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 First 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, Crystal. Good afternoon and welcome to the Credit Acceptance Corporation First 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 have a question at this time, please press the star and then the number one key on your touchtone telephone. If your question has been answered or you wish to remove yourself from the queue please press the pound key. Once again, to ask a question press star and then one.

And our first question comes from Moshe Orenbuch from Credit Suisse. Your line is now open.

Moshe Orenbuch: Great. Thanks. Doug, Brett, Ken. I was wondering if you could just give us a sense as to your view on the competitive environment? As I look at the release, there's a number of different factors that seem to be going in different directions. You're doing more volume, although some of it coming from the purchased loans, longer loan terms. Can you just gives us a sense as to how you see the current environment?

Brett Roberts: Yes, the environment continues to be difficult. I think the most relevant number in the release to look at is volume per dealer, which was down 3% year-over-year. So we look at that as an indicator of where we stand from a competitive environment perspective. We feel pretty good about our ability to continue to sign up new dealers even when the environment's difficult, so the strong unit volume growth we had for the quarter was really more a function of that than it was any kind of easing in the competitive environment.

Moshe Orenbuch: And how do we relate to the fact that for 2015, the variance relative to your forecast is negative at this point?

Brett Roberts: A couple of points on that. If you look at the table we present, it does a pretty good job of laying out the trends. I think there's a clear trend that we've talked about in the past. We had a very large positive variance in 2009 and the competitive environment was pretty favorable in 2009. Since then, you've seen each year that positive variance narrow until 2015. We now have a negative number.

The other thing to point out in the table is just the trend quarter-to-quarter. Last quarter, we had a little bit of a soft quarter from a variance perspective. It's negative changes, although they're very small. We have negative changes this quarter as well, but they're a bit larger.

The thing the table doesn't do a good job of is putting it all into perspective from a materiality perspective, so we added some disclosure to this release––some numbers that used to be in the Q's and K's, but we pulled them forward to the release to highlight them. That's just the change in the future net cash flows, which is really the number that is most relevant. Although the collection variances all went down this quarter for the 2013, 2014, and 2015 vintages, the total impact to our net cash flow forecast was $6.7 million. If you look at the adjusted earnings, the after-tax amount of $4.2 million is the amount that will be the impact to future earnings, adjusted earnings, of that forecast variance decline in the quarter. So, a pretty modest number.

Moshe Orenbuch: Thanks.

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

Vincent Caintic: Good afternoon, guys. Actually have a question on the regulatory environment. I noticed in the 10-Q that there was a Maryland CID. And I as wondering if there's any consistency with the past CIDs and any update on the status there? And then also, the CFPB put out some rules see on debt collections and I was wondering if there's any impact to Credit Acceptance from that debt collection rule? Thanks.

Douglas Busk: In terms of the Maryland matter, as we disclosed, the subpoena is focused on our repossession and sale policies and procedures in the state of Maryland. Not unusually in these types of matters, we don't really have any insight into why we received the subpoena. We are in the process of providing responsive information to the AG in the state of Maryland. I don't think there's any commonality relative to this and other subpoenas or regulatory actions. I think it's just more evidence of a very heightened regulatory environment out there.

In terms of the collection practices, being in business as long as we have, we've been focused on doing things right from a regulatory perspective. So we assess the CFPB's position on that and really anything else and make changes to our business if we think it's necessary to meet their expectations.

Vincent Caintic: Got it. Thank you. One more from me. The floating yield adjustment was pretty large this quarter and could you remind us how that functions and what that adjustment is designed to adjust? Thanks.

Brett Roberts: On a GAAP basis, we account for changes in forecasted collections by dealer loan pool. If it's a positive change for any individual pool, that's taken over time through revenue. If it's an unfavorable change, we record it as a provision expense. So there's kind of an asymmetrical treatment between positive and negative changes there.

For adjusted earnings, we take both positive and negative changes and take those over time, so the floating yield adjustment differs between the two accounting treatments. Over time, it's a timing difference obviously, so over a long period of time, GAAP earnings and adjusted earnings will be exactly the same. But when we have larger provision expenses, then adjusted earnings gets ahead of GAAP earnings and then the opposite happens when that provision flips around.

Vincent Caintic: Okay. Got it. So the floating yield adjustment is designed to smooth the provisions over the life of the loans rather than taking it upfront immediately? Would that be fair?

