can't really speak to if there's been any changes. What I can speak to is we have seen over the past several months relatively stable behavior from our subprime lenders and we saw the big correction last year as they had adjusted their behavior.

But if we look at conversion of customers that were given acceptances, I think it would be fair to say that the behavior has been relatively consistent over the last several months.

As to where the goes going forward, we want them to run a good and sustainable business and we are going to encourage them to do that and things will shake out the way they do. There's really nothing beyond that I can really say about the bounce back, other than it feels like we've been in a pretty stable place for the last several months.

Tom Folliard (President, CEO):

It's only 1.5 points or 2 points in terms of percent of sales, so it's not --. It wasn't anything significant, Scot.

Scot Ciccarelli (Analyst - RBC Capital Markets):

Right, I understand. Then one thing that I think had been mentioned previously is there's been a blending of some of the let's call it top-tier subprime customers, where some of the Tier 2 lenders have kind of moved into

© 2014 TheStreet, Inc. All Rights Reserved

that portion of the customer base. Any feel for what the impact is or any way to kind of size the impact of Tier 2 getting a little bit more aggressive on the downside?

Tom Reedy (EVP, CFO):

I think the easiest way to look at it, the way we look at it is that we are moving customers from a bucket where we are paying a discount to our lenders to one where we are receiving a premium from them. So there's a significant shift in profitability.

And just like the Tier 3 lenders, we are encouraging the Tier 2 lenders to run a business that is sustainable for them over the long time. I think we've seen their credit appetite increase over the last several quarters. That has been a good thing for us and the reason we manage a large stable of lenders there is so we can get the best offers for CarMax customers on an ongoing basis.

Tom Folliard (President, CEO):

But, Scot, it's also difficult to quantify very specifically because of the way we run our credit. We run a waterfall of credit. It goes from one tier of lenders down to the next down to the next. If it gets picked up in the middle then the bottom tier never see the application in the first place, so it's not as easy as it sounds to say, oh, we got 0.5 point or 1.5 points from this or that.

But to Tom's point, anything that gets picked up on the way down is a positive. We have a bunch of lending partners and we are grateful for all the relationships that we've built over the years, but they all run their own models and we hope they run them profitably and they can stay with us for a long time.

Scot Ciccarelli (Analyst - RBC Capital Markets):

All right, got it. Thanks a lot, guys.

Operator:

Craig Kennison, Baird.

Craig Kennison (Analyst - Robert W. Baird):

Good morning. Thank you for taking my question as well. Tom, you mentioned the drop in oil and that seems like good news for most of your customers, but I also imagine it signals tougher times in oil-based economies. I'm just wondering if you've seen that dynamic play out at all in some of those markets.

Tom Folliard (President, CEO):

Not that I know of. The way I look at that is -- you remember the CarMax customer is the average American consumer and the average American consumer has a little more spending money at this gas rate than they had before. So I think that is a positive for people's outlook, for their budget, for their wallet, for their consideration when they are looking to sign up for a loan for a few years.

I think on the new car side you saw it really impact the mix, and although we haven't seen it impact the mix as much, we were probably already a little more heavily skewed to SUVs and things like that in the first place. So we haven't really seen it impact our mix much, but I think the American consumer having a little more money to spend is a good thing.

Craig Kennison (Analyst - Robert W. Baird):

Is CAF or are your lending partners at all looking at markets like Texas or other oil-based markets and saying, you know what, we've got to score that customer differently because their incomes may actually

TheStreet Transcript

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

change?

Tom Folliard (President, CEO):

We haven't had any discussions with them along that front. Like Tom and I said, we are going to encourage them to run a business to make sense for them and we are going to do the same. If we have something to talk about on that front, we will.

There's [been] volatility in gas prices. I'm not sure if you are a lender you want to assume that this is where gas prices are going to stay for the next five years.

Craig Kennison (Analyst - Robert W. Baird):

Got it. Thanks a lot.

Operator:

Matthew Fassler, Goldman Sachs.

Matthew Fassler (Analyst - Goldman Sachs):

Thanks a lot and good morning. I've got one follow-up to someone else's question, then one of my own.

