

### **Below-Prime Auto Finance Industry** ***Slipping but Not Falling***

Our market commentary in February 2013 pointed out that the below-prime automobile finance sector attracted strong investor interest in the 2011 – 2012 post-recession credit recovery. We also expressed our opinion that the key risk in the sector was over-funding, which could cause credit underwriting and risk pricing standards to deteriorate. We recently attended the National Automobile Finance Association (NAFA) conference in late May and have had continued conversations with industry insiders over the past several weeks. We conclude that the flow of new money into the below-prime auto finance industry is having the expected effect – more robust competition is causing pricing to deteriorate and underwriting standards to slip. It is also important to take note that a few sophisticated operators and investors in the sector are “taking chips off the table”. Capital continues to flow freely to the below-prime auto finance sector, particularly via the asset-backed securities market. Finally, the Consumer Financial Protection Bureau has spread fear, uncertainty and doubt (FUD) throughout the subprime auto finance industry, which is leading to frantic efforts by lenders to bolster compliance departments and procedures.

- Intense competition is driving a slight deterioration in credit underwriting standards. According to Experian, average FICO scores for used car loans booked in 2013 was 596, down from 600 in 2011. Larger below-prime lenders have been more aggressive in loosening their pricing and credit underwriting standards. Delinquencies and losses have ticked up, but remain substantially below the levels experienced in 2008 and 2009.
- The activities of new, capital-rich below-prime finance firms have created a more difficult origination environment. According to a member survey completed for the NAFA, the below-prime book-to-look ratio (loans funded as a percentage of applications reviewed) dropped to 6.2% in 2013 from 7.3% in 2012.
- The January 2014 IPO of Santander Consumer USA marked a turning point in the below-prime auto finance sector. Warburg Pincus, Centerbridge Partners and KKR invested \$1.1 billion in Santander in October 2011; and 26 months later, they were reducing their stake via the Santander IPO. In December 2013, Palladium Equity Partners and Parallel Investment Partners liquidated their position in Regional Management Corporation (NYSE: RM), a multi-product consumer finance firm with a significant below-prime auto finance business. When private equity firms sell their stakes in below-prime auto finance companies, other investors in below-prime auto finance platforms are advised to pay attention.
- Even highly-experienced operators in the sector are reducing their exposure. Ernie Garcia, the long-time chairman of Drive Time (a major buy here/pay here auto sales/finance business) sold a substantial minority equity stake in Go Financial (Drive Time’s indirect subprime finance affiliate) to Manheim in April 2014.
- The Consumer Financial Protection Bureau has investigated several auto lenders in the past year or so, which led to three major financial settlements. The industry is rattled by this aggressive new sheriff and is reluctantly adjusting to an increasingly hostile regulatory environment. The New York Times directed its attention to the “subprime bubble for used cars” in a long article on July 19 that was critical of the industry – this type of press tends to stiffen the spines of regulators and can lead to more intense enforcement actions.
- In spite of all these worrisome signals, the below-prime auto finance industry is still quite profitable and growing. Volume and loans outstanding continue to grow, profits of many below-prime lenders are increasing, and the on-going sluggish economic recovery is improving the general

creditworthiness of consumers. Delinquencies in the broad auto finance market (including prime borrowers) hit an all-time low in May 2014. This doesn't look like a meltdown in the below-prime auto finance sector. The market is slipping a bit, but it is not falling down.

The influx of private equity into the below-prime auto finance sector stopped in the second half of 2013. No new companies have been launched by private equity firms, and there have been few sales of existing below-prime auto finance firms since early 2013. We expected this pause in the capital influx. The players on the field are fighting to gain ground, and the debt markets are aggressively funding below-prime auto finance portfolios. The heated competition is making it more difficult to achieve organic loan portfolio growth and is laying the groundwork for consolidation.

We continue to believe that the below-prime auto finance sector is primed for consolidation through mergers and acquisitions over the next two to four years. Some sales will occur as entrepreneurial owners age out of active management. Other sales will occur as smaller operators realize that the new regulatory burdens created by the CFPB are too heavy to carry without scale and disciplined compliance efforts. Other transactions will occur as larger public and private equity-backed firms buy smaller firms to expand and address specific geographies. Finally, some commercial banks will decide to invest in below-prime lending platforms to augment their activities in the prime auto lending market. Privately held firms are actively considering whether it is time to invest more capital to grow, acquire or sell.

