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 2017 Earnings Conference 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. Good afternoon and welcome to the Credit Acceptance Corporation Third Quarter 2017 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, if you'd like to ask a question, please press star and one on your touchtone telephone. If your questions have been answered or you wish to withdraw yourself from the queue please press the pound key. Once again, if you'd like to ask a question, please press star then one on your touchtone telephone or if your questions have been answered or you wish to withdraw yourself from the queue please hit the pound key.

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

John Rowan: Good afternoon guys. Was there any discernible impact in the quarter from the hurricanes, whether it be on the volume number, which was a little bit weaker versus last quarter, or anything else you'd like to call out?

Brett Roberts: No, not really. We don't do enough business in those areas to really impact the overall numbers.

John Rowan: You didn't even see anything in Texas because that's what about like 7% of your portfolio?

Brett Roberts: It's small. In the affected areas, we looked at it. There may be a small impact, but again, not big enough to affect the overall numbers.

John Rowan: Okay. And just looking at some of the metrics for the third quarter here, it looks like duration's up a little bit. Your average loan size surpassed $20,000, which I would assume is for the first time ever. But the forecasted collection rate was only down about 20 basis points from where it was versus the first half of the year. I mean, are you guys comfortable that, that forecasted collection holds true given the ramp-up in duration and loan size? And is there any reservation now that you've kind of eclipsed the $20,000 mark for the average loan?

Brett Roberts: Yes. I think what you're really asking is do we think our forecast is going to be accurate. And I think the best way to assess that is to look at our historical track record either long term, which is disclosed, or more recently, the clearest number to look at in the release if you want to get a sense for loan performance is just the net cash flow change, which is a positive $5.5 million for the quarter. I view that as basically zero given the size of the cash flows. We're attempting to forecast roughly about $6 billion in undiscounted cash flows, and our estimate changed by $5.5 million. So that tells you the forecasts are stable currently, and if you look at our longer-term track record, you'd see some vintages were a little bit optimistic, sometimes the opposite. But overall, our track record's pretty good there.

Douglas Busk: And then the change in the loan size and the term is just primarily a difference in mix. We've been writing longer-term loans for a long time. So the change in the metrics that we see in '17, or more specifically in the third quarter, is really just a function of mix.

John Rowan: Okay. And then just lastly, I think, correct me if I'm wrong, last quarter, you said that your sales force is up 20% year-to-date. Obviously, you continue to comp negative as far as units go. Can you give us an update if you continue to do any hiring in the sales force, where you are now year-to-date and whether or not all these new hires are actually contributing and you're still losing unit volume?

Brett Roberts: Yes. Through third quarter, we're up -- well, Q3 over last year's Q3, we're up about 30% in terms of the number of salespeople. So as we talked about last time, it's a longer-term play for us to increase the sales force. We don't necessarily expect it to have any impact this year. If you go back and look at our history, the last time we increased the size of our sales force, it took us about two years to roughly double the sales force and then approximately three years after that before productivity got back to where it was when we started the expansion. So you're looking at kind of a five-year process from start to finish. We're not trying to double it this time, but we are increasing its size significantly, and we expect that's something that will play out longer term.

John Rowan: By longer term, you mean -- I'm just trying to get an idea of what the curve is for your sales force to start bringing in productivity. I mean, do we start to see improved productivity next year? I'm just trying to understand because you mentioned two to three years after you doubled the size of the sales force that you got back to where you were, but I would assume that it doesn't take quite that long from a sales force perspective for someone to get up and running and contributing.

Brett Roberts: Yes. I would just use the prior expansion as a guide. All those numbers have been disclosed, you can kind of look at where we were year 1, year 2. I'm just saying it was a five-year process from start to finish. So at this point, you wouldn't expect to have a big impact from that sales force expansion.

John Rowan: Alight. Thank you very much.

Operator: And our next question comes from Moshe Orenbuch from Credit Suisse. Your line is now open.

