Below-Prime Auto Finance Industry

Good Management = Great Yields

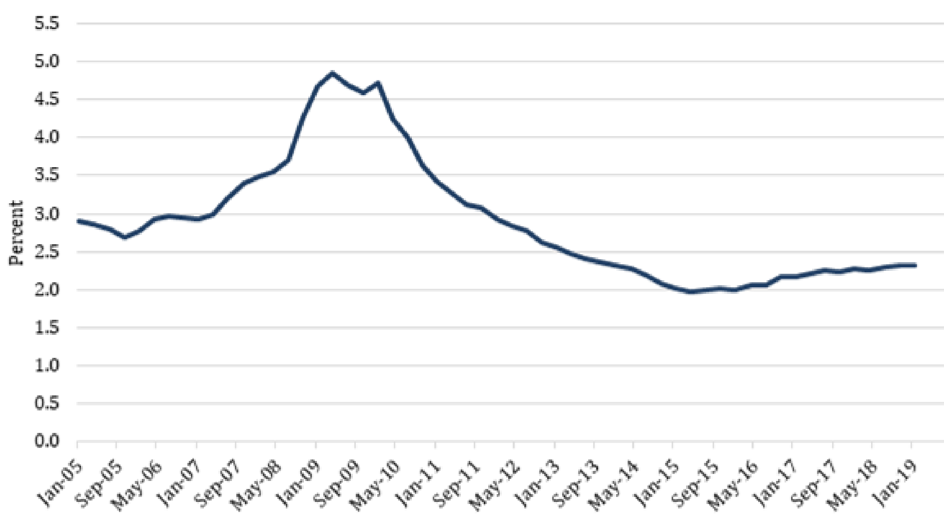
Overview

- Below-prime auto finance is out of favor with private equity investors. The wave of investments in 2010-12 led to heightened competition and loose underwriting, followed by a spike in delinquencies and losses. The result is a significant decrease in new equity capital available to the sector. While banks that lend to the below-prime auto finance industry are more cautious and selective, senior debt availability remains strong for performing industry participants due, in large part, to the asset-backed securities market.
- The industry has bifurcated between large (total receivables over $300 million) and small below-prime auto finance firms. Large, well-run players continue to grow profitably; a few smaller firms have failed.
- Few M&A transactions have been completed in recent years, although there have been some capitulations (business exits/liquidations). Several of the large, successful firms are still seeking change of control as their private equity owners run through their investment horizons.
- Large, well-managed below-prime auto finance companies may be excellent investments for yield and long term, steady growth. Family offices and other long-term investors may have an opportunity to buy below-prime auto finance originators at reasonable valuations in the next several years.
- We expect to see an uptick in mergers and acquisitions activity in the industry over the next eighteen months.

Macro Conditions

The automobile finance market is the third largest segment of the U.S. consumer credit sector (behind residential mortgages and student loans). When general economic conditions in the United States are favorable, the consumer credit sector almost always performs well.

DELINQUENCY RATES ON CONSUMER LOANS, ALL COMMERCIAL BANKS



Source: Federal Reserve Bank of St. Louis

The current economic expansion is now the longest period of growth in the history of the United States, and the economy is in good shape. The unemployment rate is 3.6% - the typical 65-year old American was in high school the last time the unemployment rate was this low. According to U.S. Labor Department data, the number of unfilled jobs was 7.5 million at the end of April 2019. That number of openings exceeded the number of unemployed people by 1.6 million – the largest such gap on record. The core inflation rate is hovering around 2% p.a. and the yield on 10-year U.S. Treasury notes is now down to 2% - real interest rates (net of inflation) on government debt are back to zero. The U.S. Federal Reserve has "tapped the brakes" on interest rate increases and quantitative tightening – an interest rate cut might occur this summer. These three positive macro-stats and continued high levels of liquidity have led to a relatively loose credit environment – consumer debt levels are up, but the increase in delinquencies/defaults has been modest due to the general health of the consumer economy. General consumer finance delinquencies reached a peak of almost 5% of balances outstanding in the second quarter of 2009; they hit a low of 1.98% in the second quarter of 2015. The delinquency rate is currently 2.33%, still low by historical standards.