**Credit Metrics Slipping, Terms are More Generous, Competition is More Intense**

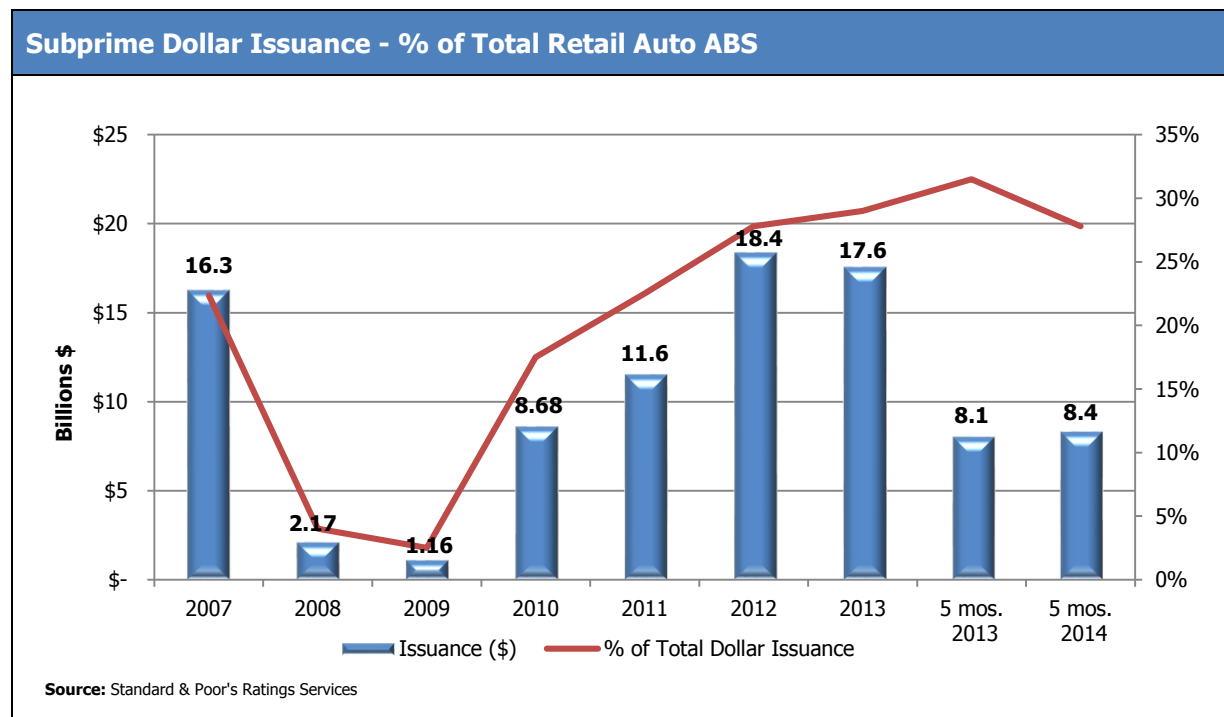
The National Automobile Finance Association and Benchmark Consulting conducted a survey of below-prime auto lenders to evaluate the state of the market (the lenders were all members of the NAFA). The survey was conducted in early 2014 and collected data for 2012 and 2013. The good news is that the survey confirmed that the below-prime auto lending market is still expanding, with participants experiencing solid increases in number of accounts and loans outstanding. The bad news is that the data reveals that credit scores for new borrowers are decreasing slightly, and terms are becoming more generous (higher LTV's, longer loan terms, etc.). The following table summarizes the results of the survey.