On the subprime piece, can you talk about whether the mix of your Tier 3 providers has changed meaningfully over the course of the past year and whether that might have contributed at all to the moderating decline in subprime penetration?

Tom Reedy (EVP, CFO):

Matt, the mix has been very consistent over the past year. The only change has been that, as you know, CarMax is running a test and took a little bit of that volume starting this year, a very small part of the volume. And we are not behaving any differently or more aggressively than our partners.

Matthew Fassler (Analyst - Goldman Sachs):

Got it. And then secondly, your wholesale profitability, while it was not off the charts, was very good and showed a bit of a pickup year-on-year in the rate of growth in wholesale margins. Any comments on what's driving your ability to continue to extract more in terms of gross profit per vehicle through your auction process?

Tom Folliard (President, CEO):

You know, similar to what I said on the retail side, Matt, it's $40 up, down, pretty close. It's just good management. As you know how we run our auctions, the car sells to the top bidder and we adjust our prices weekly as we sell through our auction.

We have had great execution in our stores. We've had great attendance from our dealers who come to our auction and support our pricing each and every week, and I think we just continue to do a good job running our auctions.

But we don't -- we weren't -- as I said before, if we get pretty close on the margin, we consider that to be good. So it was slightly up, but that is essentially flat for us.

Matthew Fassler (Analyst - Goldman Sachs):

Understood, thanks so much.

© 2014 TheStreet, Inc. All Rights Reserved

Operator:

Rod Lache, Deutsche Bank.

Rod Lache (Analyst - Deutsche Bank):

Thanks. Good morning, everybody. On that improvement in conversion that you mentioned in your release, is that a function of the types of customers that you are seeing coming through the door, lender behavior, or is it something else? I would imagine that if trade-in values moderated a little bit, that would not have necessarily helped.

Tom Folliard (President, CEO):

No, conversion for us is really a team effort. It's a combination of buying the right cars, having the right inventory at the right store at the right time, doing a great job reconditioning, having high-quality cars. We've done a lot of training with our salesforce to be able to execute and help customers overcome objections, whether it's on the trade-in or their financing or what car they want to buy.

Financing is obviously -- access to financing and the rate that they receive is another piece of conversion. You know how good a search engine we have on our Web site; I just think over time we expect to be able to continue to improve conversion, but it's very difficult point to one specific area.

But as it relates directly to finance, we didn't have anything significant change in the quarter to contribute to that. And as we said in the press release, our comps were driven partly by an increase in traffic and partly by an increase in conversion, and that's what I would expect over time for us is to be able to improve both of those marginally over time.

Rod Lache (Analyst - Deutsche Bank):

Okay. And just really quickly, I was wondering if you had any other follow-up comments on the CAF test in subprime. What are some of the takeaways and adjustments you are making and what is sort of the trajectory we should be expecting from here?

Tom Reedy (EVP, CFO):

It's still a bit early. We are seeing the first vintages that we originated cross the six-month timeframe and we really need to go through a full tax season and a full cycle with this product before we can make any conclusions. So what I can say is that we have not seen anything negative and unexpected that would lead us to dial back or not continue to test.

Like I said, we like to get through tax season and continue through the test that we have and figure out where we go from there at the end of the year. We will probably have something to say about where we are going because we are likely to use up that initial $70 million during the quarter.

Rod Lache (Analyst - Deutsche Bank):

Great, thank you. Congratulations.

Operator:

Ravi Shanker, Morgan Stanley.

Paresh Jain (Analyst - Morgan Stanley):

Good morning, everyone. This is Paresh Jain in for Ravi. Just to follow-up on the subprime pilot program, you initially set out to do $70 million through the end of last quarter. If you can provide some color as to what

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

TheStreet Transcript

prevented you from deploying the entire $70 million.

Tom Reedy (EVP, CFO):

I think we said we were going to run a test for $70 million, I don't think we gave any guidance on how long it would take. We have been doing a bit of it every quarter and we are continuing to test as we go. As I said, next quarter I think we can give you more visibility to where we will go from beyond that initial $70 million test.

Paresh Jain (Analyst - Morgan Stanley):

Thanks for the clarification. Then on competition, you are planning to expand your presence in the Denver market with I think a couple of more stores in addition to a couple already there. Sonic recently launched their EchoPark stores in that market and are looking to add more stores as well. Wanted to get your thoughts on what the initial share and pricing response has been like and where do you see it going?

