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BARRON'S ROUNDTABLE

Meryl Witmer: Used Cars and Carbon Black

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Barron's: Meryl, let's hear your picks for the year ahead.

Meryl Witmer: Sure. My first pick is CarMax [ticker: KMX]. It trades for around $70 a share, and there are 184 million shares, for an equity capitalization of about $13 billion. It also has about $1 billion of corporate debt outstanding. The company has several income streams that emanate from the sale of used cars. It sells cars to consumers, providing financing on some. It sells extended warranties, which get extremely high marks from buyers, and it also has an amazing wholesale auction business that sold about 400,000 cars in the past year to used-car dealers.

The source of the auction cars is the company's direct purchase of cars. CarMax will buy a car from any seller—not just people who come in to buy a car—and sell the older ones wholesale at the auctions. The younger ones tend to go to the CarMax retail customers. The average age of cars sold to retail is four years. At the auctions, it is about 10 years.

CarMax's proprietary data analytics give it a competitive advantage in both buying and pricing cars. It purchases cars, and prices them efficiently. Its average annual gross profit on a used car has stayed within a $25 range annually over the past seven years. In the wholesale-auction business, it has stayed within a $75 range. That's incredible.

Jeffrey Gundlach: How much do they make on the cars?

Witmer: A couple thousand dollars.

Gundlach: That's amazing.

Witmer: CarMax has a no-haggle policy; you don't have to wonder if you could have gotten a better deal. It does best when used-car prices are going down, since it passes through the savings to the consumer and does so faster than competitors.

Are there any near-term catalysts for the stock?

Witmer: Near-term, there is a big increase in cars coming off lease, and that will enable CarMax to buy them at lower prices. Since CarMax passes through savings, that could be helpful. The company also has room to expand: The current store base is about 190, growing by about 15 stores a year.

CarMax also could be a beneficiary of the new tax bill. First, its corporate tax rate will go down. We use 26% in our estimates, but it could be lower. In addition, many of its potential customers should have bigger paychecks from lower federal taxes and the bonuses and pay increases companies have announced. Job creation from economic growth should also benefit CarMax.

What are your earnings estimates for the company?

Meryl Witmer

General partner

Eagle Capital Partners

New York

Witmer: CarMax reported $3.26 a share in earnings for the year ended in February 2017, which would have been more than $4 with the lower tax rate. For the year ending in February 2018, earnings should be about $4.50 a share pro forma, accounting for the lower tax rate. We assume CarMax continues its stock-buyback program and buys about $1 billion of stock over the next six quarters. CarMax has repurchased about 20% of its outstanding shares, net, in the past four years. With minimal same-store sales growth, it will earn about $5 a share next fiscal year and $5.50 in the year ending February 2020. With a few percentage points of same-store sales growth, earnings could reach $6.25 a share for the year ending in February 2020.

CarMax had a great after-tax return on capital of 15% at its prior 38% tax rate. It has a long runway of growth with about 3% national market share and 10% share in the markets where it has stores. It deserves at least a 15 multiple on forward earnings, which gives us a one-year target price of $82 a share on the low side. But things should play out much better, and the stock could be $93 in a year.

CarMax faces some tough same-store sales comparisons in the next couple of quarters, as it is going up against 8% same-store sales growth in the prior period. Then comps get easier. By year end, we should see a good return. Henry talked this morning about platform companies built on technology. CarMax has great data, and it will continue to benefit from all of that information.

Henry Ellenbogen: Their service is great. I sold my last two cars to them.

Witmer: I did, too, and I am going to sell one and buy one soon.

How about another idea?

Witmer: My next pick is Orion Engineered Carbons [OEC)]. It trades for $27. Unfortunately, it has moved up a bit, but is still a great value. The company is based in Luxembourg, trades on the New York Stock Exchange in dollars, and reports earnings in euros. It is complicated to analyze. It came public in 2014 out of private equity, which in turn had purchased it from Evonik Industries [EVK.Germany]. Orion has been a bit of an orphan. Private equity recently sold the last of its stake at around $23 a share, increasing the float. Orion is slowly getting some attention from institutions. Its equity capitalization is $1.6 billion.

What does Orion Engineered Carbons do?

Witmer: It makes differentiated high-value specialty carbon black and commodity carbon black. In the specialty area, it is used as a pigment in printing inks and paints. It is also used to absorb ultraviolet light and impart color into adhesives, sealants, plastic pipe, and the like. And it is used in batteries. The commodity product is essential for making tires and other rubber products strong because it ensures a high resistance to abrasion and aging.

The specialty grades are about 25% of volume and about 60% of earnings before interest, taxes, depreciation, and amortization [Ebitda]. The commodity grades are 75% of volume and 40% of Ebitda. Clearly, the specialty portion is more profitable. Since 2013, specialty has grown volumes by about 35% versus 7% for the commodity, and Orion is doing a smart thing in converting commodity lines over to specialty as demand allows. The specialty industry has consolidated and has two other players, Cabot [CBT] and Birla. The commodity side has more players.

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What is so interesting about carbon black?

Witmer: In doing our research checks on the commodity side, one industry insider said we should "get our shades on because the carbon black industry outlook is very bright." This source said a lot of tire capacity is coming on in North America in the next few years with no incremental supply in carbon black. Others told us that the commodity players have shut capacity and are mostly acting rationally. China is shutting down some of the high-polluting plants. Pricing outside of North America is at good levels and improving, and pricing in the U.S. is finally starting to move up to acceptable levels.