Brett Roberts: Yes, smooth and maybe more importantly, just treat positive and negative changes consistently. I think the example we've given in the past is from an economic perspective, if I have one dealer pool that the forecasted cash flows go up by $1,000, and another dealer pool that the forecasted cash flows go down by $1,000, I think most people agree that there's been no change in our economic position. For our GAAP statements, the $1,000 negative change is recorded as a current period expense, whereas the $1,000 positive change is recorded over time. So there's an asymmetrical treatment there. So the floating yield adjustment just treats both positive and negative changes in the same manner.

Vincent Caintic: Okay. Got it. Thanks very much, guys.

Operator: Thank you. And again ladies and gentlemen to as a question please press star and then one. And our next question comes from Robert Dodd from Raymond James. Your line is now open.

Robert Dodd: Hi, guys. Looking at the loan term, obviously in 2016 up to 51, three months, during 2015 or over the last couple of years, that's been expanding modestly but then driving significantly faster, typically volume per dealer, same store sales, whichever way we want to look at it. And that obviously turned slightly negative this quarter, probably competitive. But are we reaching the point of diminishing returns in terms of expanding the loan term that you're offering through your dealers at this point?

Brett Roberts: I think the way we've talked about that in the past is when I joined the Company in 1991 the longest loan term we would do is 24 months. As we got comfortable with our ability to forecast and to price and to track loan performance over time, we decided to experiment with a longer term and so we went from a max term of 24 months out to 30 months.

When we did that, we didn't have any 30-month loans in our portfolio so we had to make an educated guess about how a 30-month loan might perform relative to 24 months. We weren't 100% confident in that guess, so what we did is we piloted it with a small group of dealers. We began to accumulate some data. As we became comfortable that we could forecast loan performance for a 30-month loan, then we began to roll that out as part of our standard program.

Since 1991, we've continued to do that. We're now out to a max loan term of 72 months. We moved from 66 months to 72 months beginning in sort of mid-2014 on a pilot basis, and then rolled that out to all of our dealers in mid-2015, and we approached it the same way as we did back in 1991. We rolled it out to a small group of dealers. We had to guess to some extent because we didn't have any 72-month loans in our portfolio. So we made an educated guess. We're now accumulating the data. We write a very small percentage of our total loans at 72 months, but as we continue to accumulate more data, we'll get more comfortable to write more of that business. The average term might continue to creep up depending on how comfortable we are with that 72-month loan term. We don't have any plans at this point to go out to a longer term than 72 months, so that might mitigate some of the increase going forward.

Robert Dodd: Got it. Thank you. Just on the variance, and you've already explained that, but are you seeing any—geographically, are there any hot spots or soft spots so to speak geographically that you're seeing?

Brett Roberts: Not really. We look at it that way. We look at our loan portfolio really segmented every way you can think of and look for places where that variance is worse than others and we make adjustments on a regular basis. But I don't think we've made any adjustments related to geography at this point.

Robert Dodd: Got it. Thank you.

Operator: Thank you. Our next question comes from Randy Heck from Goodnow Investment Group. Your line is now open.

Randy Heck: Thanks. Brett, I just wanted to follow up on your point about the added numbers you put in this release, the impact on forecast changes on net future expected cash flows of negative $6.7 million, after tax, $4.2 million. So that's the negative adjustment on this year's volume or origination, excuse me, as well as 2015, 2014, and 2013, all in aggregate amounts to $4.2 million going forward over the life of the loan portfolio?

Brett Roberts: That's correct.

Randy Heck: As opposed to an impact on this quarter? And so that's over I guess on average 2.5 years, three years, so that's $0.20 a share from those adjustments, roughly?

Brett Roberts: That's right.

Randy Heck: Okay. And then secondly, some of the expense items, the G&A I think was up a couple million bucks. Is there anything one-timish in those numbers?

Brett Roberts: Expenses are higher seasonally in Q1, and we tried to describe that in the release. From a seasonal perspective, you can think of it as $3 million to $4 million of expenses higher in the first quarter than you might see going forward excluding any unusual items that we might see going forward. I don't like to—there's no real one-time expenses. Every quarter you have things that are a little bit higher than you might have planned for, than you might expect, but those tend to even out over time.

Randy Heck: Okay. All right. Great quarter and speak to you soon.

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

Daniel Smith: Hi, guys. Is there anything that you guys have been able to identify that causes variances versus your model or is it more random or cyclical?

