BrightGateCapital
INVESTMENT~INTELLIGENCE

Annual letter to the co-investors of the fund BrightGate Focus

January 16th 2023, Madrid

"One day, in retrospect, the years of struggle will strike you as the most beautiful."
Sigmund Freud, Complete Letters.

Dear co-investors,

We hope you had a happy holiday season and wish you all the best for the year ahead.

I would like to start with a quick summary of the Fund. The Fund closed on December 31, 2022, with a NAV of 1,143.9 (Class I), representing a net annualized return of -13.2%. The Fund was established on December 20, 2019, and the annualized return since inception has been -1.6%. The ISIN codes of the share classes are ES0114904008 (class A) and ES0114904016 (I).

The Fund's philosophy is to build a concentrated portfolio of international securities with low turnover. The investment universe is not only limited to equities, and the Fund may also invest in high yield bonds, convertible bonds, and preferred stocks, when appropriate. In equities, the investment philosophy seeks companies that operate in predictable industries (generally with an oligopolistic structure), without debt, and trading at reasonable valuations – that can capitalize our investments at rates of at least 7-9% (*compounders*). Finally, the required return on fixed income investments is 8-10%, after currency hedging costs, although we occasionally invest in low coupon (or non-coupon) securities, seeking capital gains in this case.

In both equities and bonds, my *modus operandi* is to understand the profitability of the business in question, and once a clear picture has been extracted, to *link those returns organically to the valuation of the business*. BrightGate Focus is not just looking for companies that engage in M&A, grow their profits or, even less so, their sales volume, catchy phrases that never go out of fashion in the markets, *but for growth to be done profitably* – that is, investments made by our companies must exceed our cost of capital. Our investors can rest assured that most of my time is devoted to this task.

In this year's letter I will explain in detail one of the analytical tools that I have included in the investment process, and that I will use profusely from now on. Such a tool, Hamilton's theoretical scheme of the 7 Powers, aims to provide an answer to the question of what a company's competitive advantages are and how durable they are. On the other hand, and following the tradition of previous years' letters, I will summarize our ideas with more weight in the compounders part, since under normal conditions these are the stocks that will form part of the bulk of our portfolio. These summaries can be found in Appendix I to this letter.

Reflections on 2022: summary of the Fund's first three years and Hamilton Helmer's 7 Powers

BrightGate Focus began its journey at the end of 2019, so the Fund is three years old now and it is a good time to take a first look back at what these years have been like.

First of all, it is fair to say that the results have been below expectations when the Fund was established. While it is true that the measurement period is strongly conditioned by the start (the portfolio was invested just before the beginning of the pandemic) and end dates (2022 has been one of the worst years for equities and bonds), the performance of the vehicle has been penalized by some mistakes I have made, which I will now comment on. The performance has also lagged the performance of the major stock market indexes over the years, whereas it has been simply in line with the performance of fixed income indices. Although the Fund does not follow any benchmark, it is reasonable to assume that our investors' "cost of capital" for investing in our Fund is similar to that obtainable from any of the indices discussed above. *I deem any other result simply disappointing*.

As discussed in previous annual letters, lofty equity valuations in the U.S. and Europe over the past few years pushed me to look for opportunities in other geographies, *where not only geopolitical risks are a key consideration but corporate governance risks as well*. And while 2022 has been a difficult year for those stocks with high valuations, it has been no less so for stocks with the two aforementioned risks.

Returns to date in this group of companies outside the United States and Europe have been lacklustre, penalizing the Fund's aggregate returns. For example, our position in Kaspi, one of the Fund's largest, closed the year with a 30% loss, due to the combined impact of the social unrest at the beginning of the year and the outbreak of the war in Ukraine, despite the fact that the company is on track to close 2022 with 30% growth in net income. Our positions in the Korean NICE group companies (NICE Holdings, NICE D&B) have also performed negatively, despite closing 2022 with record numbers in what is a business with very little cyclicality. At Naspers, despite the aggressive share buyback program instituted this year by the company, the gains we have made have been modest, as Tencent stock, Naspers' main asset, has been penalized both by the economic deterioration that the Chinese economy is suffering and by the Chinese Communist Party's aggressive new guidelines against technology companies.

