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 Second 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, Jamie. Good afternoon and welcome to the Credit Acceptance Corporation Second 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 Adjusted 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: Ladies and gentlemen, if you would like to ask a question at this time, please press the star and then one on your touchtone telephone. If your question has been answered or you wish to remove yourself from the queue please press the pound key.

And our first question comes from Tanu Chauhan from Credit Suisse. Your line is now open.

Tanu Chauhan: Thanks for taking my question. I see that you've expanded your purchase program. Just a quick question on purchased loans. How do you reserve for them?

Douglas Busk: We reserve for them the same way we reserve for the dealer loans except for purposes of evaluating impairment; dealer loans are grouped by dealer and purchased loans are grouped by month of purchase. So we evaluate the performance of each pool of loans relative to our initial expectations. If our current expectations are lower than our expectations from a return perspective at origination, we record a provision and establish an allowance to reduce the net carrying value to the point where the yield expected at origination would be maintained going forward.

Tanu Chauhan: Okay, thank you.

Operator: Thank you. Our next question comes from David Scharf from JMP Securities. Your line is now open.

David Scharf: Good afternoon, thanks for taking my questions. First one is just a very high level question which is, how's business?

Brett Roberts: I think the quarter probably summarizes that pretty well, so if you have anything specific, we'll address that.

David Scharf: Well everybody asks, it's a variant of the usual 'explain the competitive environment', so on and so forth, but on a relative basis curious to get your sense for what both end-demand looks like, dealer receptivity looks like, and your assessment of overall consumer health relative to perhaps at the beginning of the year?

Brett Roberts: I think from an environment standpoint pretty much consistent with what we would have said last quarter. Volume per dealer is probably the easiest number to look at just to get a sense for the competitive environment, it was down this quarter, not down a lot but 1.8%. So looking at that number I don't think you can conclude the environment got a lot easier, so I would probably say more of the same, a difficult environment but not changing a lot from last quarter.

David Scharf: Okay, sounds like relatively stable? A question on active dealer counts. It looked like may have been down sequentially?

Brett Roberts: That's correct.

David Scharf: That may have occurred once in the last three or four years, is it just an anomaly, is there something attributed to seasonality, or should we be looking for a new normal in sort of the low 7,000 range as we think about the next four quarters?

Brett Roberts: We had nice growth in active dealers but yes, sequentially second quarter tends to be a little bit tougher of a quarter to grow, but I think you're right that having a sequential decline isn't something that has happened a long time. Attrition was higher this quarter and again we'd probably attribute that to the competitive environment.

David Scharf: Got it. And then lastly, and maybe this is just putting some quantification around your comments about the competitive environment, it looked like this was the biggest variance we've seen in quite a while in terms of the growth and origination volume growing so much more than the unit volume. And it looks like the advance rate per unit went up. It looks like the average term went out a couple of months. Are you finding that because of the competitive environment you have to price a little more aggressively, and should we use the Q2 levels for average term and advance rate as a good benchmark for the near term?

Brett Roberts: We look at pricing, we look at loan performance, we look at where our volume is coming from every quarter or every month, and we make changes where we see opportunities. There was a change in the mix of loans in the second quarter. We did more purchased loans which tend to be larger, and then both within dealer and purchased loans we did a little bit larger loan, little bit longer term. Again that's just based on our pricing algorithms and where we think the best opportunities are.

David Scharf: Got it, thank you very much.

Operator: Thank you. Our next question comes from Kyle Joseph with Jefferies. Your line is now open.

Kyle Joseph: Afternoon, guys, and thanks for answering my questions. Just want to see if your outlook for used car prices, from an equity sales side perspective we see that Manheim has been relatively stable, we track NADA as well, and it looks like there's a lot of moving pieces there where you're seeing relative strength in SUVs and trucks, whereas sedans and whatnot are weaker. Can you give us maybe your sense of pricing for trucks and SUVs versus sedans, and then maybe your outlook on a blended basis as well?

Brett Roberts: We really don't have an outlook for used vehicle prices going forward. We take into consideration anything that's happened to date, but we really think it's very difficult to predict where the prices are going to be. If you think about it, you write a loan today, it's a 50 month loan. The price of the vehicle over the next 50 months is really almost impossible for us to predict. So instead of trying to be experts at predicting the future, what we try to do is just structure our business so that in the event we have periods where our loans don't perform as well we'd like, whether it's because of macro factors or used vehicle prices or the competitive cycle, that the loans that we did write are likely to be very profitable. That's more how we approach it.

Kyle Joseph: All right. Then I'll bridge that to another question. For some of the vintages where the forecasted collections came down a little bit from March to June, would you attribute that to either used car prices or is that more consumer payback behavior?

