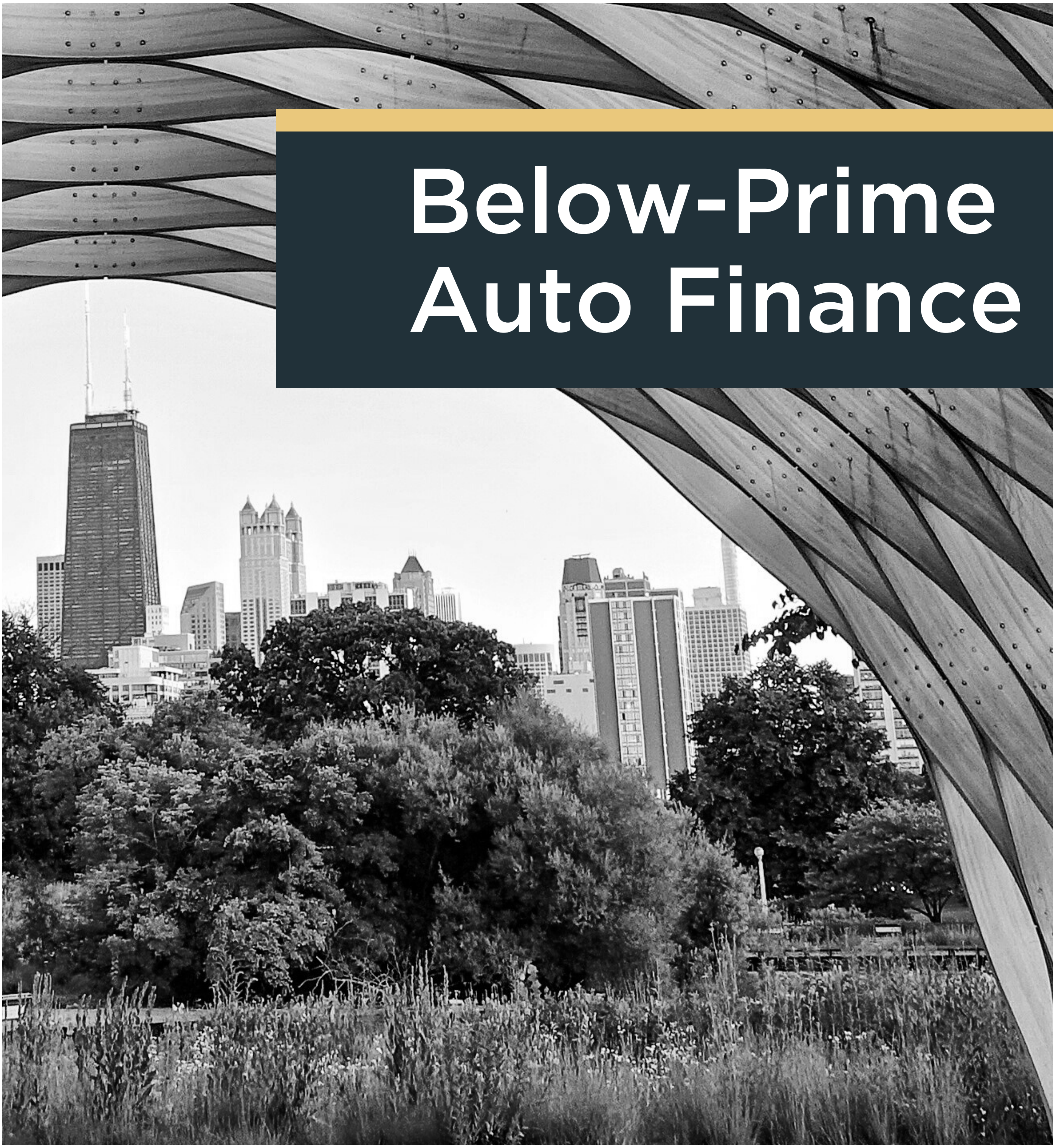
Below-Prime Auto Finance



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Below-Prime Auto Finance Industry
A balanced view

First things first: The below-prime automobile finance sector is not a source of systemic risk to the U.S. banking system or the global economy. This segment of the consumer lending market simply isn't big enough to create the next 2008-style financial crisis. According to the Federal Reserve Bank of New York's February 2016 Report on Household Debt and Credit, auto loans accounted for just 9% of total household debt outstanding. Auto loans to borrowers with below-prime credit scores account for roughly one-third of the market, so below-prime auto loans only comprise 3% of household debt nationwide. In contrast, home mortgages constitute 68% of total household debt. Commentators that equate the current situation to the mortgage crisis are not thinking clearly.