And finally, the outcome of our investment in LUKOIL is uncertain, as it depends on many factors that are absolutely unpredictable at this time. To add salt to the wound, our position in LUKOIL was our only exposure to the energy sector at the start of the year as, in retrospect, I misjudged the importance of geopolitical risks versus the protection afforded by having the healthiest balance sheet in the entire industry. In any other year of the past decade, years characterized by low oil prices and a high number of bankruptcies, financial leverage would have been the best predictor of success of an investment in the energy sector. However, this was not the case in 2022.

Looking at the rest of the portfolio, our high exposure in memory manufacturers has also penalized the Fund's performance over the past three years, as the share prices of these companies are at the same level as they were in 2019. In this case, however, the prices of these stocks have not been penalized by geopolitical considerations, but by fear of the economic cycle and by purely sectoral issues – for example, the overinvestment that both Samsung, SK hynix, and Micron have made over the past three years.

As I explain in Appendix I, I continue to have high expectations for the expected returns we will reap from both memory manufacturers and emerging market companies. In fact, during the year I have hardly changed the exposure to either of these names.

Unlike previous years, the sharp correction in valuations in the United States, especially in those companies categorized as "consumer, cyclical", have opened up the possibility of initiating positions in companies with predictable long-term business models, that earn returns above their cost of capital, with excellent management teams and that trade at attractive valuations. Although the major index providers classify all these companies under the same heading, I should mention that their long-term dynamics will be very different and their returns will most likely be uncorrelated with each other. The main industries in which we have invested are residential construction (13% of the Fund through three names, one of them in the UK), recreational vehicle manufacturing (10% through two companies) and automotive distribution (7% through two companies). In Appendix I, I have included the investment thesis for all of these and the rational to justify my optimism as to why in each case *I expect double digit annualised rates of return over the next few years*.

During 2022, I have focused on improving the one parameter of the Fund that is in my hands: the investment process. In this regard, the year has been very fruitful, as I have introduced several tools in order to improve this process – an iterative and never-ending task. In particular, I have introduced into the analysis of all our companies Hamilton Helmer's theoretical framework known as the 7 Powers, popularized by the book bearing the same name and published in 2016.

The 7 Powers framework is intended to provide an answer to the question of what a company's competitive advantages are and how durable they are. For Hamilton, a "Power" is the source of such advantages, which in turn allow the firm in question to earn returns above its cost of capital. It is important to note that *such competitive advantages belong to the firm in question and are not general characteristics of the industry in which it operates*. In this sense, Helmer's scheme is very different and, I would argue, more useful, than Michael Porter's widely popularized Five Forces framework, which purports to answer the question of whether an industry is attractive or not.

Why do I believe that Helmer's scheme is more useful than Porter's in practice? Well, because on a day-to-day basis, we managers find bad companies operating in attractive sectors and, in the opposite situation, good companies operating in less attractive sectors. Using Porter's scheme as the only filter *would potentially lead us to invest in undesirable companies by being misled by the favourable characteristics of the sector, or to miss opportunities in extraordinary companies by thinking that it is impossible to find good businesses in more disadvantaged sectors*.

In any case, using Helmer's framework does not preclude also using Porter's since, as I have explained, both pose different questions and offer different answers. In fact, the Fund's investment philosophy will continue to employ industrial analysis and impose certain sectoral constraints (especially in those sectors that I am not familiar with, that do not cover their cost of capital or that are heavily regulated) but enriched with the intuitions of Helmer's framework.

So, what are the 7 Powers? In no particular order, they are economies of scale, network economies, counter-positioning, switching costs, brand, cornered resource, and process. It is important to note that in order to obtain lasting differential returns, a company does not need to enjoy all the powers; *in many cases, just one power is sufficient*. A simple example is found in the world of mining, where the biggest (and in most cases, only) competitive advantage that one company has over another is the quality of the mines, or in mining jargon, the "grade" of the deposit – the percentage of ore out of the total rock that must be moved to extract it. A copper mine like Kamoa-Kakula, with grades of 5%, is simply a better asset than the typical mine that can be mined today with average grades of 0.6%. Such a geological difference is not transient, it is persistent, and under Helmer's framework would be a clear example of a "cornered resource".