Brett Roberts: I think used car prices is probably a factor there. I think the competitive environment is the other factor that we talked about last quarter. If you look at that table where we show variance by year of origination, the best performance versus our initial forecast was in 2009; that was a year that was very favorable from a competitive perspective. Since 2009 the environment has gotten more competitive and you can see that positive variance has narrowed, and on 2015 we have, for the first time in a while, a negative variance. So it's really just following the competitive cycle which is pretty much as expected.

Kyle Joseph: Great, thanks very much for answering my questions.

Operator: Thank you. Our next question comes from Robert Dodd with Raymond James. Your line is now open.

Robert Dodd: Hello, guys. On the upward revision in 2016 on expected collectibility, obviously up 40 basis points from last quarter, digging through the numbers it looks like the vast majority of that, if not more than all that, comes from the purchased loan pool from Q1 where expected collectibility went up something north of 200 basis points, it looks like. Can you give us any color on what was so positive about that Q1 purchased pool or the mix in there or any additional color on that improvement? Since it seems like such an outlier compared to some of the other periods when there were some modest downward reductions.

Brett Roberts: You're correct, the purchased loans performed better than the dealer loans for that period. I think it's probably too early to draw any conclusions about how 2016 loans are going to perform. We probably need another quarter or two of seasoning before we start to see numbers that we would want to give you further insight on.

Robert Dodd: Okay, thank you. And then just one more, in the Q [Form 10-Q] there's a new accounting update about ASU 2016-13 which is obviously the credit losses on financial instruments. And you note in the Q that the adoption of that, which doesn't kick in until 2020, or mandatory until 2020, is expected to have a material impact on consolidated financial statements. Can you give us any color of what you mean by material impact?

Douglas Busk: At this point we've only been able to do a preliminary review of the guidance that as you mentioned is effective in 2020. So any comments we make here are obviously subject to change as we go through a more detailed evaluation. Based on our initial review we think the new guidance is going to be an improvement over the current guidance, because both positive or favorable and unfavorable forecast changes are going to be treated the same.

You'll recall that in our current accounting there is asymmetry with positive forecast changes accounted for over time, and negative forecast changes treated as a current period expense. So I think it's going to be an improvement. Exactly what it means for the timing of revenue recognition and impairment, we're still studying that at this point. But our initial take, theoretically, is that it's going to be better accounting which lines up with better with the economics of the business.

Robert Dodd: Thank you.

Operator: Thank you. Our next question comes from Vincent Caintic with Macquarie. Your line is now open.

Vincent Caintic: Good Friday afternoon, guys. Just a broad question and maybe a historical perspective. Your forecasted collection rates have been coming down by vintage for a couple of years, and so have the spreads, and I was wondering historically how low has that gone and what sort of spreads are you willing to go down to and originate at that spread?

Brett Roberts: How low has the spread been historically?

Vincent Caintic: Right.

Douglas Busk: In the last 10 years the lowest the spread's been was 2007, about 21.5%. So that doesn't go back to the beginning of time but it goes back a considerable period of time. We look at it slightly differently than just looking at the spread. We're looking at the combination of economic profit per loan and the volume that we'll write, and we're looking to maximize that equation.

Theoretically, I guess we'd be willing to write business as long as it had a return north of our weighted average cost of capital. Obviously we've never been close to that so that hasn't been a practical consideration, but that's the theoretical answer.

Vincent Caintic: Got it, that makes sense. Maybe to add another dimension to it, between the spread declining and instead taking your capital and buying back stock, how you think about that?

Brett Roberts: I think the first priority is to invest our capital in the business. The returns today are still very, very strong, they're still well ahead of our cost of capital, so that would be our first priority. Then to the extent we have more capital than we think we can invest in the business, we'd consider a share buyback, and for that purpose we have to look at the price of the stock at a time we have that excess capital.

Vincent Caintic: Okay, got it, makes sense. Thanks very much, have a good weekend.

Operator: Thank you. Our next question comes from John Rowan with Janney. Your line is now open.

John Rowan: Good afternoon, guys. Just wanted to follow up on Vincent's question. Instead of talking about the spread, what I wanted to discuss, you just mentioned this, you said as long as our adjusted return on capital is positive, so we're talking about the 7% adjusted return on capital in excess of your capital cost that you reported for this quarter. I know that number's been trending down for quite some time. How do you look at that? Where is the point at which you pull back on volume or is anything north of 0% of that number enough to keep you guys pumping out loans?

Brett Roberts: Two different questions. If the question is at what point would we stop originating, I think Doug was referring to the weighted average cost of capital as the point at which we'd say it's not profitable for us to originate any loans if this is the best we can do.

In terms of how we price though, we're trying to maximize the amount of economic profit that we create in any period. So we look at the sensitivity of volume and the impact of a pricing change on profit per unit, and we try optimize that equation in any given period.