<b>Indicative Market Trends - NAF Survey Group</b>			
<b>Indicative Market Trends - NAF Survey Group - Combined NEW / USED</b>	<b>2012</b>	<b>2013</b>	<b>Change 2012 - 2013</b>
Avg. Total Number of Accounts at YE	55,559	58,326	5.0%
Avg. Outstanding Principal Balances at YE	\$ 574,563,611	\$ 630,479,629	9.7%
Avg. Origination Credit Score - New Vehicles*	554.4	554.0	-0.1%
Avg. Origination Credit Score - Used Vehicles*	537.6	536.6	-0.2%
Avg. Amount Financed	\$14,285	\$14,638	2.5%
Avg. Term - Payoff Accounts (months)	30.5	28.9	-5.2%
Avg. Payment-to-Income*	12.5%	12.6%	0.8%
Delinquency Rate 30+ Days	5.4%	6.4%	20.1%
Avg. Annual Net Charge-off Rate (dollars)	5.9%	6.9%	17.4%
Avg. Annualized Repossession Rate (units)	8.9%	9.5%	6.4%
Book to Look	7.3%	6.2%	-15.1%
* Individual Dollar weighted scored, unweighted average of all participants			
Source: NAF Association Survey, BenchMark Consulting analysis			

Competition is becoming more intense. The NAFA/Benchmark survey revealed that the book-to-look ratio dropped to 6.2% in 2013 down from 7.3% in 2012. One of the fast-growing, private equity-backed companies in the sector complained about the aggressiveness of larger industry participants – “We approve a contract at \$8,000 with a 12% dealer discount and a 29% APR for 36 months and Santander approves the contract for \$15,000 with a 15% discount and a 19% APR for 66 months.”

**Access to the Asset-Backed Securities Market has Improved**

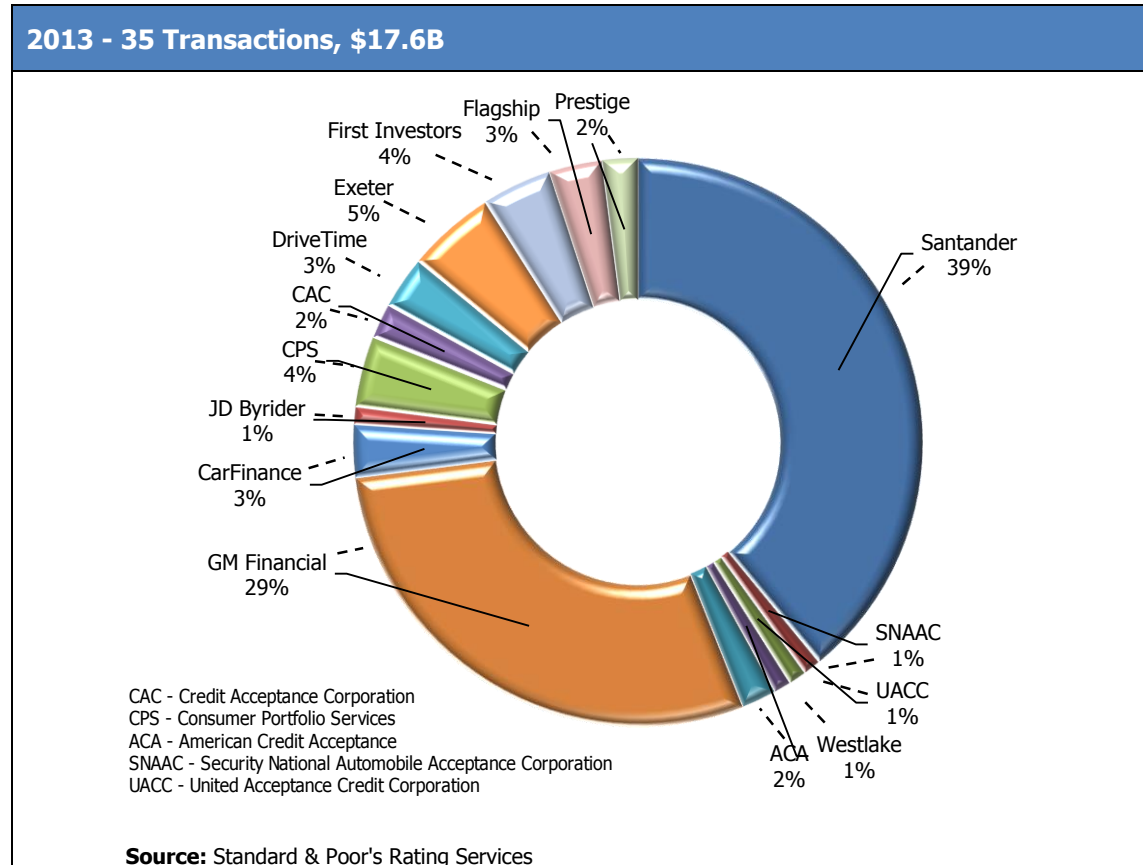
The issuance of securities backed by below-prime auto loans hit a low point of \$1.2 billion in 2009. By 2012, total dollar value of below prime auto loan ABS exceeded \$18 billion, and that level of activity held up in 2013.



