CREDIT ACCEPTANCE CORPORATION

Moderator: Douglas Busk
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5:00 p.m. ET

Operator: Good day, everyone and welcome to the Credit Acceptance Corporation Third Quarter 2016 Earnings Call. Today's call is being recorded. A webcast and transcript of today's earnings call will be made available on Credit Acceptance's website. At this time I would like to turn the call over to Credit Acceptance Senior Vice President and Treasurer, Doug Busk.

Douglas Busk: Thank you, Jesse. Good afternoon and welcome to the Credit Acceptance Corporation Third Quarter 2016 Earnings Call. As you read our news release posted on the Investor Relations section of our website at creditacceptance.com, and as you listen to this conference call, please recognize that both contain forward-looking statements within the meaning of federal securities law.

These forward-looking statements are subject to a number of risks and uncertainties, many of which are beyond our control, and which could cause actual results to differ materially from such statements. These risks and uncertainties include those spelled out in the cautionary statement regarding Forward-Looking Information included in the news release. Consider all forward-looking statements in light of those and other risks and uncertainties.

Additionally, I should mention that to comply with the SEC's Regulation G, please refer to the Financial Results section of our news release, which provides tables showing how non-GAAP measures reconcile to GAAP measures.

At this time, Brett Roberts, our Chief Executive Officer; Ken Booth, our Chief Financial Officer; and I will take your questions.

Operator: At this time, I would like to remind everyone that in order to ask a question please press star and the number one on your touchtone telephone. We will pause for just a moment to compile the Q&A roster.

Your first question comes from John Rowan from Janney. Your line is open.

John Rowan: Good afternoon, guys. I just want to make sure I understand your commentary here around unit volume growth. Obviously, it peaked in September of 2015 at 41%. The unit volume growth has come down now, to 12% for the quarter in the third quarter of 2016. But then in the subsequent paragraph you say that it declined 8.3%. I just want to make sure, the unit volume is down 8.3% and not growth has come down to 8.3%. Am I reading that correctly?

Brett Roberts: That's correct. So year-over-year unit volumes were 8.3% less in October than the same period of the prior year.

John Rowan: Okay. And then later on in the paragraph there, you talk about forecasted collection rates coming down, and that you believe that the reduction in forecasted collections has impacted the unit volumes for the year. Can you discuss that a little bit? I mean, are we at a point where forecasted collections are starting to really hurt dealer holdback payments? And that could be what's causing some tepid unit volume numbers for you?

Brett Roberts: No, I don't think that's what we’re saying. We're just saying we see the trends of loan performance throughout the last four quarters, and we reacted to those trends. The amount that we pay the dealers at loan inception is a function of the collections that we expect. So if we expect lower collection levels then we're going to pay the dealers less money, and that's what impacts loan volume in our opinion.

John Rowan: Okay. It doesn't look like you guys repurchased any stock during the quarter, correct?

Brett Roberts: Correct.

John Rowan: Okay. I've haven't looked through the 10-Q yet, is that a function of not having an authorization or liquidity? Do you think you'll get back in the market to repurchase stock?

Brett Roberts: We continue to approach it the same way. The first thing we look at is whether we have excess capital, and if we do, then the Board makes a decision when it's appropriate to buy it back. We'll continue to use the same criteria and over time you could probably expect we'll repurchase more shares.

John Rowan: And then last question, obviously asking about the provision expense. I know in the past we've talked about it, whether or not it's the accounting noise in the portfolio or whether or not it seems like there is actual pressure in the underlying fundamentals of the auto loan book. Can you just give us an idea of how you look at in the provision expenses of $22.8 million this quarter?

Brett Roberts: As we’ve said before, we really focus on the adjusted results. We don't really look at the provision internally. We have GAAP statements that we prepare and we release, and you're welcome to look at those. But internally we focus on the adjusted results for the reasons we talked about in prior calls.

John Rowan: All right. Thank you.

Operator: Your next question comes from John Hecht with Jefferies. Your line is open.

John Hecht: Afternoon guys. Thanks much. Just going a little bit back to the volumes. Volume is down; unit volume is down in October. Can you tell us what's going on with the loan volume as we go to the fourth quarter? And maybe you could even flavor it with some of your thoughts on the competitive environment and what that might mean to loan volume in the quarter.

Brett Roberts: Well it's November 1, we gave you volumes through yesterday. So that's about as current as we can get.

John Hecht: Yes, unit volume. But your average loan size has gone up a lot over the past year, so that offset the unit volume decline. I'm wondering if you could just give us just a little bit more color about the total volumes including the average size.