Tom Folliard (President, CEO):

Yes, we really don't have anything to report there. They've been open for a very short window of time. We've been open for a couple of years with two stores.

Denver has always been a very attractive market for us. We have owned real estate there for a number of years. We have a couple more stores coming in the next 12 to 18 months, but they were coming anyway, and then we have an additional store down in Colorado Springs. But their store has been open for only a month or two so nothing to report at this time.

Paresh Jain (Analyst - Morgan Stanley):

Thanks so much.

Operator:

(Operator Instructions) Rick Nelson, Stephens.

Rick Nelson (Analyst - Stephens):

Thanks, good morning. I would like to ask about the other segment revenues. The growth in extended protection plan revenue really accelerated this quarter. If you could comment there, that would be helpful.

Tom Reedy (EVP, CFO):

Yes, if you remember last year we had a significant adjustment in the extended protection plan reserve and so the reason you see a significant increase this year year-over-year is really because last year was impaired a bit. If you back out that adjustment, it's more like a 9% increase in those other revenues.

That comes from a combination of the extended protection plans, an improvement in the mix between subprime and nonprime, which means we have less discount that we paid to the subprime providers, and kind of relatively flat service income. But the reason it's such a big step up was because last year was down.

Rick Nelson (Analyst - Stephens):

Thank you for that. Also 13 stores last year, 10 the year before. Any color as to how those stores are coming into the comps and how big a driver they are to the nice comp you reported this quarter? Do you have --?

Tom Folliard (President, CEO):

It's awfully early in their life, but if you look at the size of the base, one year's worth of openings impact on

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

comps, the first year that those stores become comp stores is very, very little. But obviously over time they will add to the total sales. You look at our total increase of 14%, half of that is coming from new stores and half of that is coming from the existing stores with the 7% comp.

But we are on a pretty steady opening pace. You mentioned we opened 10 the year prior, 13 last year. We will get another 13 open this year. We are still on that 10 to 15 store pace for the next couple of years. Lots of great places for us to go build stores, lots of market that we are going back in and adding new stores.

Rick Nelson (Analyst - Stephens):

Thanks a lot and good luck.

Operator:

Bill Armstrong, CL King & Associates.

Bill Armstrong (Analyst - CL King & Associates):

Good morning. The only question I have left is on the EPP penetration rate, it was lower a little bit. I was wondering if you could expand on that and maybe -- I don't know if you would disclose what the actual penetration rates are this year versus last year and why they are down.

Tom Reedy (EVP, CFO):

It is down a couple points, not down significantly. As we discussed early in the year, with the change in the reserve we were going to make some changes to pricing to recover that additional reserve. And we also talked about the fact that our partners continually are having us change prices on their product in order to preserve their business based on the experience they've seen in the portfolio and there have been price changes based on their needs as well.

So what we've seen is some price changes and we've seen a little bit of degradation in penetration. But I think we need to see where that is going to shake out over the course of the year because penetration is also highly dependent on people's performance in the stores and the initiatives that we have around selling that product.

Tom Folliard (President, CEO):

But our penetration is around 60%. We're really proud of our execution. I think our store teams do a great job of working with customers and showing them the value of buying an extended service plan, and then our providers do a really good job of managing that through the life the car.

So we think we offer a great product and our customers realize the value in it. We do as good a job as anybody out there in selling this product and then delivering a great experience for the customer after.

Bill Armstrong (Analyst - CL King & Associates):

So it sounds like the decline in penetration is more an issue of pricing rather than execution?

Tom Folliard (President, CEO):

Yes, and as Tom said, we talked about that at the beginning of this year.

Bill Armstrong (Analyst - CL King & Associates):

Okay, thank you.

Operator:

© 2014 TheStreet, Inc. All Rights Reserved

TheStreet Transcript

David Whiston, Morningstar.

David Whiston (Analyst - Morningstar):

Thanks, good morning. Looking at your cash flow statement, and ignoring the increase in auto loan receivables, and then just doing an adjusted CFO minus CapEx and free cash flow as a percentage of revenue and for the nine months 2014 versus nine months 2013 it's down quite a bit, which looks to be the increase in inventory.