Moshe Orenbuch: As I'm looking in your release and the Q, you talk about the fact that the collection rates for the loans in '15 and '16 were consistent with expectations at the start of the period, although they started to decline a little bit this year, right? I mean, '15 has been down fairly consistently. '16 was originally written up and then has been written down. And then you're kind of writing '17 up even in the current quarter. And I guess, is there something different that you're doing in '17 that would make that outcome different than in '16 where you initially wrote them up and then wrote them down?

Brett Roberts: Yes. I think the best answer to that is, again, we're trying to forecast $6 billion in cash flows and our total change in our estimate during the quarter was $5.5 million. So I think the takeaway from the release—a reasonable takeaway is that our collection forecasts were very stable for the quarter.

Moshe Orenbuch: Okay. One of the questions that I've gotten from one or two investors, which unfortunately I can't answer, is you've had a mention of the CECL standard and that it would have a material impact on the recording of your reserve. I guess, I'm not really sure how to interpret how that would impact. I mean, have you guys done any work? Could you give us some guidance as to how that would impact you?

Douglas Busk: As we've talked about on prior calls, we've begun our assessment on that. The guidance is extensive and it's complicated, and it's not effective until 2020. Having said that, we're making good progress. We're working with our auditors on it. So when we know more, we'll talk about it. But at this point, we haven't finished quantifying the impact it will have on our financial statements.

Moshe Orenbuch: Yes. But any sense of how it would work, like what you would be—in other words, I believe I understand how you are doing it now in terms of forecasting the cash flows. How would it differ under that standard?

Douglas Busk: I mean, the cash flows are what the cash flows are. In terms of how we account for the loans, I'd really prefer not to comment until we have that all sorted out.

Moshe Orenbuch: Thanks.

Operator: Thanks and our next question comes from Kyle Joseph of Jefferies. Your line is now open.

Kyle Joseph: Thank you very much guys for taking my questions. Some of these have been asked, but digging down a little bit more into the competitive environment, just wanted to get your thoughts on loan volume trends. We've been hearing a lot about big banks pulling back from the auto finance market. I recognize your market may be a little bit more insulated.

But how long does it take for you guys to see the impact of the big guys pulling back before we eventually see it in your market?

Brett Roberts: If there was a pullback, I think we'd see it immediately. Our sense is that the competitive environment hasn't changed that much. You have some players who are pulling back; you have some that are doing the opposite. Our volume per active dealer was down for the quarter versus last year. There are some other factors that play into that, but I don't think there's any evidence, at least in our numbers, that the competitive environment got a lot easier.

Kyle Joseph: Right. Well, I was kind of looking at—your spreads have actually appeared to kind of bottom out in 2015. I was wondering if that was a sign of that. Or is that just some tweaks on your underwriting?

Brett Roberts: Yes. Like I said, there's a few other things going on. I mean, obviously, the one big factor is the changes we made to our initial forecasting a year ago. So late last year in Q3, to address the negative variances that you see on the '15 and '16 business, we lowered our initial forecast for go-forward business. So that's had an impact on loan volume. And the economics of the loans are, I think, on balance a little bit better than they were a year ago. So that's a positive as well. But you have a fairly significant change in volume per dealer. I think when you take all of that into consideration, I think it's difficult to say the competitive environment got a lot easier. But to answer your question, if it gets easier, we'd see it almost immediately.

Kyle Joseph: Got it. Okay. So in the context of that, can you update us on your capital allocation strategies from here in terms of new originations versus share buybacks?

Douglas Busk: We continue to think about it the same way we always have. Our first priority is to make sure we have the capital that we need to fund the business. And if the answer to that question is that we do and we can buy the stock back for a price that we're happy with and is less than we think the intrinsic value is, then we do that. So historically, we've bought back a lot of stock over time, but the pattern of those repurchases has been pretty lumpy.

Kyle Joseph: Got it. And thanks very much for answering my questions.