Nonetheless, the below-prime auto finance sector remains a favorite villain in media reports. Even comedians are piling on – British comic John Oliver of "This Week Tonight" recently roasted the industry. Mr. Oliver's piece was not balanced, but it did generate some laughs.

In our market commentary of February 2013, we reviewed the significant increase of risk capital flowing into the below-prime auto finance sector in the 2010 to 2012 post-recession credit recovery. In July of 2014, we noted that industry participants were facing heightened competition and that some sophisticated investors (*e.g.*, major private equity firms, such as Warburg Pincus and KKR) were exiting their investments in below-prime auto finance firms, perhaps signaling a valuation peak. Over the past two years, competition has not abated, and consumer auto debt has ballooned. The total auto finance market (prime and non-prime) is booming due to the symbiotic relationship between the expansion of credit and the sale of cars. According to data compiled by the St. Louis Federal Reserve Bank, total auto loans hit $1.1 trillion in the second quarter of 2016 – a new high, and substantially above the $800 billion peak that occurred prior to the 2008 financial crisis. Adding to the list of worries in the below-prime segment of the auto lending market is an increase in credit quality costs. In addition, capital is beginning to become less available to below-prime auto finance firms, as senior lenders become more restrictive. Finally, we have seen a few below-prime auto finance companies curtail operations or exit altogether over the past year. All of this is unfolding in a regulatory environment that is increasingly challenging as the Consumer Financial Protection Bureau investigates, enforces, examines, and fines industry participants.

- The strength of automobile sales is driving auto-related debt outstanding to new highs. Growth in new car sales is slowing, however, which has heightened competition among lenders. Loan terms are lengthening, and pricing is tight. In the below-prime credit segment, there are a few signs of adjustment. Legacy players in below-prime auto finance are pulling back – Santander Consumer USA Holdings (NYSE: SC) reported a 6% decrease in originations in the first quarter of 2016; it scaled back due to an unfavorable shift in the risk/reward dynamics in below-prime auto finance. GM Financial, Ally Financial (NYSE: ALLY) and some major banks such as Wells Fargo also reported reducing their below-prime auto finance exposure in 2016. Smaller, younger below-prime auto lenders are still pouring money into the sector as private equity-backed companies strive to expand earnings and achieve scale.
- There have been a few below-prime auto finance companies that have ceased operations over the past several months. GO Financial, the indirect auto finance firm that is 49% owned by Cox Automotive and 51% owned by Drive Time Automotive, announced in May that it is winding down – no new loans. Another privately-held below-prime auto finance company, Dealer Funding, announced that it would cease new loan originations at the end of June. Other longtime industry participants such as MarkOne Financial have also shut their doors. Tricolor Auto Group, a 14-store buy here/pay here auto retailer/finance operation based in Texas, recently was acquired by an

industry competitor. These companies held small shares of the below-prime auto finance market, but the increasing number of exits demonstrates that pressures are building in the sector.

- Taken as a whole, the credit performance of the U.S. auto lending market remains strong. The severe delinquency rate (share of balances 60+ days past due) in June 2016 was 0.94%, a 3bps increase over the previous year. Auto write-offs are at 20.2bps, an increase of 1.2bps year-over-year. The performance in the below-prime segment is not as positive, however. Since some rapidly expanding, young below-prime lenders lack the sophisticated risk assessment tools utilized by legacy market participants, there has been some concern regarding the quality of recent-vintage loan pools. Standard & Poor's data on cumulative net losses on below-prime auto finance securitizations reveals a deterioration of performance – first quarter 2015 ABS issuances are generating static pool losses that are slightly higher than the 2008 pools through the first year after issuance. Losses on the 2008 pools were twice as high as the losses on the 2011 vintage of below-prime auto finance ABS transactions. Recessions always cause losses on below-prime auto finance portfolios to spike; fortunately, the U.S. economy is not heading into a downturn… yet.
- Capital flows into below-prime auto finance are changing. The availability of risk capital from private equity and public markets has declined significantly - there have been few new private equity investments into the sector since 2014. Below-prime auto finance ABS issuance has also declined by 9% year-over-year during the first five months of 2016, according to Deutsche Bank. Our recent conversations with senior lenders to the below-prime auto finance industry reveal that some institutions are not considering new borrowers – they are standing pat with their existing stable of borrowers and monitoring their performance very closely. Nonetheless, the existing supply of capital appears more than adequate to fund the sector's growth and might exceed the ability of the industry to continue to generate quality below-prime auto loans.
- The Consumer Financial Protection Bureau is now five years old. This aggressive regulator is run by a single director, who is protected from Congressional and Executive branch oversight. While the CFPB is generally enforcing laws that have been on the books for years - the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act and others – the bureau has extensive rule-making power that borders on legislative authority. The CFPB has the resources and the power to vigorously enforce these old laws and new regulations, something that the Federal Trade Commission and others lacked.