Investors that are seeking yields above government or investment grade corporate debt rates have continued to provide debt capital to the consumer finance sector.

The good times will eventually come to an end, and a recession is inevitable. Some non-bank consumer lenders (such as LendingClub and Avant) are tightening credit standards and cutting costs in order to be ready for a downturn. Sentiment is shifting – Reuters reported that 25% of the economists it surveyed in March 2019 expect a downturn in the next twelve months. The tariffs and trade conflicts promulgated by the Trump administration could raise consumer prices and trigger the downturn, or a spike in oil prices caused by the escalating conflicts with Iran in the Persian Gulf could shock the economy into a recession.

Below-Prime Auto Finance Industry Conditions

The below-prime auto finance industry is affected by several factors that do not show up in overall consumer finance sector performance statistics. Here are some of the issues that are impacting the below-prime auto finance market:

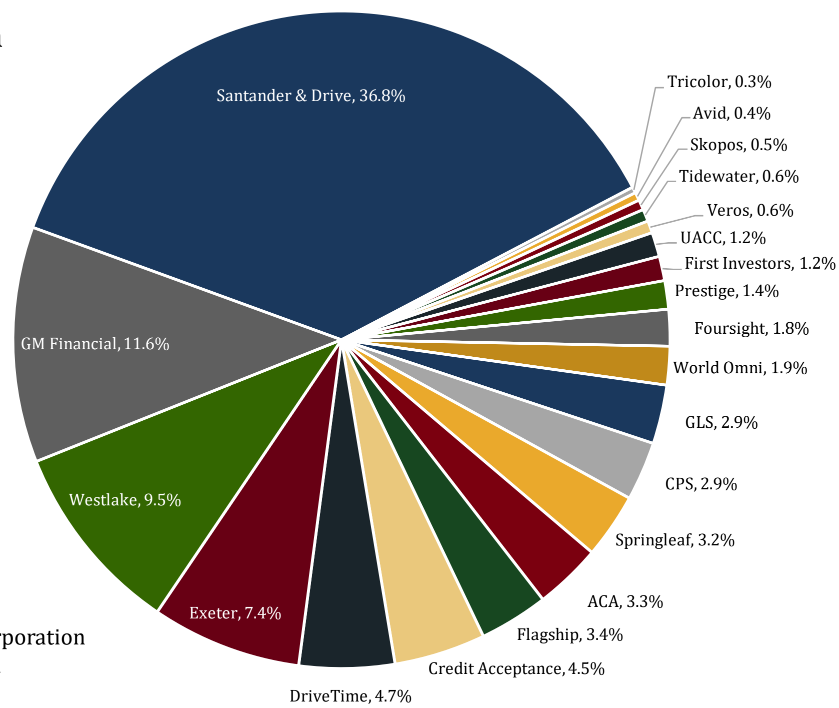
- ***Past aggressive underwriting has led to elevated delinquencies for some firms.*** The most aggressive lenders to the subprime auto sector are experiencing higher delinquencies and losses; the 2014 – 2016 timeframe saw a deterioration in credit standards and auto dealer management as new entrants and others fought for volume. Many players tightened up their underwriting and controls in 2017 and non-prime auto financing volume dropped. A period of renewed growth occurred in the second half of 2018, so performance may dip again. The impact of liberal standards has been revealed in the performance of the asset-based securities issued by a few significant issuers.
- ***Private equity investors have hit the horizon of disappointment.*** The rash of below-prime auto finance investments made in 2010 – 2012 has reached the exit timeframe for their institutional investors. Some private equity firms have elected to capitulate, either by halting loan origination and turning portfolios over to third-party servicers to liquidate or selling portfolios to competitors at discounts. Other financial sponsors are holding successful businesses but find current M&A valuation levels for those franchises to be unacceptable. While there have been some below-prime auto loan portfolio sales, there have been few significant sales of fully functional below-prime auto finance firms in the past three years. The last platform acquisition in the below-prime auto finance industry was Automotive Credit Corp's purchase of Top Finance, a relatively small regional firm. Sponsor-owned firms will eventually be sold due to the ten-year liquidation schedule of the typical private equity fund.
- ***Bifurcation of the below-prime auto finance sector.*** The industry appears to be splitting into two groups. Larger firms with critical mass are experiencing increased volume and growth in market share. These larger firms have invested in automated credit decisioning and data analytics that reduce static pool losses; the larger firms are also able to hire and retain skilled leaders and technical people needed to implement a tech-forward operation. In addition, large firms have made significant investments in compliance staff and infrastructure. The second segment of the industry consists of smaller players that have not achieved critical mass and do not have the resources to invest in credit/analytic technology. Many of these smaller market participants are shrinking; and some have