An interesting way to help us initially identify the Powers that a company may command is to determine its life stage. For Helmer, *not all the Powers are accessible from the beginning of a company's life, since they are obtained, or lost, as the company reaches maturity* (defined by Helmer as growth in sales volume). Powers such as cornered resource or counter-positioning can be acquired early in the life of a company, while others such as branding or processes are only attained after a long period of time – for example, the time it takes to build a brand like Tiffany or develop the processes of a company like Toyota.

It goes without saying, but the book is a must-read, and given the brevity of these letters I cannot do it justice. To partially alleviate this deficiency, I have included in Appendix II for those readers interested my application of Helmer's framework to a newly included portfolio company, CarMax. I have performed similar analyses for the rest of the companies in which we are invested, and I believe the process has been highly instructive.

Turning to the main portfolio metrics, as of December 31, the Fund had a cash position of 13.4%, with the remainder invested as follows: equities (*compounders*) 74.7%, high yield bonds 3.7%, special situations 6.3% and preferred shares 1.9%. By geographies, our main weighting is in North America (50.1%; mainly the United States, with a small exposure to Canada through our investment in Imperial Oil), followed by Asia (15.1%), Europe (10.2%), the Middle East (6.5%) and finally Africa (4.7%; through our position in Naspers). As always, all of our companies have a long and exceptional track record of profitability (as measured by their return on net operating assets), and the additional investments they are making exceed our cost of capital. As I mentioned last year, I believe this combination of liquidity with attractive companies at reasonable prices will make us better positioned than the indices and our competitors this year, giving us the flexibility to take advantage of investment opportunities as they arise.

On the other hand, our Ping Petroleum bond, the only credit in our fixed income portfolio, has a YTW (in euros) of 12.8% with a duration of 1.3. I would have liked to have had a higher percentage of the portfolio in high-yield bonds, but I have been unable during the year to find sufficiently attractive credits with healthy balance sheets and yields (in euros) of over 10%. In this sense, Ping Petroleum was the only bond we started the year with, and the only bond in our portfolio at the end of the year.

As you know, our equities have not generally been currency hedged, while our fixed income portfolio has. However, given the high exposure we have accumulated during the year to US equities with exclusively local businesses, I thought it prudent to partially hedge the currency in these names. Although over the long term exchange rate movements should be broadly neutral for the Fund's performance, it is worth noting that in 2022 the impact was slightly positive for our results, given the appreciation of the dollar against the euro. Although I believe that the dollar will structurally appreciate against the euro in the coming years, such macroeconomic considerations are irrelevant to the construction of the portfolio, which is based solely on my conviction in each of its securities, and not on the currency in which they are denominated. Given the lack of good assets at reasonable prices in the Eurozone, I foresee a similar exposure to the dollar as last year.

I remain at your disposal to answer any questions that may arise or to go into detail on any of the securities that make up our portfolio.

Nullius in verba,

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Appendix I. Thesis summary of our main long-term equity positions

Memory manufacturers (SK hynix, Micron Technology)

Our exposure to memory manufacturers amounted to approximately 13% of the Fund at year-end. This exposure has been reduced over the past twelve months due to two factors. Firstly, the sharp declines in the sector and secondly, our divestment of Samsung Electronics, which represented around 4% at the end of last year, and which I explained in detail the reason for its divestment in a previous monthly update.

After more than two and a half years invested in the sector, it is quite sobering to see that our investment in these names has not paid off so far and that we actually have slight losses (excluding dividends) in the two manufacturers. Despite the sharp slowdown in demand experienced in recent quarters, and which is expected to continue through 2023, the main elements of the original thesis remain intact, and I continue to believe that this is an extraordinary time to invest in these two companies. In fact, one of the big risks of the thesis, which was YMTC's entry into the NAND segment, has been diluted during the year, as despite the progress that YMTC has made in its manufacturing process (with the first ever-produced 232-layer NAND memory units), the new restrictions that the US has imposed on the company will greatly limit its future evolution, leaving it in the most likely case as a marginal producer. Moreover, CXMT, the Chinese DRAM competitor, has made no apparent progress during the year, and the possibility of it eventually producing at scale and profitably is further away than ever.