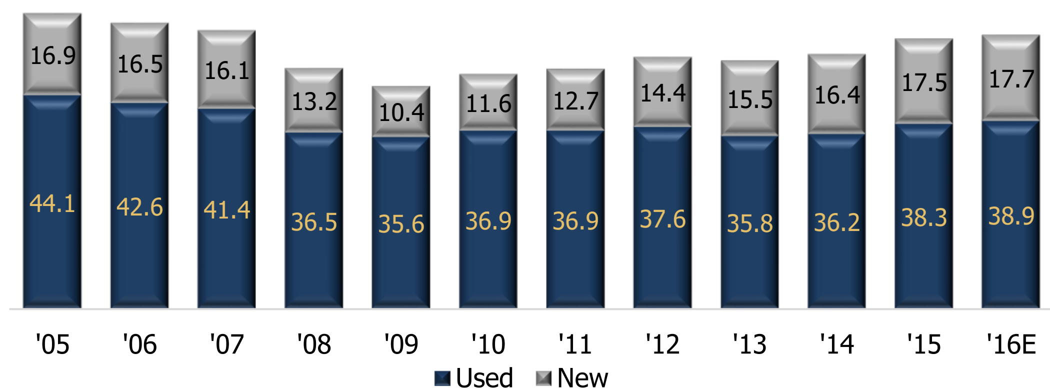
While growth and investor enthusiasm for the sector has cooled recently due to the signs of stress, the below-prime auto finance sector is still fundamentally solid. There are several below-prime auto finance firms that are executing well and expanding profits. Credit Acceptance Corporation (NASDAQ: CACC) reported adjusted earnings of $82.3 million in the first quarter of 2016, a 14% increase over 2015's first quarter. Capital One Financial Corp. (NYSE: COF) reported an increase in subprime auto loan originations in the first half of 2016. Several privately-owned below-prime auto finance firms continue to thrive. At the macro level, conditions for consumer credit remain favorable – the overall auto loan default rate has held steady at about 0.9% in June 2016, and the combination of modest economic growth, low inflation and declining unemployment creates household creditworthiness. Indeed, FICO reported in June 2016 that the share of U.S. adults with credit scores under 600 (definitely subprime territory) fell to 20.7%, the lowest level since 2005; the peak was 25.5%. Consumer creditworthiness is strengthening as the slow motion recovery bumps along.

In the below-prime auto finance market, we are seeing a culling of the herd. Consolidation activity will lead to a smaller group of larger firms that will have the resilience and mass to withstand the inevitable recession and the earnings power to absorb the costs of the much more invasive regulatory environment.

Auto-related Debt Hits a New High; Below-Prime Segment Showing Signs of Stress

The National Automobile Dealers Association (NADA) reported new car sales of 17.5 million in 2015; 2016 sales are expected to reach 17.7 million. Used car sales in 2015 hit 38.3 million units and are expected to inch up to 38.9 million in 2016. The following graph shows how auto sales have behaved in recent years:

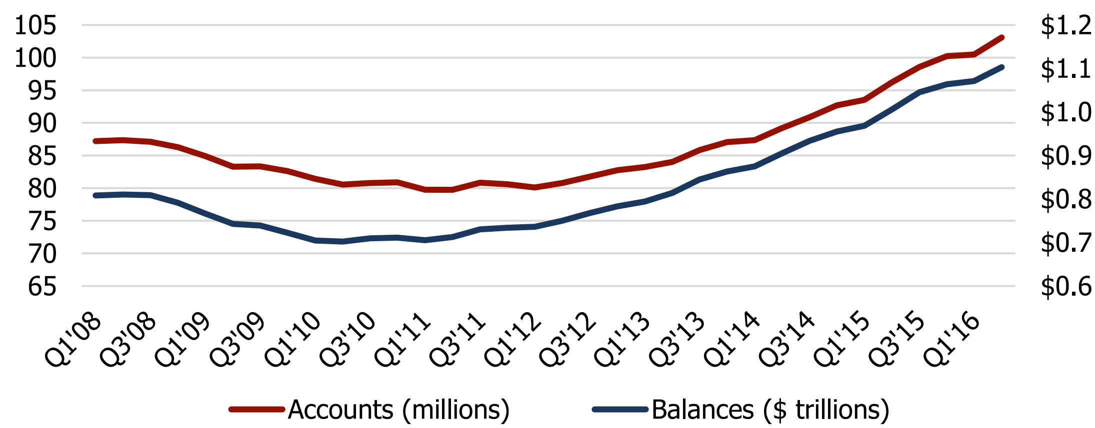
NEW AND USED AUTO SALES *(millions)*



Source: NADA, Edmunds, U.S. DOT and Colonnade estimates

Increasing auto sales means increasing levels of auto-related debt. According to Experian, over 85% of new vehicle purchases and 55% of used vehicle purchases were financed in the fourth quarter of 2015. Total auto loans outstanding surpassed $1.1 trillion in the second quarter of 2016 – a new record. U.S. banks accounted for over $415 billion of the total. The total number of outstanding automobile loans increased to over 100 million at the end June 2016.

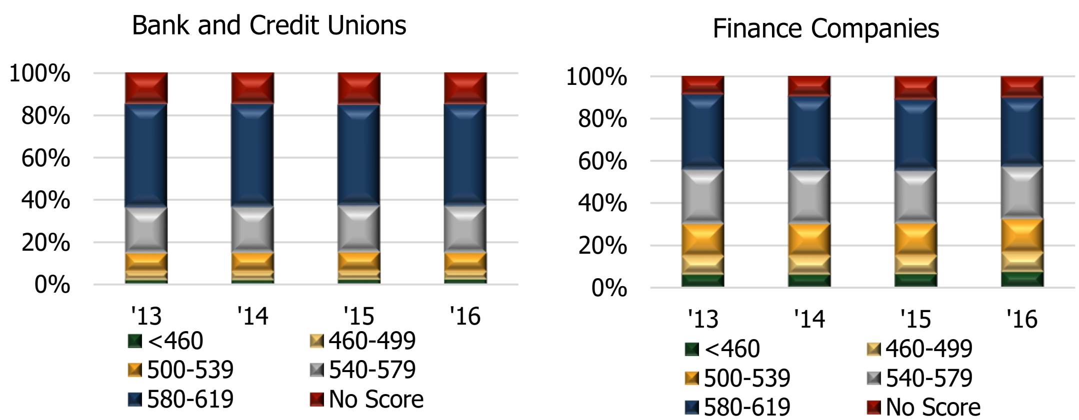
OUTSTANDING U.S. AUTO LOANS



Source: New York Fed Consumer Credit Panel/Equifax

There have been several shifts in the below-prime segment of the auto finance market. The overall share of below-prime credit borrowers as a percentage of the total auto lending market has held relatively steady – about 40% of bank and credit union loans and 55% of finance company loans, according to Equifax. The mix within the below-prime credit segment is changing, however. Lenders, especially finance companies, are making more high-risk loans.

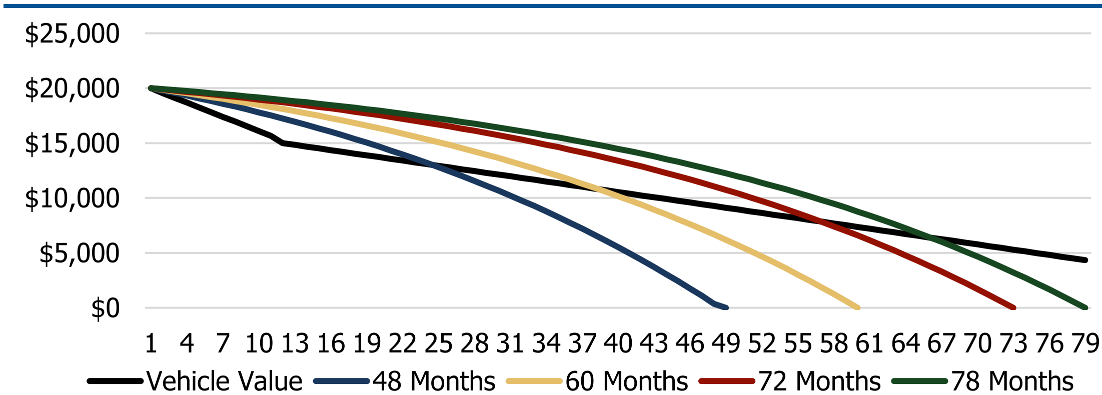
EQUIFAX NON-PRIME CREDIT RISK DISTRBUTION BY CREDIT SCORE



Source: Equifax; Note:[1]YTD Feb-16

The lengthening term of auto loans adds additional risk to the current vintage of auto loans. In a remarkable development, consumers with lower credit scores are receiving longer loan terms than prime borrowers. This is undoubtedly due to the effort to create an affordable payment for consumers that may not have sufficient disposable income. It is obvious that a longer loan term creates problems. The loan-to-value ratio is high throughout the term, and the borrower may have no equity in the loan throughout its life. The likelihood of a negative life event (*e.g.*, unemployment, health issues) increases with the term of the loan. Longer loan terms to a below-prime borrower increase default risk and reduce collateral value relative to the loan balance. The chart below illustrates the effect of longer loan terms on loan collateral adequacy. With a 48-month loan, amortization brings the loan principal balance down to collateral value in the 25th month. With a 78-month loan, the loan principal balance exceeds collateral value until the 62nd month.