exited the business entirely. At least a dozen indirect below-prime auto finance firms and buy here/pay here auto sales/finance firms have exited the market since 2016. None of these failed firms were public companies, and none have been large enough to precipitate a crisis in the industry. This level of distress has accelerated the bifurcation of the market.

- ***Access to capital.*** High levels of liquidity and the pursuit of yield have kept debt capital flowing to the below-prime auto finance industry. There has been a flight to quality, however. The banks that have traditionally provided financing to smaller players in the below-prime auto finance market have tightened their credit standards. Some have exited the non-ABS segment of the market. While it is challenging for a new issuer to complete an asset-backed securities transaction, there were some first-time issuers that closed transactions in the past year or so, including Avid Acceptance and Tricolor Auto Group. Experienced issuers are tapping the market with relative ease. While debt capital is available to solid market participants, risk capital is in short supply. The private equity sector has turned its back on the below-prime auto finance industry – no new investments have occurred since 2016.

INDUSTRY NONPRIME AUTO LOAN ABS 2018

55 transactions, $30.5bn



UACC – United Acceptance Credit Corporation
CAC – Credit Acceptance Corporation
CPS – Consumer Portfolio Services
ACA – American Credit Acceptance

Source: S&P Global Ratings

Large Players are Getting Bigger

An intense focus on growth regardless of market conditions leads to difficulty in the below-prime auto finance business; this has been true in the past (particularly in the late 1990's) and it is still true today. Several of the larger, successful participants in the below-prime auto finance market are delivering excellent returns on capital deployed by managing growth and maintaining strict credit guidelines. Critical mass and good management generate great yields for these firms and their owners.

TOP TEN BELOW-PRIME AUTO FINANCE FIRMS

Company	Ownership	Total Assets ($Billion)
GM Financial (AmeriCredit)	General Motors Company	$97.2
Santander Consumer USA (Drive Financial)	30.2% Public 69.8% Banco Santander	$45.0
Credit Acceptance	Public	$6.2
Automotive Drivetime	Ernest Garcia II	$4.7
Exeter Finance Corp	Blackstone Group	$4.7
Westlake Financial	80% Hankey Group 20% Marubeni Corp	$4.0
Consumer Portfolio Services	Public	$2.5
American Credit Acceptance	Johnson Group	$2.5
Flagship Credit Acceptance	Perella Weinberg Partners	$2.2
Global Lending Solutions	Blue Mountain Capital	$1.8

Sources: Public filings and press reports

The top two participants in the below-prime auto finance sector accounted for almost half of the ABS transactions completed in 2018