Of course, it has not all been good news in recent years. Specifically, according to my estimates, all three manufacturers have been overinvesting and, in Micron’s case in particular, its node progression has been faster than expected. Although at the microeconomic level such acceleration has allowed Micron to have a more efficient cost structure than its competitors (given the higher density of bits per wafer produced), at the industry level it has generated more bit production and, more importantly, has probably alienated its competitors, who have seen that due to their prudence in introducing new nodes Micron has overtaken them after several decades of being the least advanced producer – such a reason may be behind Samsung's recent reluctance to cut its capex program for 2023, although this is purely speculation on my part.

The above negative aspects should not prevent us from looking at the situation as a whole. To properly assess the evolution of our investment in SK hynix and Micron since we entered, it may be interesting to consider the following figures. Micron closed 2019, the last year for which information was available when the position was initiated, with net operating assets (NOAs) of $33.6bn and net operating income (NOI) of $6.6bn, giving a return on assets of 20.6% (Micron's NOAs at the close of 2018 had been $30bn). Three years later, at the close of 2022 (Micron closes its fiscal year in October), Micron had $45bn in NOAs, generating $8.3bn. in NOI and having an RNOA of 19% (Micron closed 2021 with NOAs of $40bn.). In other words, Micron's asset base has grown 33% in 3 years and the returns it has earned on that investment have barely changed. SK hynix's numbers are similar, although they have been somewhat more penalized by its investment in Intel's NAND business, which is much less profitable than SK hynix's historical DRAM assets. Given that Micron trades at just over 1x EV/NOA (SK hynix trades below its NOAs), one doesn't need heroic assumptions to conclude that the stock should deliver double-digit annualized rates of return over the next decade, and with relatively low risk.

Kaspi.kz

We initiated our position in Kaspi during the second half of 2021 and, in retrospect, I could not have chosen a worse time. During January and February 2022, the company's shares were successively penalized, first by social unrest in Kazakhstan and, second, by the Russian invasion of Ukraine. Although Kazakhstan declared itself a neutral country from the beginning of the conflict, investors viewed the geography with suspicion, indiscriminately selling all their investments. As a result, the stock fell more than 60% from highs. Since then, with a more stable political situation and evidence that Kazakhstan will not be involved in the conflict, the stock has gradually recovered, closing the year with losses of approximately 30%.

At the operational level, the company's reality could not have been more different. 2022 is going to be another record year for Kaspi, for at least three reasons. First, for the first time in the company's history, the marketplace and payments businesses already account for more than 50% of the company's profits, which means that from now on the results will not be so dependent on the credit cycle. Secondly, Kaspi expects to close the year with annual profit growth of over 30%, which shows the strong growth that each of the businesses are still having, despite the fact that during the first half of the year the loans Kaspi granted on the fintech side were well below the original expectations, as the management team preferred to be conservative. And finally, the company has introduced new initiatives over the past two years that are performing very well, showing the strength of the huge network economies that the business possesses. In the marketplace business, Kaspi has introduced new verticals in travel (in late 2020) and grocery (in 2022), while on the payments side it has introduced B2B payments. While many of these initiatives receive lower take rates than Kaspi's other businesses (e.g., take rates in travel and grocery are 3-4%, compared to 8-9% for the rest of the marketplace), they also increase the size of the potential market, so my original expectations for a decade's profit growth have remained largely intact.

Although the initiative to expand the business model to Ukraine has obviously been affected and I do not know when it will finally be launched (the investment Kaspi had made in Ukraine to date was testimonial), as I explained in last year's letter the investment thesis does not rest on any successful international expansion.

At year-end, Kaspi's market capitalization was $13bn, and assuming 30% earnings growth (and USDKZT exchange rates of 460), Kaspi will close with earnings of $1.2bn, for an implied P/E of 10.8x. Given the strong expected growth and the discount at which the stock is trading (I estimate a P/BV of 10x at year-end, with ROEs of 90%), I expect annualized returns of 16% for the next few years, and higher if the international expansion comes to fruition.