Douglas Busk: We don't have dollar volume at this point. We just have unit volume. I mean, you're right, the dollar volume has grown more significantly than unit volumes in the last two quarters for sure.

John Hecht: Okay, and so maybe we can talk about that a little bit then. I've seen your purchase loan business is growing at a much greater rate than the dealership business. Maybe you could talk about it. Is that influenced by something internal? Or is that influenced by the competitive environment? How should we see the balance of that play out going forward?

Brett Roberts: I think the primary driver that you see throughout the release is we continue to be in a difficult competitive environment. It's one that's been in place for quite some period of time.

Our strategy in prior cycles like this has been to grow the number of active dealers. It's pretty hard to grow volume per dealer in the environment that's as competitive as it is today. And we've had some success with that strategy in the past. And I think what we allude to in the release, that that strategy gets more difficult as the number of active dealers grows; it becomes tougher to grow that active dealer base at the same rate.

And so we're starting to run into a situation where our existing salesforce is signing up as many dealers as they're capable, but it's not enough to offset attrition and the impact of the competitive environment on volume per dealer and still leave us with rapid growth. I think that's where we are today.

The purchased loan program has helped. That is, as we've talked about, a separate channel for us. We've probably had more success in growing that segment of the business than we thought we would. And so, that’s certainly helped. And as the prior caller mentioned, the average size of the contract is up as well, so you have some dollar volume growth. But ultimately, if we want to be a lot larger company than we are today, we have to figure out how to grow unit volume and that's certainly been challenging in the existing competitive environment.

John Hecht: Okay. And then is there any way you can give us, sort of characterize maybe the terms in that purchase model. What's the average loan yield and size and duration or anything like that to help us forecast what that might look like going forward?

Brett Roberts: I'm not going to give you any additional numbers other than what's in the 10-Q and the release. There's quite a bit of information, particularly in the 10-Q on the average loan size, average advances, et cetera.

The purchased loans are larger, they're longer-term. We acquire those in a different way. We give the dealer one payment upfront instead of dealer holdback payments at the end. But other than that, they have similar characteristics. They're a little bit lower yield, a little bit larger size, but we're happy with the profitability of loans we're writing right now.

John Hecht: And then a last question. Do you buy those, similar to the dealer loans, do you buy the purchased loans at a net discount on average?

Doug Busk: Yes. We have information in the press release and the 10-Q that shows what percent of the underlying consumer loan principal plus interest we are acquiring those at.

John Hecht: Thanks very much.

Operator: Thank you. Our next question comes from Moshe Orenbuch with Credit Suisse. Your line is open.

Moshe Orenbuch: Great, thanks. To stay on that purchase program, you buy them at a discount to the principal plus interest, but what price do you buy them at relative to the actual principal amount?

Brett Roberts: Again there's a lot of information in the 10-Q and in the release on advance rates and the average size of the purchased loans and how much we give the dealers relative to the expected cash flows. I would just point you to the information that's already been disclosed.

Moshe Orenbuch: The question that I'm struggling with is, to the extent that the purchase program becomes a larger piece of the total company, at what point does the level yield accounting no longer seem appropriate, or at least appropriate for that piece of the business?

Brett Roberts: I don't follow you. Why would purchased loans have anything to do with the accounting?

Moshe Orenbuch: In other words, purchased loans are similar to the way other finance companies conduct their business, and they record those loans at the purchase price, and then they kind of accrue losses based upon a loan-loss reserve methodology. It's a different accounting methodology. I guess, when this was under 10% of the company, it's -- I struggle because it's quite hard for us to follow the quality of that underlying business because you don't have the protections that you have in the portfolio program.

Brett Roberts: Let me just answer it this way. The accounting we follow is the required accounting. I can tell you that when we adopted the accounting they didn't say, well purchased loans are small, so account for them any way you want to.

They looked at our accounting treatment for both dealer loans and purchased loans and the accounting treatment that we follow is what was prescribed at the time for both of those. So both our auditors and the SEC, when they looked at it, they both agreed that the accounting we use is the accounting we should be using.

Moshe Orenbuch: Okay. Thank you.

Operator: Your next question comes from Leslie Vandegrift with Raymond James. Your line is now open.

Leslie Vandegrift: Good afternoon. Hi. First question, we talked about this last quarter a bit on the forecasted collections for earlier in 2016. They changed positively a little bit this quarter, although not as much as first quarter to second quarter. I was curious if we had some more information now that we've got a little bit of time between now and then on that first quarter 2016 pool write-up that we had just in a one quarter change and a little bit this quarter as well.