The Below-Prime Auto Finance Cycle Grinds Forward

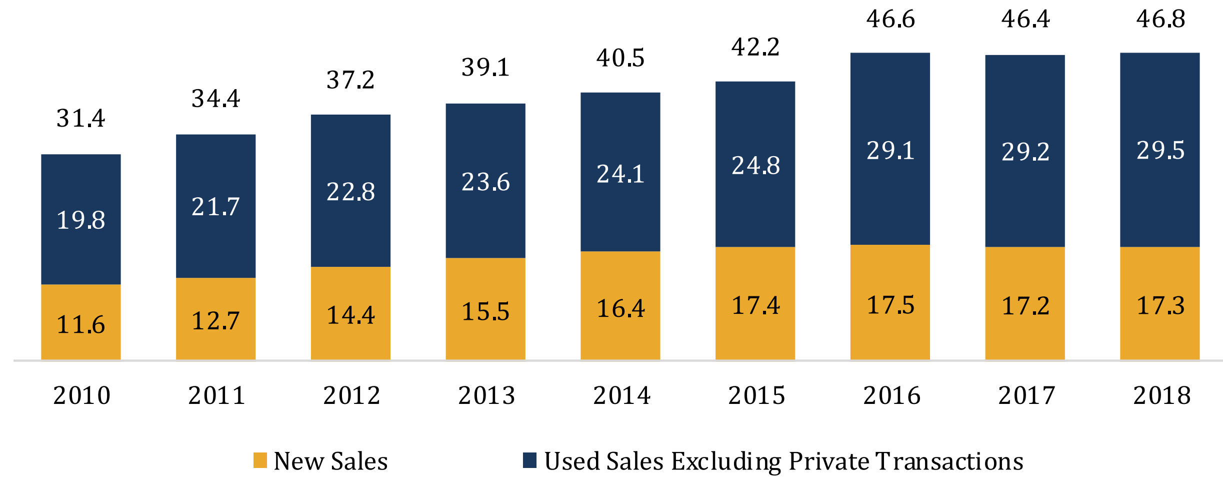
In our market commentary of February 2013, we reviewed the significant increase of risk capital flowing into the below-prime auto finance sector in the 2010 to 2012 post-recession credit recovery. In July 2014, we noted that industry participants were facing heightened competition and that some sophisticated 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. In August 2016, we predicted that consolidation activity would lead to a smaller group of larger firms with the resilience and mass to withstand the inevitable recession and the earnings power to absorb the costs of the much more invasive regulatory environment.

The consolidation phase is now in full swing, and the ownership of these businesses may shift to yield-oriented investors rather than the "buy low/sell high" crowd. This group of investors is attracted to well-managed below-prime auto finance firms due to their high yields and high returns on assets and equity, their need for significant capital, and their predictable cash flow.

Demand for Auto Credit Remains Robust

While new car sales peaked in 2016 at 17.5 million, used car sales have continued to grow, hitting 29.5 million in 2018. Demand for used cars is likely to remain robust, in part because of the ever-increasing cost of new vehicles and increasing cost differential between new and used cars. The below-prime auto finance market is closely tied to used car sales.