VEHICLE DEPRECIATION VS. LOAN AMORTIZATION AMOUNT



Source: S&P Global Ratings

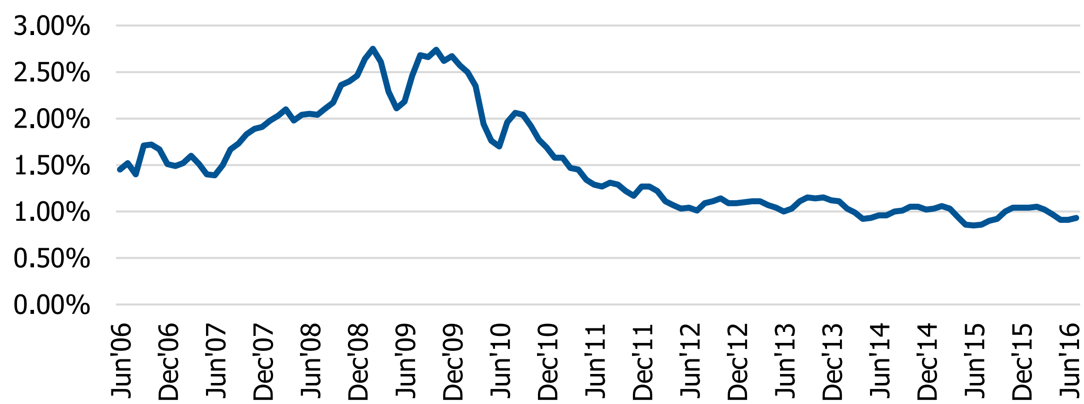
The competitive environment among lenders in the below-prime auto finance market has also led to yield compression. The combination of longer loan terms, deteriorating collateral positions and lower yields has led to a pull-back and/or retrenchment by a number of market participants.

- The percentage of Ally Financial's auto loans to borrowers with credit scores below 630 dropped to 12% thus far in 2016, compared to 14% in 2014.
- Santander Consumer USA has been scaling back in the below-prime auto finance market – originations by this major below-prime lender dropped 6% year-over-year in the first quarter of 2016; originations for its core below-prime lending segment dropped by 15% (Santander Consumer's announcement of second quarter results have been delayed for unspecified reasons).
- Tricolor Auto Group, a 14-store buy here/pay here auto retailer/finance operation based in Texas, was acquired by an industry competitor in January 2016. The buy here/pay here segment of the below-prime auto finance sector appears to be under pressure. America's Car-Mart (NASDAQ: CRMT) reported a 61% drop in net earnings for its fiscal year that ended April 30, 2016 (but earnings recovered somewhat in the first quarter of fiscal 2017 as credit losses dropped significantly). Our conversations with other significant privately-owned BHPH firms reveal that several players in the segment are struggling in the current environment – indirect below-prime auto lenders are capturing the "best of the worst," leaving the BHPH sector with a smaller, less creditworthy group of customers.
- A few participants in the below-prime automobile finance sector have completely withdrawn from the market. The most significant of these companies is Go Financial, an indirect subprime finance firm launched in 2011 by the major BHPH firm DriveTime (Ernie Garcia/Ray Fidel). In 2014, Cox Automotive (Manheim) purchased a 49% stake in Go Financial. Go Financial was sizable, with 500 employees and a network of 3,000 auto dealers. Go Financial abruptly shut down new loan originations in May 2016 and will run down the portfolio. The Cox Automotive stake in the indirect auto lender will be bought back by the majority shareholders. There have been at least two other below-prime auto lenders that have stopped originating new loans – Mark One Financial (in Florida) stopped funding in spring 2015, and Dealer Funding halted originations at the end of June 2016.

Credit Quality in the Auto Finance Market is Strong Overall; Below-Prime Segment Sliding a Bit

Auto loan default rates have remained under 1% since April 2016 (0.93% in July), according to S&P/Experian.