So obviously we've got a lot more inventory supply coming online. Do you think over the next 12 months you are going to continue to have a lot of a decrease in working capital from inventory accumulation?

Tom Folliard (President, CEO):

We are going to manage our inventory in line with what our sales expectations are and then also the fact that we are continuing to build stores. We are building them all over the place and we are building at about a pace of about a store a month or a little better than that.

So oftentimes -- a lot of times you look at our inventory and some of it is just based on timing. When is next store being opened? Are we reconditioning those cars in another market, getting them ready for that other store?

But even if you look at our inventory reported at the end of the quarter, about half of the unit increase is in our existing stores, which delivered a 7.5% comp and about half our unit increase is represented in our new stores. So our inventory will go up as our store base goes up and our comp sales go up. But it won't necessarily -- it's not going to exceed that to any great degree.

Tom Reedy (EVP, CFO):

I think there's a bit of seasonality in that as well. Q3 was a significant inventory build as we are coming into the tax season, so you'd need to look at it over a more spread out period I think.

David Whiston (Analyst - Morningstar):

Okay. Last question, I know in the past you've talked about starting from scratch on targeting inventory mix weekly, but I'm sure there's a lot more IT in the Company over the past few years. Are you really at a point where you are sourcing -- maybe even changing your sourcing habits daily or several times a day?

Tom Folliard (President, CEO):

Not really, it doesn't move that fast. Weekly is pretty fast, especially with the size of the investment in each individual car. Remember that half of our cars right now are coming from appraisals that we are buying directly from the consumer, and you really need a week's worth of data at least before you can make a decision about what to do the following week.

So we are pretty comfortable with the way we are managing it right now. I think what has gotten better and better for us each and every year is the ability to apply that data to a buying model that is very, very store-specific.

Then the other benefit that we have gained over the last several years is, as our brand get stronger, the more cars that are on our Web site, the better the pictures, the better the search engine, the more accessibility the customer has to inventory in other markets.

And that is about a third of our sales. Our car is transferred at the customer's request, so it's another way for us to leverage that inventory. But I think hopefully we will continue to get better at this.

© 2014 TheStreet, Inc. All Rights Reserved

David Whiston (Analyst - Morningstar):

You said transfers are a third of sales?

Tom Folliard (President, CEO):

Roughly, yes. Right around 30%.

David Whiston (Analyst - Morningstar):

Okay, thanks.

Operator:

And we have no further questions in the queue. I will turn the call back over to Mr. Tom Folliard, CEO.

Tom Folliard (President, CEO):

All right, thank you very much. I want to thank all of you for joining us today on the call. I also, of course, want to thank all of our associates for everything they do every day, especially around the holiday season.

I wish all of you guys a happy holidays and we will talk to you again next quarter. Thanks for joining us.

Operator:

This concludes today's conference call. You may now disconnect.

All rights reserved (c) 2014 TheStreet, Inc.

Please feel free to quote up to 200 words per transcript. Any quote should be accompanied by "Provided by TheStreet" and a link to the complete transcript and www.thestreet.com. Any other use or method of distribution is strictly prohibited.

THE INFORMATION CONTAINED IN EACH WRITTEN OR AUDIO TRANSCRIPT (the "TRANSCRIPT") IS A REPRODUCTION OF A PARTICULAR COMPANY'S CONFERENCE CALL, CONFERENCE PRESENTATION OR OTHER AUDIO PRESENTATION. THE TRANSCRIPTS ARE PROVIDED "AS IS" AND "AS AVAILABLE" AND THESTREET IS NOT RESPONSIBLE IN ANY WAY NOR DOES IT MAKE ANY REPRESENTATION OR WARRANTY REGARDING THE ACCURACY OR COMPLETENESS OF THE TRANSCRIPTS AS PRODUCED, NOR THE SUBSTANCE OF A PARTICULAR COMPANY'S INFORMATION.

THE TRANSCRIPTS ARE PROVIDED FOR INFORMATIONAL PURPOSES ONLY. THESTREET IS NOT PROVIDING ANY INVESTMENT ADVICE OR ENDORSING ANY PARTICULAR COMPANY.

TheStreet Transcript