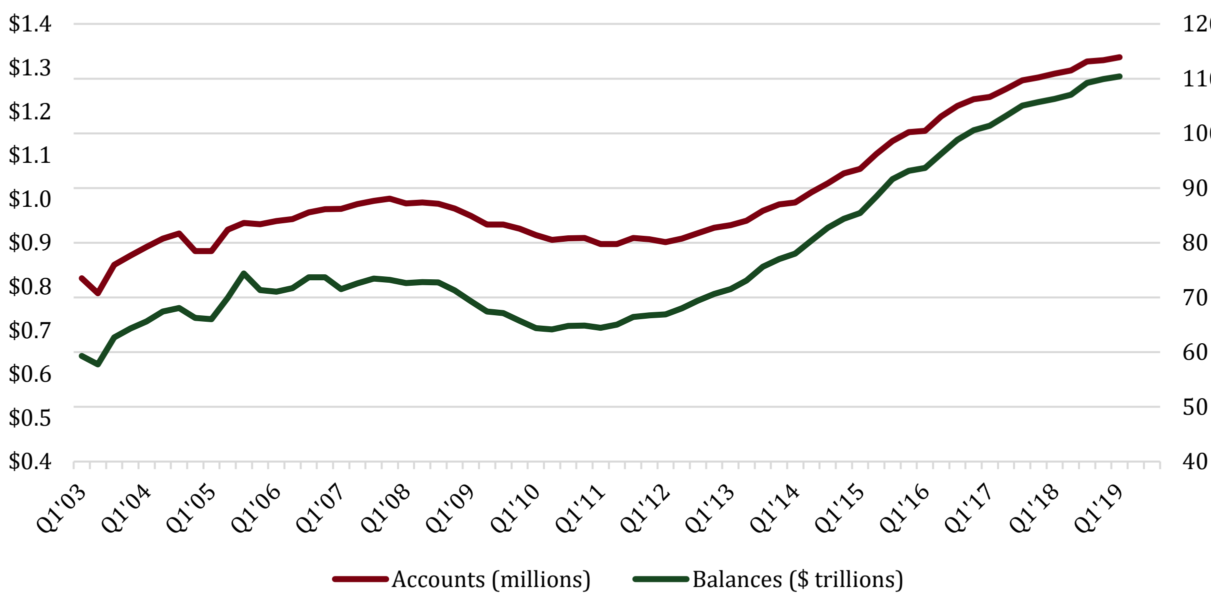
NEW AND USED AUTO SALES *(millions)*



Source: NADA

Total auto loans outstanding at the end of 2018 nearly hit $1.3 trillion, a new record high.

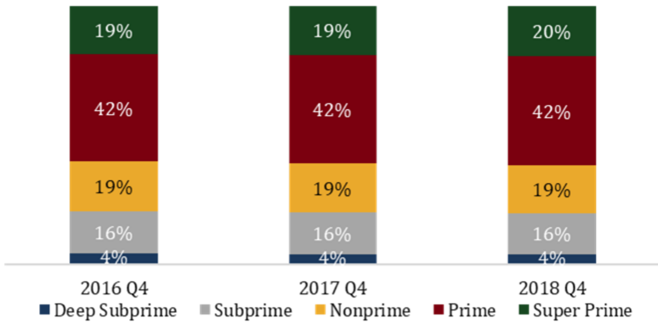
OUTSTANDING U.S. AUTO LOANS



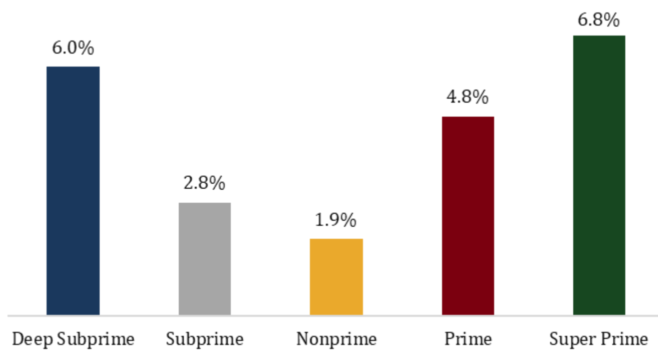
Source: Federal Reserve Bank of New York

Below-prime borrowers (credit scores below 660) accounted for about 38% of the total auto finance market at the end of 2018. Credit scores have been slowly improving over the past few years; below-prime borrowers accounted for almost 40% of the total market at the end of 2016. The average auto loan balance carried by below-prime borrowers also increased in 2018.

LOAN BALANCE RISK DISTRIBUTION



YEAR-OVER-YEAR BALANCE CHANGE



Category	Score Range
Super Prime	781-850
Prime	661-780
Nonprime	601-680
Subprime	501-600
Deep Subprime	300-500