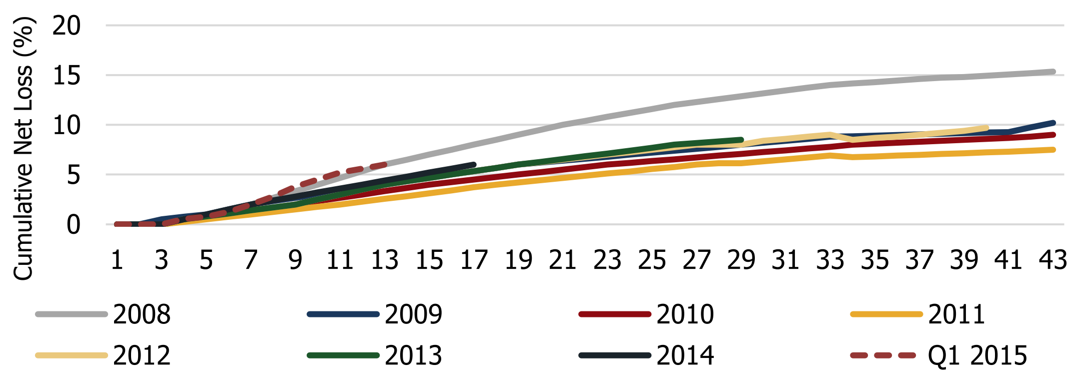
S&P/EXPERIAN AUTO DEFAULT INDEX



This compares to default rates of 0.66% for first mortgages and 2.92% for bank credit cards. Overall consumer credit default rates remain close to 12-year lows. The Atlanta Federal Reserve Bank reported that median wages grew at an annual rate of 3.6% in the first half of 2016; consumer sentiment continues to be fairly solid, and consumer borrowing has expanded. We appear to be in the "comfortable" section of the credit cycle, but it won't last forever.

The below-prime segment of the automobile finance market has had a bit more deterioration. The decline in credit performance appears to be within the operating parameters expected by industry veterans. One CEO of a finance company told us, "Below-prime borrowers are now behaving the way we expect them to behave. Back in 2011 to 2013, they were behaving more like prime borrowers." No aggregate statistics exist for the below-prime auto finance segment, since much of the information is private; the portfolios are funded by banks, and there is no public reporting. S&P's statistics regarding the performance on ABS transactions backed by below-prime auto loans provide a reasonable estimate of the market, however. Cumulative net losses on 2015 below-prime auto loan ABS transactions are tracking the history of the 2008 pool, as shown by the graph below.

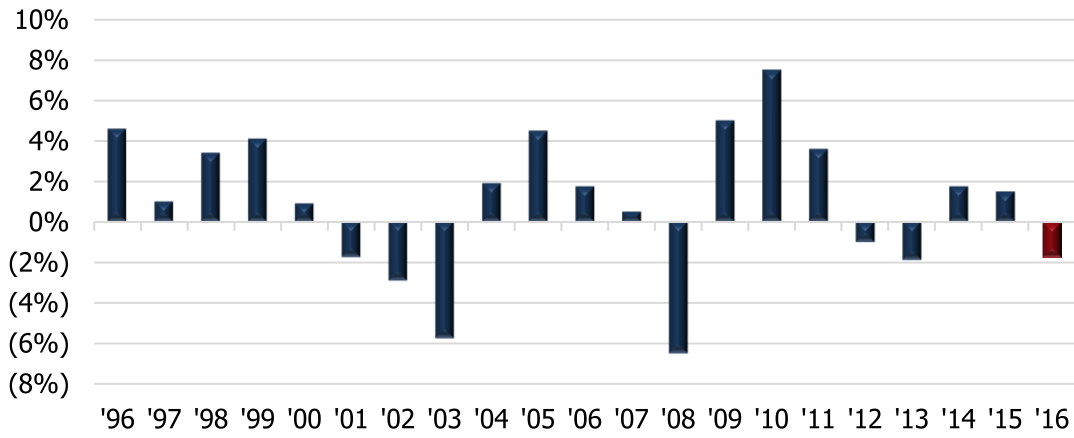
SUBPRIME CUMULATIVE NET LOSSES (%) BY VINTAGE (for months 1 through 43)



Source: S&P Global Ratings

The loss curves for the 2015 vintage may be skewed by the fact that many below-prime auto loan issuers during that year were focused on the deep below-prime niche. Larger players in the industry are tightening credit to below-prime borrowers somewhat, so we do not expect default rates to spike significantly, unless the U.S. economy experiences a significant downturn. Some industry participants report that the softening of used vehicle values is impacting recovery rates when cars are repossessed – this means loss severity on defaults and total write-offs are likely to grow in the medium-term. The recent changes in the Manheim Used Vehicle Value Index support this viewpoint.