Brett Roberts: Let me speak to that. Everything that we know impacts loan performance that we capture and is data we use in our forecast. So what's left really are changes in the external market. This quarter, as you probably heard in some other conference calls, vehicle values have declined. That contributed to some extent.

And I think just the pattern that tends to follow the competitive cycle is the other thing I would point to. I talked about that earlier. 2009, we didn't have much competition. Your score card tends to perform better when there's limited competition. In 2009 we had a large positive variance. As competition has returned to the market over the last six years, you've seen that variance start to decrease. So it's following that trend that we pointed out many times over the years. So those two things would be the factors I would point to.

Daniel Smith: Okay. So all else equal, same model car and stuff like that, how does that affect the ultimate collection on a loan? Is it adverse selection or what do you think causes that?

Brett Roberts: I think it's probably adverse selection. It's hard to say for sure. I think there's potentially another factor at play which is—in 2009, I think the consumer—if we gave that consumer a loan, they probably had a pretty good sense that if they didn't pay for this vehicle that they probably weren't going to get another loan. When it gets more competitive, I think maybe there's a sense that the customer has other options and maybe if they don't pay for this vehicle, there will be somebody else that might give them a loan. It's hard to know how much is adverse selection and how much is that the factor I just described. But we have seen this play out in other competitive cycles where when competition gets difficult, it becomes a little bit tougher to outperform your forecast.

Daniel Smith: Okay. So should we expect over most cycles that the variance will be positive when unemployment is high and the variance will be negative when unemployment is low? Is that—do you think that's kind of a given?

Brett Roberts: You're talking about unemployment now?

Daniel Smith: Well, I'm just using that as a proxy for a good economy.

Brett Roberts: Right. I think what we're trying to do with the variance is—we want our initial forecast to be accurate. And the reason for that is if you look at a year where we have a strong positive variance, that's the same number we use to price the loans. What that means is we probably left volume on the table that year and we ended up making more per loan than our models would have shown. The opposite is true in years where you have a negative variance, it means you probably wrote a little bit too much volume and your profit per unit was a little bit lower than what your models would tell you is optimal.

So we're shooting for zero and if you look at our history, I think we got now 17 years of historical forecasts that we've published. I think we've only achieved zero one time; that was in 2004. So we're always going to be wrong, but we always approach it the same way where we take all the available information and we try to put the best number we can because that's what gives us the best chance to produce the most profitability in a given year.

I think the other thing to point out is if you look at those last 17 years, and we look at those very closely and see what we can learn from that, I think what you'll learn is it's very difficult to forecast loan performance perfectly. And so keeping that in mind, it's driven a lot of decisions that we've made here because we're cognizant of that. One is we shoot for a higher return on capital than what you would see in the rest of the industry. What that means is if we do have a year or two where you have a negative variance, it still means the loans are very likely to be very profitable.

The other thing that's an advantage for us is the reason that the impact to our net cash flows was only $6.7 million, is a portion of our forecast decline is offset by reductions in dealer holdback. So the way our basic model works, it provides a cushion against years when you may have a negative forecast variance.

And then finally, the other thing we do with that in mind is we keep our balance sheet conservative and we keep lots of available capacity on our revolvers. So when we have a period where loan performance is a little bit tougher than in other periods, we have, again, a large margin of safety. So it isn't a surprise what we're seeing today. It's something we've prepared ourselves for and something that we've considered as we put together our business model.

Daniel Smith: Do you think that it's a fair statement to say that as long as capital is readily available in the industry that the variances will be more likely negative against your model if the model is kept constant and that during the next recession, the variances are more likely to be positive?

Brett Roberts: It depends on what we do to the model. Obviously, we see all the same numbers you do. We're looking at the trends very carefully. We take into consideration how the loans have performed historically and also how they're performing today. Part of what will drive that variance is how good a job we do predicting the future.

Daniel Smith: I'm saying keeping the model constant.

Brett Roberts: If you don't change the model, I think the competitive cycle has a lot to do with the variance. I think macro factors like the unemployment rate would have a lot to do with that variance and I think vehicle values would have an impact as well.

Daniel Smith: Okay. All right. Thank you for your time.

Operator: With no further questions in the queue, I would like to turn the conference back over to Mr. Busk for any closing or additional 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 with you again next quarter. Thank you.

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

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