Market Commentary – July 2014

The largest below-prime finance operators make up the bulk of the ABS issuance (top three issuers accounted for over 70% of securities issued in 2013 and 100% in 2010), but several new issuers entered the market since 2011.

The following chart presents transaction activity in this asset class in 2013.



While Santander and GM Financial (AmeriCredit) accounted for 68% the dollar volume of below-prime auto loan ABS transactions in 2013, there are several new names that have entered the securitization market for the first time. The flood of liquidity has greatly increased the availability and attractiveness of structured finance deals for smaller below-prime auto finance firms. The markets are eagerly buying ABS deals as small as \$200 million.

The pricing of below-prime auto loan ABS transactions has been stunningly attractive thus far in 2014. The following chart provides summary details of some of the below-prime auto loan ABS transactions that have been priced in the first half of 2014.

<b>Selected Below-Prime Auto Loan ABS Transactions</b>			
<b>Pricing Date</b>	<b>Issuer</b>	<b>Total Rated Debt (\$'s in Mil.)</b>	<b>Weighted Avg. Cost of Debt</b>
5/20/2014	Exeter Automobile Receivables Trust 2014-2	\$500.0	2.64%
5/20/2014	Westlake Automobile Receivables Trust 2014-1	\$320.7	1.79%
4/15/2014	American Credit Acceptance Receivables Trust 2014-2	\$259.2	2.61%
4/8/2014	Flagship Credit Auto Trust 2014-1	\$266.1	2.45%
4/4/2014	First Investors Auto Owner Trust 2014-1	\$220.0	1.80%
4/1/2014	SNAAC Auto Receivables Trust 2014-1	\$210.0	1.93%
3/18/2014	Prestige Auto Receivables Trust 2014-1	\$390.0	1.75%
3/17/2014	CarFinance Capital Auto Trust 2014-1	\$235.2	2.63%
3/11/2014	AmeriCredit Automobile Receivables Trust 2014-1 (GM Financial)	\$750.0	1.65%
3/10/2014	CPS Auto Receivables Trust 2014-A	\$180.0	2.51%
1/8/2014	Santander Drive Automobile Receivables Trust 2014-1	\$1,589.7	2.23%
<b>TOTAL YTD ISSUANCE</b>		<b>\$4,920.9</b>	<b>2.15%</b>

The credit enhancement required to complete these transactions varies significantly, ranging from a high of 45.8% (the AAA tranche) to 1% (the B+ tranche). The amount of credit enhancement is determined by the expected cumulative net loss of the collateral pool at closing. These transactions tend to receive credit rating upgrades over time because they “deleverage” quickly due to the velocity of the underlying auto loans. Prepayments also increase the credit enhancement as a percent of outstanding securities. Asset-backed securities backed by below-prime auto loans generally perform quite well – this asset class weathered the financial crisis and recession with ease due to the strength of the credit enhancement and the velocity of the auto loans.

### **Sophisticated Investors/Operators are Reducing their Below-Prime Auto Finance Exposure**

There have been some notable developments in the below-prime auto lending sector since early 2012.

1. *Santander IPO:* Santander Consumer USA Holdings Inc. (NYSE: SC) completed its initial public offering in late January 2014. All of the \$1.7 billion in proceeds went to SC’s shareholders, with the bulk received by Centerbridge, Warburg Pincus and KKR. Banco Santander S.A. continues to hold a majority stake (about 65%) in SC; the SC pre-IPO shareholder group (including the private equity investors) still owns 78% of the stock. The stock was priced at \$24/share, traded up quickly to \$26/share and has now settled down to under \$20/share. SC originated \$20 billion of loans in 2013. The company had total assets of \$29 billion at March 31, 2014. SC is the behemoth of the below-prime auto finance sector, and its very sophisticated private equity investors hit the exits in January (cutting their holdings from 25% of the stock to 4.25% post IPO). We see this as a bearish signal; the peak of the current below-prime consumer credit cycle may have passed and we are on a gradual downward slope. The private equity folks are getting out by selling in the public market.