Homebuilders (Green Brick Partners, LGI Homes, Persimmon Homes)

We have a 13% exposure to homebuilders, spread across three names, two of which are U.S. (Green Brick Partners and LGI Homes) and one of which is British (Persimmon Homes). Although the geographies are different, the investment thesis in each of these companies is the same.

At the aggregate level, the US and UK real estate markets have not built enough units over the past decade, and since the pandemic, inventory levels have been at historically low levels.

At an individual level, each of these companies has a large asset base built up during the pandemic (e.g., Green Brick has land for 8+ years at current construction rates), attractive returns on their asset base (average RNOAs over the past five years for Green Brick, LGI and Persimmon were 13%, 19.5% and 30%, respectively) and management teams that fully understand the importance of capital allocation, which I believe is the biggest risk when investing in these types of businesses. For example, Green Brick has repurchased 10% of its shares in the first three quarters of the year, believing that such use was the most efficient use of its capital. Finally, all three companies have healthy balance sheets that will enable them to withstand a more uncertain environment over the next few quarters and all are trading at very attractive valuations.

While I am aware of the unfavourable dynamics of the residential market over the next few quarters, given higher interest rates and unaffordable housing prices, I believe this is the right time to buy these names, where uncertainty and pessimism are extreme and the prices of these stocks have already discounted a large part of these concerns. As economic uncertainty dissipates and delivery volumes pick up, the market will correctly reprice the earnings power of these companies over the cycle.

I should point out that the investment thesis does not rest on "getting the timing of the cycle right", as the companies have realistic business plans that I estimate will create a lot of value for their shareholders over the longer term, especially in the case of Green Brick, given its current smaller size – and which I anticipate may double over the next five years. I have target prices in the base case on all three companies that are at least a double from current prices, which would imply annual internal rates of return in the range of 13% (for Green Brick) to 18% (for LGI). If, on the other hand, share prices do not recover along the real estate cycle, their capital allocation will allow us to recover the investment either through dividends (in the case of Persimmon) or aggressive share repurchase programs (in the case of the US companies).

RV companies (Patrick Industries, Thor Industries)

We have an exposure of about 10% to two companies operating in the recreational vehicle (RV) industry, both of them in the US: Patrick Industries and Thor Industries. The investment thesis of the latter was explained in the previous letter, so here I will summarize our investment case for Patrick Industries.

Patrick is certainly a fascinating case study. The company manufactures and distributes components for the RV industry (its main vertical, representing more than 50% of sales), recreational watercraft, manufactured housing and traditional residential housing. After a near-bankruptcy experience during the 2008 crisis, in which the company almost went bankrupt given the weakness of its only business at the time (manufactured housing), Patrick has expanded into the other three businesses through an aggressive and extremely well-executed acquisition policy. That policy was so astounding that Patrick's share price had the best performance in all of North America in the period from the Global Financial Crisis to 2017, multiplying its price 50-fold.

Aside from consolidating the industry and having been awarded for it, the business Patrick operates is of a high quality for several reasons. First, it is an industry with an oligopolistic structure, in which customers (in this case, RV OEMs such as Thor Industries and Forest

River) are also highly concentrated, with great discipline throughout the value chain. Second, Patrick manufactures a multitude of components (in a manufacturing process that is still largely manual), many of them low value per part, making it difficult for potential competitors to replicate Patrick's product range (in Helmer's scheme, such an advantage would correspond to "switching costs"). And third, many of these industries (especially the RV industry, where most of the units manufactured are sourced exclusively from Elkhart, Indiana) operate with close, long-term customer-supplier relationships that have been forged over the years.