In addition, the trend toward hybrid and electric vehicles is great for carbon black since tires require more carbon black to withstand the heavier weight. A stronger economy with more miles driven is wearing out tires, and people with more money in their pocket from lower taxes might replace the worn tires a bit more quickly. With increasing demand, we see pricing moving up for the commodity product. The specialty area should continue its growth in demand with stable pricing, except for the pass-through of oil prices. Oil is the main raw material for manufacturing carbon black.

Take us through the financials, please.

Witmer: Orion has committed to convert its financials from IFRS [International Financial Reporting Standards] to GAAP [generally accepted accounting principles] accounting and thereby change its reporting currency to dollars, which should be a catalyst for the share price. Because it was a buyout, Orion has excess amortization charges to its earnings above its maintenance capital-spending needs. We add 50 cents to earnings per share to calculate our after-tax free cash flow per share. With the benign pricing environment in commodity and growth in specialty, we see after-tax free cash flow per share growing from about $2.15 last year to $2.50 in 2018 to $2.80-$3 in 2019. The company has done a great job paying down debt and has superb corporate leadership. We see it trading at about a 14 multiple and have a target price of about $40 in a year, up from $27 today.

Oscar Schafer: How cyclical is the business?

Witmer: There is slight cyclicality to it on the tire side: 25% of carbon black goes into new cars. There is some on the commodity side, but it is a worldwide market. On the specialty side, there's been growth, even through recession.

Schafer: Is the balance sheet good?

Witmer: Yes. Debt coverage is about 2.3 times adjusted Ebitda, and the company is going to generate a lot of cash. The price increase in carbon black in the commodity market is a game changer because Orion is going to start earning an appropriate return.

Our summer intern wrote about the company. It's a shame that he isn't here to listen to your presentation.

Witmer: He did a good job. I could hire him.

Last year, I recommended two companies in the United Kingdom: Dart Group [DTG.UK], at the January Roundtable, and Howden Joinery Group [HWDN.UK] in the midyear Roundtable, in June. I am recommending them again. They are great companies, still at great prices. While there is still some uncertainty around Brexit [Britain's exit from the European Union] this year, their competitive positions have only strengthened.

ROUNDTABLE PART 2

- Henry Ellenbogen: The Case for a Credit Bureau, a Ski Resort, and More
- Mario Gabelli: Bullish on Media and Entertainment
- Jeffrey Gundlach: Bullish on Commodities and Bank Loans
- Abby Joseph Cohen: Drilling for Oil and Making Gadgets
- William Priest: Bullish on Screen Technology and Chip Gear
- Scott Black: Making Chips and Crushing Sand
- Meryl Witmer: Used Cars and Carbon Black
- Oscar Schafer: Loading Up on Auto Parts, Off to the Movies
- Paul Wick: How to Play the Big Trends in Tech

Dart, the parent of Jet2.com and Jet2holidays, grew its revenue 41% in the half-year ended on Sept. 30, as it successfully opened new bases at Birmingham and Stansted airports and continued to expand the brand. It sells high-quality, affordable vacation packages, along with flights. Its Jet2holidays, the vacation-package business, was ranked fourth in the U.K. among 250 companies for highest customer satisfaction.

Its competitive position improved in October when Monarch Airlines, the price disrupter in the industry, filed for bankruptcy and liquidated, eliminating capacity. On the day of the announcement, Jet2.com added 100,000 seats and ultimately added a total of 650,000 seats to a base of about nine million. Additionally, competitor Ryanair [RYA.Ireland] had some significant scheduling problems with its pilots last year, forcing it to cancel a lot of flights and making it a risky bet for the annual family vacation. Vacations are Jet2's profitable niche.

How might Brexit affect Dart Group?

Witmer: It won't matter much. Britain is a cold, rainy, cloudy island, and people have to get away. We view management as exceptional, and they're owner-operators [the founder owns 38% of the company]. The stock is 700 pence ($9.62), and we estimate the company will earn at least 75p a share in the year ending March 2019. There will be about 300p per share of extra cash on hand at the end of the year if it isn't used for growth. Using an 11 multiple on forward earnings, plus that extra cash, yields a target price of over 1,000p.

The other pick in the U.K. is Howden Joinery. It has 617 million shares outstanding at a price of 467p for a market cap of £2.9 billion [$4 billion], and no debt. Howden is the leading British kitchen wholesaler and distributor, with a dominant market share of more than 50%. It sells kitchen cabinets, countertops, and private-label appliances. It sells only to contractors, so the retail customer can't price-shop the product. It can deliver the cabinetry within two days of an order being placed, so it delivers almost instant gratification. The business performed well in the first 10 months of 2017, with total sales growth of 6.3% and same-store sales growth of 4.4%. Sales are accelerating, with total sales up 8% from June to October and same-store sales up an estimated 6%.

Does the company have any special advantages?

Witmer: Howden is vertically integrated and can adapt to customer preferences quickly. It introduced 25 new products and ranges last year, which helped drive demand. The average kitchen remodel through Howden is £5,000, so the cost is very reasonable. The company gives autonomy to its location managers. It has 680 locations, and all employees are incentivized by profits at their respective location. The intricacies of fitting a kitchen make it immune from internet competition.

Howden had 29.2p in earnings per share in 2016 and should report a similar number in 2017 because it opened a new distribution center while keeping the older one running to avoid delivery issues. We see earnings growth resuming, with earnings per share of 33p in 2018 and 38p in 2019. We value the company at 15 times forward earnings per share. It has no debt and should have about 50p of extra cash by year end. It has a history of returning cash to shareholders with dividends and buybacks. Our target price is 620p in a year, up from 467p recently.

Thank you, Meryl.

Email: editors@barrons.com