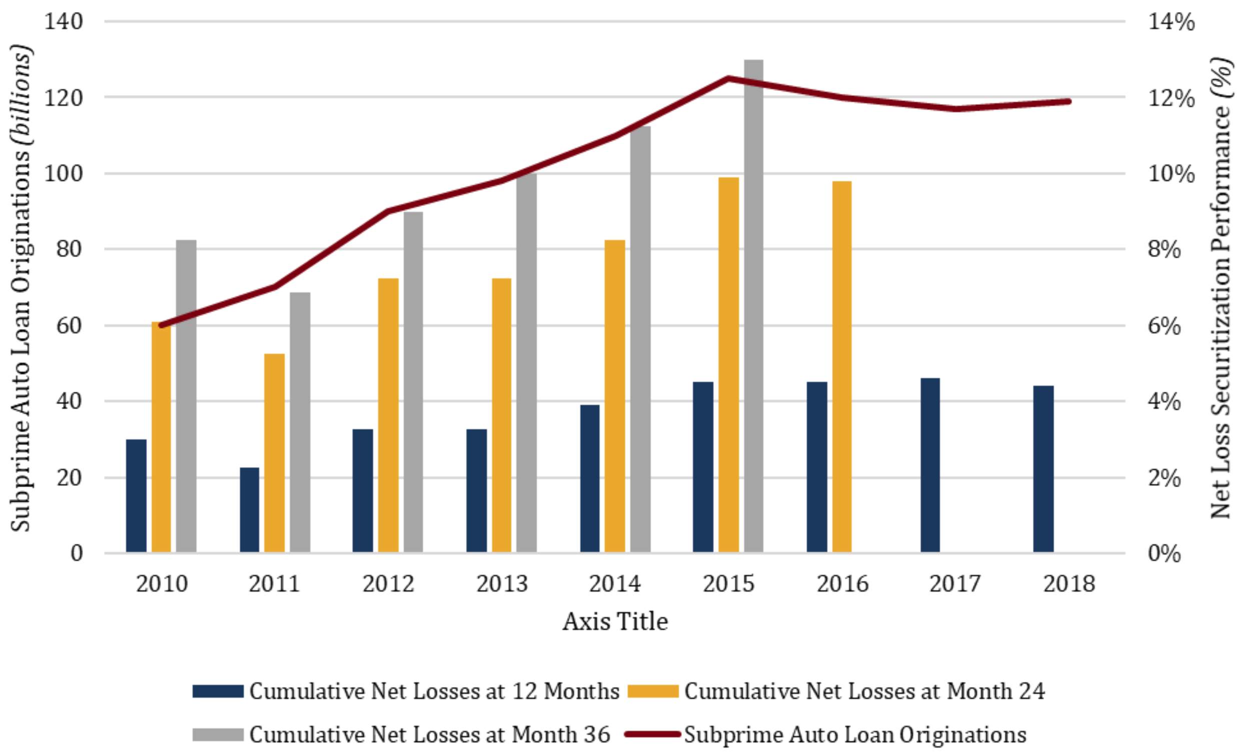
Source: Experian State of the Automotive Finance Market Q4 2018

Average original loan terms of below-prime auto finance ABS issuers have been increasing. Around 84% of loans had an original term in excess of 60 months, according to S&P.

These statistics support the conclusion that below-prime auto finance firms are becoming a bit more aggressive; terms offered to consumers are liberal. The overall financial health of consumers (as measured by credit scores) continues to improve slightly as the economic expansion rolls along. Liberal credit terms extended late in an economic expansion tend to cause elevated losses when the economy softens.

In the below-prime auto finance segment, losses appear to be closely correlated to loan volume – when volume increases, so do losses (eventually). The aggressive lending in the 2014-2015 timeframe created elevated losses thereafter. The data for below-prime auto loan asset backed securities demonstrates the connection.

ABS CUMULATIVE NET LOSS (CNL) VS SUBPRIME AUTO LOAN ORIGINATIONS



Bifurcation of Below-Prime Auto Finance Industry

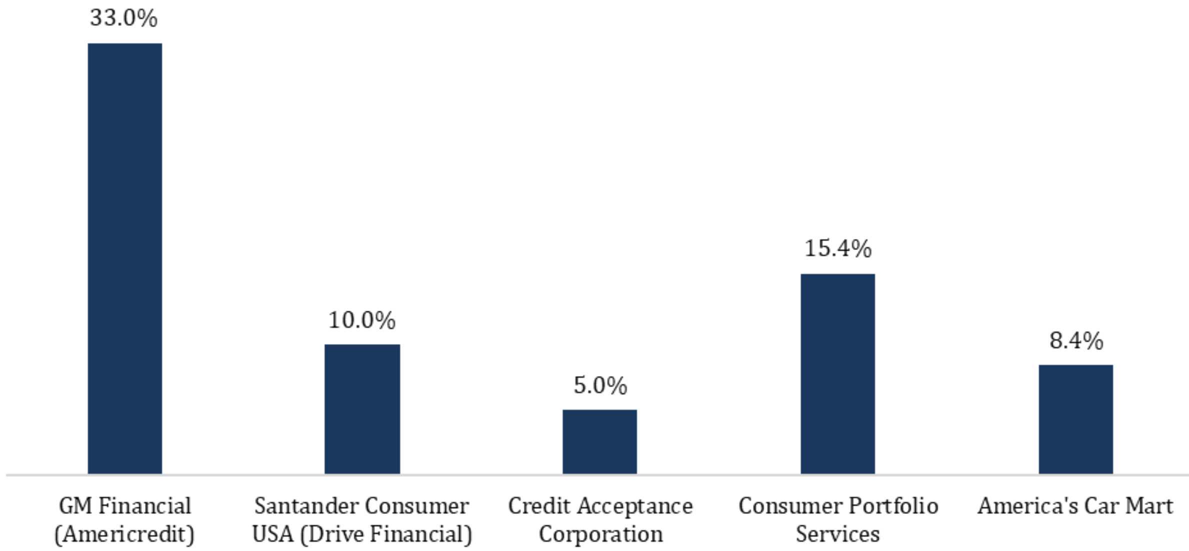
As mentioned earlier, there have been a dozen or so below-prime auto finance firms that have failed in recent years. Each of these troubled firms has its own story, but the reasons for their demise fall into three broad categories:

- ***Inadequate mass and operating history:*** None of the firms that have failed held significant market share in the below-prime auto finance sector; capital availability to smaller firms has declined in the past few years. Several of these firms were launched in the wake of the 2009 – 2010 recession and were attempting to grow rapidly. In some cases, credit decisioning systems and management talent were inadequate due to resource limitations.
- ***Underwriting errors:*** The land grab mentality of some new players led to relaxed lending standards. When the losses from poor credit decisions hit the operating results of the finance companies, they had inadequate capital to absorb the blow.
- ***Loss of conviction:*** Some of the companies lost the support of equity capital providers when it appeared that equity valuations in the below-prime auto finance sector were falling; origination activities ceased and the portfolios were either sold or placed with a third-party servicer.

The companies that have gone out of business reflect a broader trend – larger firms are growing and gaining market share; smaller firms are shrinking and becoming irrelevant. The critical mass break point appears to be about $300 million of finance receivables.

The top publicly traded companies in the below-prime auto finance business all grew their volume in the first quarter of 2019:

Q1 VOLUME CHANGE



The Elusive Exit

There have been no significant sales of below-prime auto finance firms in the past few years despite several attempts by investors. Flagship Credit Corporation (owned by a Perella Weinberg fund) filed for an initial public offering in 2015; the deal never priced and the S-1 was finally pulled in April 2018. Exeter Finance filed for its initial public offering in January 2019; the deal has not priced yet. There have been several attempts by private equity investors to sell their subprime auto finance portfolio companies; no significant firm has traded. Recent exits that have occurred have been capitulations – portfolios were sold or turned over to be serviced by larger firms (Westlake Financial Services and First Investors Financial Services have assumed portfolio servicing duties for a number of the below-prime auto finance firms that have ceased originating new loans). TCF Financial also closed down Gateway One, an auto finance that it bought for $94 million in late 2011.

Here is a list of the below-prime auto finance acquisitions over the past several years.

Date	Target	Buyer / Investor	Transaction
19-Apr	Metrolina Credit	Nicholas Financial	Nicholas bought Metrolina - $22MM of net receivables
17-Sep	Top Finance	Automotive Credit Corp.	Top was a small California-only lender - $50MM portfolio
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
15-Mar	Carfinco (Canada)	Banco Santander	Carfinco is a Canadian subprime auto finance 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

Ten of the transactions listed above involved private equity firms as buyers; some of those investments are overdue for liquidation. Eventually, these properties must be sold since the funds that hold the investments are time-limited.

Conclusion

While the fundamentals of the below-prime auto finance industry have not deteriorated significantly, the sector is quite out of favor with traditional financial sponsors. This cyclical sector generates assets that produce solid risk-adjusted returns, but success requires a significant investment in systems and human capital. Successful participants in the business also understand that a decrease in volume caused by disciplined underwriting is beneficial in the long run. We expect that the current logjam will break as private equity investors are forced to take their properties to market in the next few years. There will be transactions, but the valuations are unlikely to meet the original expectations of the investors. These market dynamics will create compelling investment opportunities for long-term, yield-oriented investors, such as family offices and other non-traditional financial sponsors.

For more information on the Below-Prime Auto Finance sector, please contact:

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