Doug Busk: They continue to perform a little bit better than we expected at origination, so when you update the actual performance experience that you've incurred to date into your forecasting models that results in a little bit of improvement in the all-in forecasted collection rate, so it's just reflecting the better experience we have seen thus far.

Leslie Vandegrift: So the ones that were originated earlier in the year, you're actually seeing cash collections above what you originally expected on that, at least earlier?

Doug Busk: Yes.

Leslie Vandegrift: Okay. And then when we talk about -- you guys already talked about the purchase volumes, but on the recovery value side, I know you look at your own portfolios rather than indices, and was curious what your take right now is, and for the next few months going forward, on how you feel about when you repo the recovery value for the cars you're seeing, especially since it's on the older used vehicle side on these terms.

Brett Roberts: There's obviously been a lot written about predictions of what used vehicle values are going to do in the future, we're certainly aware of all that. We track all the vehicles in our portfolio and the change in the black book value every month. Obviously it's a used vehicle so it's a depreciating asset that goes down every month.

What we've seen so far this year is a steeper decline in terms of the depreciation on the vehicles in our portfolio than we have typically seen, probably the steepest declines this year going back to, I think 2008 was the last time we saw depreciation this steep.

So that's certainly impacting the loan performance to date, and it's something that we've included in our forecast. As we talked about last time, the actual amount that we receive at auction from the repossessed vehicles isn't a huge percentage of our total expected cash flows.

So we don't necessarily have a prediction of what those used vehicle values are going to do in the future. It's not as important to us as it is to potentially other more traditional lenders. You could write a loan today, it's a 50-month loan, trying to predict what used vehicle values are going to be over the next 50 months is obviously very difficult.

So instead what we do is we try to build a margin of safety into our business model as you know that predicting collection rates is very difficult, so we try to set up a situation where even if our collection forecast comes in a little shy of what we expected, the loans would still be very profitable, and that strategy has worked for us very well over time.

Leslie Vandegrift: Okay, and then on the overall loan portfolio side, when you look at, not just at the undiscounted collection rate that you guys have in there with the forecasted collections, but on actual net present value of total loan portfolio, purchase and portfolio program, how is that looking right now?

Brett Roberts: I'm sorry I didn't quite follow that.

Leslie Vandegrift: The net present value of the loan portfolio, how has that changed since last quarter?

Doug Busk: I think we have a fair value disclosure in the 10-Q that will answer that question.

Leslie Vandegrift: Okay. Sorry didn't have a chance to go through it all right before. And then, on the same direction there and I apologize if it's right beside that chart. The restructuring that you guys have had on the portfolio, rather on loans done this year or in 2015, et cetera, the more recent vintages. How much of that have you had to restructure already, and people going in to extend the term or reduce rates, we have seen a lot of term changes across the industry. So just curious what you guys have seen.

Doug Busk: We don't extend or rewrite contracts, except where we're required to by law - bankruptcy, SCRA, things like that. So we just don't do that is the answer.

Leslie Vandegrift: Okay, all right, perfect. And then last question, and I apologize if this was asked at the beginning of the call, I got on two minutes late. For the last few months, we have seen the same number of shares registered to sell by the Chairman. Now, we haven't seen that volume come through and they haven't been sold according to filings. But is there a regulatory reason why he has to register that specific number of shares each quarter, even if he has no intent to sell them?

Doug Busk: I know that the Chairman has filed a notice of intent to sell under Rule 144. Unfortunately, I'm not intimately familiar with the requirements under that rule, whether that's something that he needs to re-file periodically, or just what the details are. I do know that that notice has to be filed before the first sale, but unfortunately I can't tell you a lot more than that.

Leslie Vandegrift: Okay. Nope, I understand. Perfect. That's all my questions. Thank you.

Operator: Your next question comes from David Scharf from JMP. Your line is open.

David Scharf: Hi. Good afternoon. I hopped on late, as well. So I apologize if these were asked. One was just a point of clarification. Am I correct in assuming that the last couple quarters, the increase in the average loan size is primarily a mix issue with purchased loans generally being larger, or is it actually something else that's more related to the type of vehicle being bought and the extended term that allows the consumer to afford it on a monthly basis?

Brett Roberts: I think the average loan size is up slightly in both segments. And then the mix accounts for the rest of it.

David Scharf: Got it. Got it.

And another question and this is more qualitative, but I'm wondering do you have any insights into just general discussions of dealer health lately? This is more of an industry macro question for you; if you don't want to comment that's fine.

But as we read more about used car values obviously declining, signs that the consumer may be losing a little bit of steam. As you gauge the overall health and profitability of your dealer network, particularly those independents which are two thirds or more, is there any sense that we may see more attrition over the next few quarters as some of the dealers run into more profit constraints, or is it too early to tell?