MANHEIM USED VEHICLE VALUE INDEX *(% change on annual average basis)*



Capital Flow to the Below-Prime Auto Finance Sector is Declining

The below-prime auto finance industry rebound began in 2010, and several participants injected risk capital via acquisitions and growth investments. Risk capital transactions slowed beginning in 2014, but the auto lenders continued to receive increased funding from bank lenders and the asset-backed securities market. In 2015 and 2016, there were a few acquisitions in the buy here/pay here segment of the below-prime auto finance sector, but almost no new indirect below-prime auto finance company investments. The table below presents the significant transactions that have occurred since the beginning of the recovery in 2010.

Selected Below-prime Auto Finance Early Stage Financings

Date	Target	Buyer / Investor	Transaction
14-Dec	Praxis Finance	Varde Partners	$100MM investment
14-Aug	Veritas Auto Finance	Atalaya Capital/Oaktree Capital	$125MM equity and debt raise
13-Feb	Pelican Auto Finance	Flexpoint Ford	$50MM investment
12-Aug	Resurgent Auto Finance, renamed Global Lending Services	BlueMountain Capital	$100MM investment
12-Jul	Skopos Financial	Lee Equity Partners	$110MM investment
12-Feb	Auto One Acceptance	UBS/Family office/Individuals	$10MM investment
11-Dec	Excel Finance	RedRidge Finance Group	Undisclosed investment
11-Oct	Honor Finance	CIVC Partners	Undisclosed investment /acquisition
11-May	CarFinance Capital	Perella Weinberg	$50MM investment
10-Sep	Flagship Credit Acceptance	Perella Weinberg	$50MM acquisition and growth equity investment

Selected Below-prime Auto Finance Acquisitions

Date	Target	Buyer / Investor	Transaction
16-Apr	American Auto Center	York Capital Management	Acquisition of a BHPH firm
16-Jan	Tricolor Auto Group	Ganas Auto/Investar	Industry consolidation transaction in the BHPH segment
15-Jun	U.S. Auto Sales	Milestone Partners	Acquisition of a BHPH firm
14-Jul	Car Outlet	Marubeni	$120MM acquisition of a Chicago-based BHPH company
14-Mar	Metrolina Credit	ML Credit/Comstock Capital	Small acquisition of two-branch below-prime finance company
13-Nov	NorthState Acceptance	Pine Tree Equity Partners	Acquisition of North Carolina-based below-prime lender
13-Sep	Persian Acceptance Corp.	Carfinco	Canadian auto finance firm bought a Massachusetts-based below-prime auto lender
13-Feb	Nationwide Acceptance	Prospect Capital	Approximately $85-90MM acquisition
12-Nov	White River Capital	Parthenon Capital	$79.5MM take-private transaction
12-Oct	First Investors Financial Services	Aquiline Capital Partners	$100MM acquisition
11-Dec	Gateway One	TCF Financial	$94MM acquisition
11-Oct	Security National Automotive Acceptance	Culpeper Capital/Fortress	Acquisition
11-Oct	Santander Consumer USA	Warburg Pincus, KKR, Centerbridge Partners	Acquired 35% for $1.2BN; transaction value of $4BN
11-Sep	Fireside Bank	Consumer Portfolio Services	Acquired $237MM loan portfolio
11-Aug	Exeter Finance	Blackstone Group	$50MM transaction value plus planned investment of $277MM
11-Jul	Westlake	Marubeni	$250MM investment
11-May	First Investors Financial Services	JAM Special Opportunities Fund II	$12.5MM capital infusion
11-May	J.D. Byrider	Altamont Capital	Acquired buy-here/pay-here retail auto sales/finance operation
11-Feb	United PanAm Financial	Pine Brook Partners	$110MM acquisition
10-Oct	AmeriCredit	General Motors	New core of GM's captive finance arm. $3.5BN transaction
10-Sep	CitiFinancial	Santander Consumer USA	Acquired $3.2BN loan portfolio plus servicing rights for $7.2BN of loans retained by Citi

Some of the private equity investors in the below-prime auto finance sector have been attempting to exit. Flagship Credit Acceptance, controlled by Perella Weinberg, filed for an initial public offering in April 2015. That transaction never closed, even though Flagship is a sizable player with a $3 billion loan portfolio. The exit alternatives for private equity owners of below-prime auto finance companies are not attractive in the current market. In the past year, below-prime auto finance deals occurred at modest valuations.