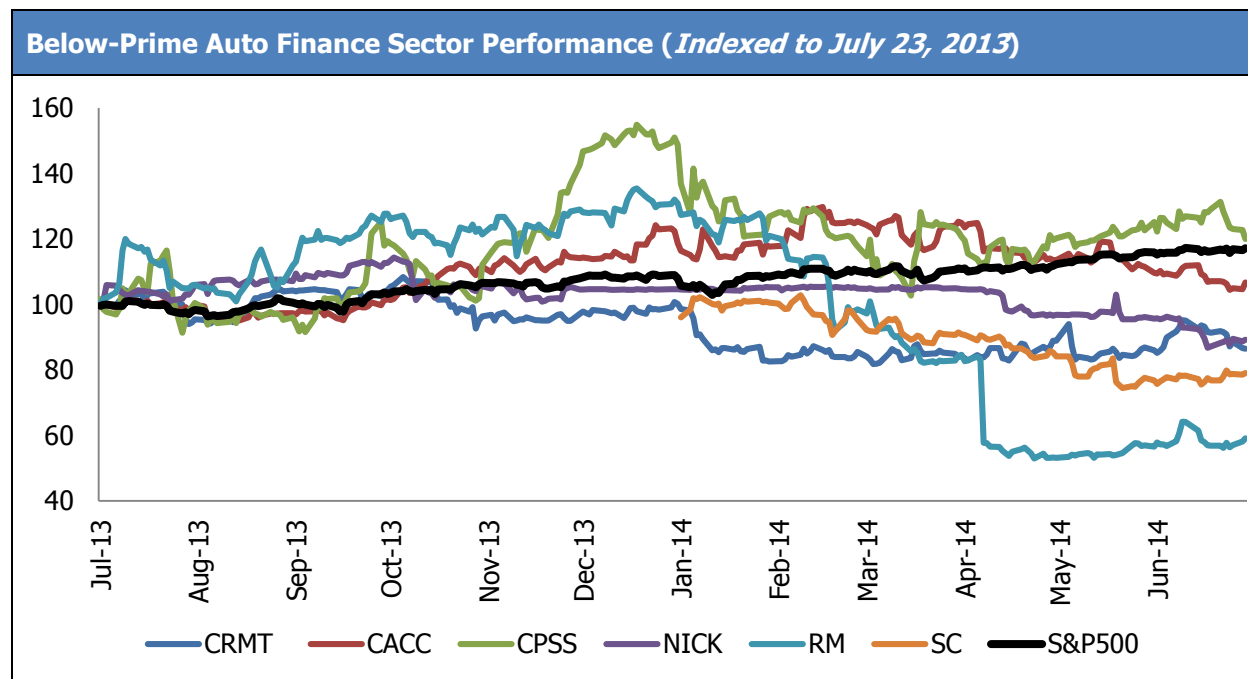
2. *Regional Management Corp. Secondary Offering:* This is a smaller version of the Santander story. Regional Management Corp. (NYSE: RM) is a multi-product consumer finance firm with a substantial below-prime auto finance business. Palladium Equity Partners and Parallel Investment Partners purchased a 76.5% interest in RM in 2007; they sold the bulk of their shares when the company went public at \$19/share in 2012 (raising \$92 million). In December 2013, the private equity firms sold their final 14.33% interest in RM via a secondary offering that priced at \$31/share (raising over \$60 million). RM's stock moved up to almost \$36/share in early 2014, but fell to under \$15/share in late April due to a decline in first quarter earnings caused by a spike in credit losses. Once again, the private equity investors were able to exit early.
  
3. *Manheim buys minority equity stake in Go Financial (Ernie Garcia):* In April 2014, Go Financial sold a minority equity stake to Manheim, the automobile auction subsidiary of Cox Enterprises. Go Financial is an indirect auto finance affiliate of DriveTime Automotive Group, Inc., the integrated auto retail and below-prime finance firm with assets in excess of \$2.3 billion. Both DriveTime and Go Financial are controlled by Ernie Garcia. Garcia has been in the below-prime auto finance sector for over 20 years. While Manheim and Garcia have not disclosed specifics regarding the terms of the minority equity investment, it does appear that Garcia is reducing his total exposure to the below-prime auto finance sector.
  