This is why Patrick's returns on net operating assets have been phenomenal the last few years (average 15% since 2014), despite the heavy accounting "dilution" that always comes with an aggressive acquisition policy, even if from an "economic" perspective it has made a lot of sense. After being labelled as a Covid beneficiary in recent years, Patrick's shares have fallen more than 50% from their peak reached in the spring since 2021 – in fact, the shares are trading at levels of five years ago, despite the fact that the company's turnover has more than doubled, its NOI has increased threefold and, in short, the company has made a multitude of acquisitions with RNOAs well above its cost of capital. Given that the company has grown residual earnings at average annual rates of 41% over the past six years, one doesn't need to be very optimistic to expect strong share price appreciation from the levels at which it now trades – resulting in implied returns over the next decade in the 15-20% range.

Light vehicle distribution (Lithia Motors, CarMax)

Finally, during the year, we added 7% of the Fund to yet another consumer discretionary theme: automobile distribution. Our investments in this industry were made through Lithia Motors and CarMax.

Lithia Motors is one of the largest dealerships in the United States, with 278 locations at the end of last year. Traditionally, dealerships have been a very attractive business in the United States, helped by legal barriers to entry that regulate distribution at the state level, reducing regional competition. In addition, the sector has a high level of fragmentation, which means that companies such as Lithia may have interesting consolidation opportunities in the future. Finally, although dealer margins in the sale of new and used vehicles are low, the repair business and the sale of financial products (where Lithia charges a fee on the sale of the product) are stable businesses with high margins and little capital needed to operate them, which makes the aggregate profitability of operating a dealership high.

At the individual level, Lithia has a strong management team that is executing on its business plan to (profitably) reach 500 locations by 2025 and $50bn in sales. Such growth is predicated on a mix of inorganic and organic growth, the latter primarily through initiatives such as Driveway and DFC. Lithia's CEO is known in the industry for his in-depth knowledge of the KPIs of major U.S. dealerships, which has helped to make the acquisition policy successful so far.

Like residential construction companies and those in the RV industry, dealerships have been seen as one of the big beneficiaries of the pandemic, and the shares of all these companies have been heavily penalized over the past few months. Fears of the transition to electric vehicles (with fewer parts, and therefore fewer replacement and repair needs) is the other threat to the business model that has already been heavily discounted by the market. After the fall, Lithia trades at 1x NOA, a valuation absolutely disconnected from the reality of the business. Since 2011, Lithia has grown its NOAs at annual rates of 25%, with average returns on equity of 23%. I estimate returns of 20% per annum, one of the highest in our portfolio, over the next few years, and higher still if the business plan ends up unfolding as planned.

On the other hand, CarMax is the leading US company in the used car market, having sold 942k cars during the last fiscal year. In addition to having had a disruptive business model at the time, based on transparent pricing, a simple purchasing process and a broad product offering, CarMax's business currently has high economies of scale. This advantage derives both from its ability to replenish its supply of cars at better prices than its competitors and the possibility of obtaining huge amounts of information on vehicle prices, which allows it to have a superior pricing policy superior (historical gross margins have been very stable, at around $2,100 per unit). Moreover, the company has an enviable corporate culture and strong internal processes, having not closed a single store since the company's founding in the 1990s. Finally, CarMax has a profitable lending business, where its long history here also acts as a barrier to entry with respect to its competitors.

Although as with the previous companies the near term for CarMax is going to be uncertain, there are other factors that have reduced the risk of the thesis lately. In particular, the more than likely bankruptcy in the coming months of its main online competitor, Carvana, will again focus the attention of the investment community on the importance of growing volumes profitably, something in which CarMax will continue to be the undisputed industry leader.

At recent prices, CarMax trades at multiples of 1.5x its NOAs, higher than all other dealerships – although its historical performance has also been better. Since 2011, CarMax has grown revenues, residual earnings, and net operating assets at rates of 12%, 11.5% and 13%, respectively, and the company has pointed to additional growth opportunities in the used car market (CarMax currently has less than 5% market share), which may be higher if Carvana's volume losses are higher than the market is now expecting. Assuming modest forward growth of 2%, I estimate returns for the stock in the 13-17% range, lower than what can be obtained at Lithia or any of its competitors, but with lower business risk, as CarMax's business will not be affected by the speed of transition to electric vehicles.

Appendix II. Application of the 7 Powers to the case of CarMax

The following is a brief analysis of Helmer's framework as applied to CarMax.