The asset-backed securities market for below-prime auto finance issuers has tightened in 2016. Below-prime auto finance ABS issuance has declined by 9% year-over-year during the first five months of 2016, according to Deutsche Bank. Bank lenders to independent below-prime auto finance companies are also tapping the brakes. One major lender reported that they only boarded two new clients in 2015; another bank told us that they are "standing pat" with existing below-prime auto finance clients and are not seeking additional exposure to the sector. We have also heard rumors about a few distressed firms that were forced into capitulation transactions; the equity and subordinated debt holders allegedly took losses, but the senior lenders came out whole. One of our more senior banking contacts that serves the below-prime auto finance sector believes that the current environment is "typical" for this point in the credit cycle – some lenders became too liberal in 2015 and are now tightening up.

Consumer Financial Protection Bureau – The New Status Quo

The CFPB is now the direct regulator of each nonbank auto finance firm that "makes, acquires or refinances 10,000 or more loans or leases in a year". There are about 34 companies that fall in this group – we believe the smallest of the group is Carhop, a BHPH firm owned by Alpine Investors. The CFPB examiners are working through the initial round of examinations; this is likely to result in operating changes and possible fines. The CFPB's enforcement actions have already hammered the below-prime auto finance sector. Using the laws against discriminatory lending as a wedge and employing the controversial disparate impact methodology of estimating discriminatory lending damages, the agency has pressured larger auto finance firms into significant settlements. Even the CFPB admits that this methodology has the potential to over-estimate lending bias. Ally Financial, American Honda Finance Corp, and Toyota Motor Credit are among the larger lenders that were pressured into significant settlements ($22 million to $80 million). Below-prime auto finance companies that have been hit with a variety of settlements/fines include Drive Time (large BHPH operator), Herbie's Auto Sales (small BHPH business), Security National Automotive Acceptance Company (below-prime lender focused on the military market, owned by Fortress) and Carhop (BHPH operator owned by Alpine Investors). It appears that the CFPB's approach is focused on punishment and extraction of fines/settlements through the threat of ongoing, expensive litigation. Auto finance companies continue to invest in their compliance functions; some lenders have been examined by the CFPB but were not fined or forced into a settlement.

The Morality of Below-prime Auto Finance

According to Census data from the 2013 American Community Survey, 86% of U.S. workers get to their jobs in an automobile. Most drivers are all alone in the car – 76% of commuters are solo drivers. The U.S. hit its peak of car commuting in 2000 at 88%, and carpooling has been declining steadily since 1980. The rate of car commuting is lower in major urban areas where public transportation is a viable option – solo car commuting is used by 50% of workers in New York City and 60% of San Francisco's workers, as compared to 84% in Detroit.

Since only one in twenty U.S. workers use public transit to get to work, owning a car is key to employment. No car means no job, in many cases. This holds true whether you make minimum wage or millions. If you are not making much money, forking out several thousand dollars for a dependable vehicle is usually not possible. Getting a commuter car requires financing. If you have a good job that pays a decent wage, have many years of earning history and have always paid your bills on time, you can get a darned good deal on a vehicle and its financing – auto manufacturers are offering 0% loans through their dealers as a sales incentive (for qualified borrowers, of course – and you have to have a sterling credit score). If you fall in the below-prime credit category, you can still get a car loan. It may not be a great deal as compared to the deal offered to prime borrowers, but you can obtain transportation; you can get to your job, which will produce the income that will allow you to service your loan and improve your credit score. A good credit score is one of the components of a successful life in the United States.

To an individual that has the privilege of a significant income and a stable life, the terms of below-prime loans may appear to be egregious. This point of view feeds the narrative regarding below-prime auto finance as immoral predatory lending. Reality is complicated, however. A high-cost auto loan is not necessarily evil. A below-prime auto loan can be a path forward for a person that has suffered setbacks that led to credit problems. In the American car-commuting, consumption-centric culture, a below-prime auto loan may be the only alternative available to someone seeking to join the mainstream. Credit is the lifeblood of our country, and it is not necessarily virtuous to restrict the options available to people that have experienced credit difficulties in the past. There is an honorable way to participate in the below-prime lending market – with full disclosure, presentation of multiple options to borrowers, and an active effort to move consumers into lower-cost financing alternatives as their credit scores improve. Most below-prime auto finance firms are doing their best to behave honorably while serving their customers, employees and investors.

Representative Transaction

Colonnade represented Serent Capital on the sale of Tricolor Auto Group to Ganas Auto and Investar Financial in January 2016

tricolor auto

a portfolio company of

Serent CAPITAL

has been sold to

Ganas Auto

a portfolio company of Investar Financial

The undersigned acted as exclusive financial advisor to Tricolor Auto

Colonnade Securities LLC

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