4. *Prospect Capital's planned acquisition of Nicholas Financial collapses:* In December 2013, Prospect Capital Corporation (NASDAQ: PSEC), a business development company, announced its agreement to buy Nicholas Financial, Inc. (NASDAQ: NICK) for \$16/share or \$199 million. The deal was to close in April 2014. In the quarter that ended March 31, 2014, NICK reported a 40% YOY decline in earnings due to reduced loan pricing and higher credit losses. On May 7, PSEC announced that the SEC was investigating the company for treating equity investments in seven portfolio companies as debt for accounting purposes. This situation, combined with NICK's swooning earnings, caused the deal to crash officially on July 1, 2014. There have been no white knights in the wings; NICK is now a jilted company trying to recover from a failed acquisition. NICK's stock price is languishing in the \$13 – \$14/share range, significantly below PSEC's offer price.

**Trading Ranges for Public Below-Prime Auto Finance Companies Have Declined**

The pure play below-prime auto finance firms have mostly experienced declining share prices over the past year in spite of a general increase in equity market indices over this period. All of these auto finance firms are trading well below their 52-week highs. The following table presents trading data as of July 17.

Below Sub-Prime Auto Finance Firms											
Company Name	Price	52 week high	% of 52-week high	Shares Outstanding	Market Capitalization (\$ Millions)	Tangible Book Value (TBV)	Price/TBV	Pretax ROAA	After Tax ROAE	P/LTM EPS	
<b>America's Car-Mart Inc. (NasdaqGS:CRMT)</b>	\$ 39.46	\$ 47.93	82%	8.7	\$ 343	\$ 213	1.6x	9%	10.1%	17.5	
<b>Credit Acceptance Corp. (NasdaqGS:CAAC)</b>	\$120.99	\$150.89	80%	21.6	\$ 2,612	\$ 715	3.7x	16%	36.2%	11.9	
<b>Consumer Portfolio Services, Inc. (NasdaqGM:CPSS)</b>	\$ 8.13	\$ 9.64	84%	24.8	\$ 202	\$ 117	1.7x	3%	28.1%	10.5	
<b>Nicholas Financial Inc. (NasdaqGS:NICK)</b>	\$ 13.28	\$ 17.20	77%	12.3	\$ 163	\$ 63	2.6x	10%	12.0%	9.8	
<b>Regional Management Corp. (NYSE:RM)</b>	\$ 15.09	\$ 36.23	42%	12.7	\$ 192	\$ 174	1.1x	10%	18.1%	7.0	
<b>Santander Consumer USA Holdings Inc. (NYSE:SC)</b>	\$ 19.36	\$ 26.50	73%	348.8	\$ 6,753	\$ 2,780	2.4x	3%	17.8%	14.1	

The following graph provides data on the trading history of this group of finance firms:



**The New Master of FUD (Fear, Uncertainty and Doubt) – The CFPB**

There is definitely a new sheriff in town for auto lenders – the Consumer Financial Protection Bureau. The CFPB has spooked the industry with a few high-profile enforcement actions. There are a number of investigations underway that will likely result in more large settlements from auto lenders. The CFPB has identified auto-lending discrimination as a top enforcement priority, and they are attacking lenders over actions taken by dealers and other third parties. The CFPB is also hunting for auto lenders that are engaging in deceptive practices (directly or via third-party vendors). Here is a quick synopsis of the environment that the CFPB has created.

*Ally Financial/Ally Bank Settlement:* The Department of Justice and the CFPB joined forces to hammer Ally Financial and Ally Bank for alleged discriminatory lending practices. Ally reached a settlement in December 2013, including \$80 million in compensation to the victims of the alleged discrimination and \$18 million in penalties. This is the largest auto loan discrimination settlement in U.S. history. The discrimination was tied to the practice of dealer mark-ups on auto loans. When an indirect lender quotes a rate on an approved borrower, the dealer is allowed to quote a higher rate (within certain limits) and pocket most of that mark-up which is paid to the dealer by the lender as payments are collected. The DOJ and CFPB alleged that minority group members were being disproportionately hit with the mark-ups. The CFPB is pushing lenders to aggressively monitor the interactions between dealers and car buyers/borrowers to make sure that the dealers are not engaging in discriminatory practices. The CFPB is also acting in a ferociously aggressive fashion, grabbing a large settlement from Ally for conduct that cannot be conclusively proven to be discriminatory. Ally does not collect information on the race or ethnicity of prospective borrowers and claims to set pricing based on consumer creditworthiness and contract characteristics. Ally has denied the allegations set forth by the CFPB (but they settled anyway).