John Rowan: Maybe one question on the competitive outlook. Did you see any bump up in the deals that were coming through when some of the other competitors who really tried to mimic your model, like Go Finance, they started closing up shop, because there are others too that seem to be pulling back from the loan sharing market if you will. Was there a discernible shift in competition at some point surrounding those exits?

Brett Roberts: I don't think so. It's such a big market that what one player does really doesn't impact us so much. It's really just such a large market that as long as the flow of the capital is there, there's going to be plenty of competition, and what one player does isn't going to impact us too much.

John Rowan: Okay, thank you, have a good weekend.

Operator: Thank you, and as a reminder ladies and gentlemen, if you’d like to ask a question at this time, please press star and then one on your touchtone telephone. Our next question comes from David Scharf with JMP Securities. Your line is now open.

Douglas Busk: David?

David Scharf: I'm sorry, I had you muted. Just a quick follow up on the dealer base, can you remind me the general mix between franchise and independent?

Douglas Busk: It's approximately 70% independents, the remainder franchise.

David Scharf: Okay. The attrition in the quarter, was that proportional or was it felt more broadly in the independent base?

Douglas Busk: I certainly haven't looked at that so at this point I'm not prepared answer that question, sorry.

David Scharf: Okay, got it. Thank you. Have a great weekend.

Operator: Thank you. Our next question comes from Ken Bruce with Bank of America. Your line is now open.

Ken Bruce: Thanks, good evening, gentlemen. Hoping you might be willing to discuss what's driving the dynamic behind the higher purchased loan volume versus the dealer loans, what's making that shift occur?

Brett Roberts: As we've talked about before we really view that as a separate channel, so we have our traditional portfolio program with the risk sharing, that's the program that we prefer. But there are certain dealers, typically larger franchise dealers, some of the larger dealers in the country that we just couldn't penetrate with our traditional program. So the purchase program is really a separate channel to target dealers that we know we can't penetrate with our traditional program. So what's driving it is we just have a lot of demand for that program today, we're having a lot of success by expanding that program and that's showing up in the numbers.

Ken Bruce: Is that an outbound strategy from Credit Acceptance or is that just more of where the demand happens to be coming from on the part of these larger dealers? Is there something specific that you've set out to do, or is it just the way that the market is played out?

Brett Roberts: I think it's stuff that we set out to do. We identified it as a separate channel and we started to work on ways to penetrate that channel, and we're just starting to have more success than maybe we thought we would at this point.

Ken Bruce: Okay, great. That was it, thank you.

Operator: Thank you. Our next question comes from Andrew McQuilling with UBS O'Connor. Your line is now open.

Andrew McQuilling: Thank you very much for the time. As you extend the loan duration from let's say 48 months to 53, is there a linear relationship between how the collection comes down? Is it pretty linear? Collection rates?

Brett Roberts: I think that's probably fair.

Andrew McQuilling: And can you give us a sense, five months, how big a difference there is? Just some kind of benchmark?

Brett Roberts: How big of a difference there is in what?

Andrew McQuilling: Well let's say a loan at 48 months, you plan to collect 70, a loan at 53, you plan collect 68, 67, something like that. Does that explain a lot of the decline in loan collections?

Brett Roberts: It's certainly a factor but typically when you go out to a longer term a lot of other things change as well. You probably have a different vehicle so it is hard to say. There's other variables that change as well. But generally speaking the longer the loan, if nothing else changes, the collection rate's going to be lower, and you see that in some of the estimates.

Andrew McQuilling: And then the difference in duration, the returns to Credit Acceptance between a 48 month loan and a 53 all good? All pretty happy? Pretty consistent, I guess?

Brett Roberts: Generally speaking, the yield that we would expect, the revenue yield on a larger loan is going to be a little bit less. The expenses are also less, so all in we'd probably end up in about the same place.

Andrew McQuilling: And one more if I could, just the percentage of purchased loans through franchise dealers, is it 100%, or pretty close to it?

Brett Roberts: No.

Andrew McQuilling: And I only know you only give purchased loans to independents once they've demonstrated that they're good citizens. But do you have a mix split?

Brett Roberts: Nothing that we're going to disclose, but you're correct in your assumption that franchise dealers have greater access to it than the independents.

Andrew McQuilling: And I only know you only give purchased loans to independents once they've demonstrated that they're good citizens. But do you have a mix split?

Brett Roberts: Nothing that we're going to disclose, but you're correct in your assumption that franchise dealers have greater access to it than the independents.

Andrew McQuilling: Terrific and nice quarter, thank you.

Operator: Thank you. Our next question comes from Michael Tarkan with Compass Point. Your line is now open.

Michael Tarkan: Thanks for taking my questions. Just a couple quick ones. Can you help us with the average age of your vehicles right now, where that's been trending? And then how have repo rates been trending? Thanks.

Brett Roberts: Neither of those are numbers that we disclose at this point.

Michael Tarkan: Okay, thank you.

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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