Brett Roberts: No. I don't think that's a question I have much insight on.

David Scharf: You don't. Got it.

And then lastly, we obviously have the unit volume metrics in the commentary in October. I'm curious, what about overall application volume. Meaning, are you seeing a change in the -- is the decline in applications being submitted commensurate with the increases and decreases in October of the actual unit volumes you're closing, or are you finding that your approval rates are changing?

Brett Roberts: Speaking just for October, the application volume grew, but not as quickly as it had prior, but I think it's more a function of the number of applications that we're converting into deals.

David Scharf: So your underwriting is conforming to the environment and tightening a bit in October. Got it. Thank you very much.

Operator: Your next question comes from Daniel Smith with Teton Capital. Your line is open.

Daniel Smith: Hi guys, I wanted to clarify your most recent collection estimates. Do they incorporate the higher rate of depreciation that you called out in collateral values?

Brett Roberts: Yes.

Daniel Smith: Okay thank you.

Operator: Your next question comes from Randy Heck with Goodnow Investment Group. Your line is open.

Randy Heck: First, just want to say very nice quarter; pretty much say that every quarter. First question I have is, the ABS deal you guys announced last week, what was the all-in cost, was it 3%? There's three tranches. But how does the cost of that compare to the prior one that you did earlier this year or last year, is it comparable?

Doug Busk: It was. The all in rate including issuance fees was 2.9%. That was about 30 basis points less than the deal we did in May of this year.

Randy Heck: Less okay. Because I thought the cost of capital had been going up so this was even lower. Okay.

Doug Busk: There was a period early in the year where rates had gotten wider, but in recent months the opposite has occurred.

Randy Heck: Okay. And then there were a couple questions earlier about purchased loans versus dealer loans and I'm not quite sure what the confusion was about. But it says it right here on the press release, your advance rate for purchased loans was roughly $0.49 on the dollar versus your dealer loans at $0.42 on the dollar, and correct me if I'm wrong, but the only difference is -- or the major difference is that with purchased loans, you don't have to share the back-end with the dealers. So therefore you pay more up front, but you get to keep everything you collect.

Brett Roberts: Correct.

Randy Heck: Is that essentially correct? And perhaps Brett or Doug you can share with us why some dealers prefer a purchased loan where they are probably in the end getting lower economics than a dealer loan. Other things being equal. Why they choose to sell you a loan.

Brett Roberts: Sure. So I think the primary reason and the reason we identify this as a separate channel is there are dealers out there who are just not as interested in our traditional program. They want all their money up front. Typically with large dealer groups and the largest dealers in the country, what happens is you run into processes in the dealership that just don't allow our traditional program to work.

Sometimes it's accounting-related if they're public, publicly-traded; they don't want to deal with the contingent payment at the end. Other times it's just due to the processes at a large dealership, or the commission structure and the way they pay their salespeople is an obstacle.

Over the years we've tried to overcome those obstacles and stick with the traditional portfolio program. In more recent times, we've decided to say okay, if the dealer doesn't want our traditional program, is there still a way we can get some business done with that dealership. And so that's really was the genesis of the purchase program. And what we found out there is there's a pretty large group of dealers, primarily franchised dealers, primarily larger franchise dealers, that are interested in our purchase program, and, like I said earlier, we just had a lot more success with it this year and the latter part of last year than we would've expected.

Randy Heck: Okay. And how many years have you been doing these purchased loans?

Douglas Busk: We've been doing them for over 10 years.

Randy Heck: Okay. And it's gone pretty well so far. Is that a fair conclusion?

Brett Roberts: I think it's gone pretty well. We like our traditional program. We like the alignment of interest. We like to share in the proceeds from the loan with the dealer. We think that creates a good relationship and aligns everyone's motivation.

So we really like that program but we have to be realistic as well. I mean we're having trouble growing that program right now. That shows up in the numbers. The purchase program, it is a different program for us. We been doing it a long time; it's been at times a significant portion of our business and at other times a lower portion. We'd love to be able to grow both programs, but for right now the purchased loan program is the one that we're having more success with.

Randy Heck: Okay. All right. Thanks so much.

Operator: Thank you. And with no further questions in the queue I would like to turn the conference back to Mr. Busk for any additional or closing remarks.

Douglas Busk: We'd like to thank everyone for their support and for joining us on our conference call today. If you have any additional follow up questions, please direct them to our Investor Relations mailbox at

IR@creditacceptance.com. We look forward to talking to you again next quarter. Thank you.

Operator: Once again, this does conclude today's conference. We thank you for your participation.

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