*U.S. Bank/Dealer Financial Services Settlement:* In June 2013, the CFPB ordered U.S. Bank and its third-party auto finance program vendor (Dealer Financial Services *aka* DFS) to repay \$6.5 million to over 50,000 borrowers related to a lending program directed towards military service members. The CFPB alleged that the two lending partners failed to disclose costs and fees. The regulator also claimed that U.S. Bank and DFS misled military borrowers about the costs and benefits of certain add-on products (such as extended vehicle service contracts).

Auto Finance News reported in late May that the CFPB has initiated fair-lending enforcement investigations against six additional lenders (three banks and three non-banks). Fifth Third Bank, American Honda Finance and Toyota Motor Credit have announced that they have received information requests from the CFPB and/or the U.S. Department of Justice.

In our conversations with various participants in the below-prime automobile finance sector, we identified one group that is delighted with the activities with the CFPB – lawyers that specialize in compliance with consumer finance regulations. One partner at a major consumer finance law firm told us “I can’t hire lawyers fast enough. Life is extremely good, and I am highly confident that the CFPB will never be eliminated.” The legal community is struggling to respond to the groundswell of demand on the part of all consumer lenders (including auto lenders) as the CFPB sweeps in to attack major industry participants for bad behavior (both real and imagined). The program at the National Auto Finance Association conference in May was crowded with presentations on various aspects of the new regulatory environment. Lenders are **Fearful** of regulatory attack, they are **Uncertain** due to the improvisational nature of CFPB actions, and they are **Doubtful** they can do much to be safe from enforcement actions. For the CFPB, this is a “Mission Accomplished” moment.

The revolving door that connects regulators with the private legal compliance sector is spinning rapidly. If you are a bright attorney with two to three years of experience at the CFPB, many private consumer finance law firms will be quite eager to welcome you to their team. To cite one example, Richard Hackett, former Assistant Director of the CFPB, crossed over in 2013 to become a partner at Hudson Cook, one of the top consumer finance regulatory specialist firms in the nation.

We do expect the semi-panic over the CFPB to subside. The regulatory actions will settle into a pattern, and firms will have clear guidelines to follow, eventually. The CFPB will increase the power of industry incumbents because new entrants will shy away from entering a field that has a regulator with such a nasty reputation.

### **In Spite of Worrisome Signals, Below-Prime Auto Lending Steams Ahead**

Loan pricing and credit quality are slipping slightly, private equity investors are exiting, public market values are declining, the CFPB is on the prowl and the New York Times is writing subprime auto finance disaster stories. These are not positive factors for the below-prime auto finance sector. But the recovery in the U.S. economy is grinding along, labor market conditions are improving, and consumer confidence is increasing; these macro factors are quite positive for below-prime automobile lenders.

Here are some of the more encouraging signals and observations:

- According to Equifax, subprime vehicle loans originated in March 2014 surged higher than any single month in seven years. Volume in March hit \$13.1 billion, an 8.8% increase year-over-year.
- Fitch reported that annualized net losses in the below-prime auto finance sector posted an unexpected decline in May, down 11% from 3.91% in April to 3.48%. One of the factors behind



this improvement is on-going strength in wholesale vehicle values, which has reduced deficiency balances after liquidation of collateral.

- The rapid influx of private equity capital appears to have abated. The last significant transaction in a below-price auto finance firm was the \$50 million growth equity investment by Flexpoint Ford to launch Pelican Auto Finance. That transaction closed in February 2013. Since the private equity industry has not launched any new companies in sixteen months, it is likely that the competitive landscape in the below-prime auto finance sector is set for a while. This could lead to more stability in loan pricing.
- Of the 200 million Americans with a credit history, 34% have FICO scores between 300 and 649 (the below-prime range). Below-prime auto finance remains a large and fragmented market. A well-run below-prime auto finance firm can generate attractive profits throughout the credit cycle.