I think this is a particularly instructive example for several reasons. First, CarMax is a company widely regarded for its long and successful track record of profitability. Second, it is not obvious why a company should earn high returns on its capital in an industry as obscure as used cars. And third, its competitors have not to date been able to replicate CarMax's returns, suggesting that CarMax may enjoy unrecognized sources of competitive advantage.

The 7 Powers framework yields the following results:

- Economies of scale: *"business in which unit costs go down as production volume goes up."* CarMax derives large economies of scale from its ability to buy and sell cars (both at retail and at auction) at attractive prices, its pricing algorithm (it is able to price its products more appropriately) and, in the case of its finance division, access to historical database.
- Network economies: *"business in which the value received by a consumer increases as the installed base increases."* CarMax does not enjoy network economies.
- Counter-positioning: *"a newcomer adopts a new superior business model which cannot be replicated by the incumbent given the potential damage to its existing business."* Initially, CarMax had an innovative and differential business model, based on price transparency, ease in the purchase process and great product variety versus traditional dealerships. However, online competitors (such as Carvana) and some traditional dealerships have gradually introduced some of these features, diluting CarMax's counter-positioning.
- Switching costs: *"the expected loss a consumer would suffer in switching from one supplier to another for future purchases."* There are no switching costs. Customers can buy their car from another store, as there is price transparency in the industry (especially in the 0–10-year-old range) and consumers shop largely based on price.
- Brand: *"lasting attribution of a higher value to an objectively identical product, which is derived from the seller's historical information."* CarMax is the most recognizable brand in the used car market, built on the ease of the purchase process, the inspection process applied to each vehicle, the 90-day warranty and the ability to return the vehicle after one month.
- Cornered resource: *"preferential access with attractive terms to a desired asset that can independently enhance value."* Unlike traditional dealerships, whose business is protected by state distribution laws, CarMax has no cornered resource.
- Processes: *"set of activities and organizational structure of the company, which enables lower costs or a superior product, and which can only be replicated by a lasting commitment"*. CarMax has better processes than the competition, a result of its long and successful history. New stores are profitable from the first year of opening, a store has never been closed, and the finance business is seamlessly integrated with the vehicle purchasing process.

The results of the analysis can be summarized schematically in the following table:

BENEFIT (TO POWERHOLDER)		BARRIER (TO CHALLENGER) → Unwilling to challenge: Collateral damage	Unwilling to challenge: Share gain cost/benefit	Unable to challenge: Hysteresis	Unable to challenge: Fiat
ΔCost	Input		**SCALE ECONOMIES:** Benefits from its size due to its ability to source and sell cars (both retail and wholesale), its pricing algorithm (more data points) and CAF historical database. On the other hand, a low share of fixed costs prevents from larger scale economies.		**CORNERED RESOURCE:** the business does not own material patents, preferential access to inputs or cost-saving manufacturing techniques.
ΔCost	Scale of production/distribution				
ΔCost	Production/distribution approach	**COUNTER-POSITIONING:** KMX used to have a differentiated business model, with price transparency (no-haggle) and lots of choice versus traditional auto dealers. Since then, dealers have introduced these policies and there are also new players (Carvana).		**PROCESS POWER:** Proven business model in which stores are profitable from year 1 (it has never closed a store). CAF is seamlessly integrated. Additionally, management team tenure has been long, and its track record is strong.	
ΔValue (ΔP)	Superior deliverables		**SWITCHING COSTS:** customers can switch easily to KMX's competitors, as price transparency is the norm in the sector (especially in cars 0-10 years old) and customers mostly buy based on price.		
ΔValue (ΔP)	Affective valence			**BRANDING:** it is the most recognisable brand when customers have to buy a second-hand car (easy process, inspection process, 90-day warranty, and a 30-day money back guarantee), but that does not translate into superior pricing power.	
ΔValue (ΔP)	Uncertainty				
ΔValue (ΔP)	Benefits from other users		**NETWORK ECONOMIES:** KMX customers do not benefit from having one additional user in the network.		

It clearly enjoys one of the seven powers.
It weakly enjoys one of the seven powers.
It does not enjoy one of the seven powers.

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