While conditions are not as favorable in mid-2014 as they were in mid-2011, the general condition of the below-prime auto finance industry is still solid.

### **Waiting for the Wave**

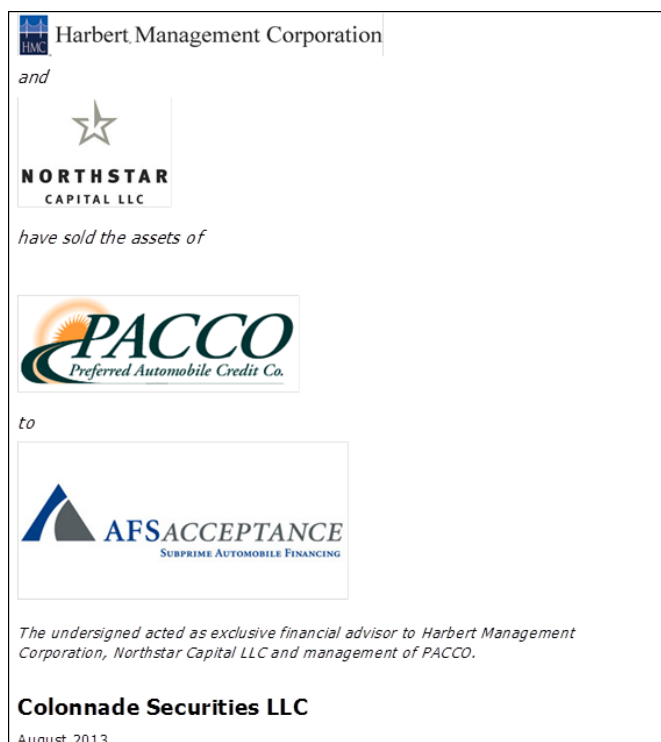
When the competitive landscape is stable and organic growth is challenging, the “urge to merge” emerges. We believe that conditions are in place for consolidation in the below-prime auto finance industry. The wave has not arrived, however, and it is hard to predict when it will hit. We are pretty sure that it is coming.

- The first wave of private equity investments in the sector during this cycle occurred in 2010 and 2011. Since most private equity firms have a hold period of three to six years, these finance firms will be on the market soon. One below-prime auto finance business owned by a private equity firm (Preferred Automobile Credit Company) was sold to another industry participant in late 2013.
- Santander Consumer is a large, publicly-traded enterprise that needs to generate significant volume to replace portfolio runoff. To grow substantially, acquisitions are likely necessary. Santander was an aggressive buyer of below-prime auto finance operations (Triad, HSBC, CitiFinancial) in the 2009 – 2010 timeframe.
- Banks are beginning to dabble in indirect below-prime auto finance to augment the meager returns of their indirect prime auto finance businesses. It is possible that banks will return as buyers of independent below-prime auto finance platforms.
- There are still several entrepreneurs that own below-prime auto finance businesses. As the regulatory pressure (and expense) increases, some of these owners may decide that they cannot survive without scale to bear these burdens, or that they have just had enough. In addition, retirement will drive the sale of some operations.

Privately held firms are actively considering whether it is time to invest more capital to grow, acquire or sell. It may not hit for a year or more, but the consolidation wave is coming.

## Representative Transaction

***Colonnade represented Harbert Management on the sale of Preferred Automobile Credit Co. to AFS Acceptance***



In August 2013, AFS Acceptance acquired the assets of Preferred Automobile Credit Co. (PACCO), a specialty finance company that acquires and services auto finance contracts primarily in the below-prime credit tier, from Harbert Private Equity Fund II, Northstar Mezzanine Partners IV and management. Terms of the transaction were not disclosed.

### **About AFS Acceptance**

AFS Acceptance of Plantation, FL is a full-service auto finance company that has served the subprime customer financing needs of franchise and independent car dealers since 1996. [www.afsacceptance.com](http://www.afsacceptance.com)

### **About Harbert Management**

Harbert Management Corporation of Birmingham, AL is an asset management firm whose private equity team is currently investing Harbert Private Equity Fund III. [www.harbert.net](http://www.harbert.net)



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