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

David Scharf: Good afternoon and thanks for taking my questions as well. Brett, I was wondering; maybe a bigger-picture, longer-term question. With the 30% increase in sales headcount, and I guess that's on top of the big expansion you had coming out of the last recession, is there a goal you have in mind for how big you want the footprint to be in terms of dealer count for this company?

Brett Roberts: Not a stated goal. I mean, we're trying to grow economic profit as fast as we can. We do that by expanding. Typically, our expansion has come by adding dealers so that's what we're trying to do. There's historically a strong correlation between how many salespeople we have in the field and how many dealers we're able to add, and so we're just trying to capitalize on that.

David Scharf: Okay. I was trying to get a sense for that dealer count. When we look at 7,700 now in the context of however many 14,000, 15,000 franchise and obviously more independents, I mean, do you have a sort of a top-down view of the dealerships in terms of either regionally or performance-wise which ones you don't have an interest in and what's left in terms of an ultimate target? Just trying to get a sense for whether you view CACC as a 10,000 dealer footprint long term or 15,000 or 25,000 because it's a big ramp in sales force, obviously.

Brett Roberts: Yes. I understand the question. I mean, we're reluctant to sort of give you a stated goal long term this is how big we're going to get. I mean, we're obviously trying to get as big as we're capable of getting, and we think adding to the sales force helps us do that.

David Scharf: Got it. Got it. And in terms of the origination mix, which has been trending more towards purchased loans, are all the purchased loans from franchise dealers? Or do you have equal representation among independents? And I'm trying to figure out kind of who you might be doing more business with as that mix shift continues?

Brett Roberts: Yes. The largest share of those are franchise dealers, what we call national accounts, which are the kind of the largest dealer groups in the country. We allow independents to write purchased loans if they’ve closed a pool of 100 loans on our portfolio program. So once we have some experience with an independent, if that's positive, we'll allow them to access the other program. And then there's a limited number of independents that are allowed to write purchased loans from the beginning. Those are independents that we view as kind of quasi-franchise dealers, working to distinguish them from the traditional independents and we've allowed them to write purchased loans as well. But most of it is franchise dealers and the larger national accounts.

David Scharf: Got it. Got it. And then lastly, just on the credit side. Just curious about any observations you have on consumer health. Obviously, we're still at arguably peak employment. But in terms of any early indicators you look at, such as percentage of missed payments within the first couple of months, things like that, any noticeable change in payment patterns versus a quarter ago?

Brett Roberts: Anything we know and we can capture or see is in our collection forecast. So I'd just point you to that number as being sort of our overall metric. That includes the consumer and their payment patterns and what we see at origination and what we see as the loan moves through the collection process. Typically, we're a little bit countercyclical there. If you look at our historical numbers, if the economy gets a little bit choppy, our collection numbers tend to go up. You'd say, well, how can that be? Well, that's because competition usually eases and we get a different borrower on the origination side. So this is probably the toughest environment that we can be in that we'll face, which is when it's very, very competitive. That gives us a segment of the population that typically other lenders aren't willing to do. And when things get easier, then we get a little bit different mix.

David Scharf: Got it. Thanks very much.

Operator: Thank you and one last time, if you'd like to ask a question please press star then one on your touchtone telephone. If your question has been answered or you'd like to withdraw yourself from the queue hit the pound key. Our next question comes from Leslie Vandegrift from Raymond James. Your line is now open.

Leslie Vandegrift: Good afternoon. Most of my questions have been answered. But I know you didn't want to give guidance exactly yet on the ASU changes to the CECL method on expected losses. Do you have a time line for when you guys are going to know what those accounting changes are, six months, nine months, a year before we'll kind of have an idea of where that's going?

Douglas Busk: Probably sometime in '18.

Leslie Vandegrift: Okay. And obviously, the standard is moving into more expected losses being taken into account rather than just incurred. Do you believe that this is going to be considered a major change for your accounting? Or have you already been doing some of that before?

Douglas Busk: I mean, we said in our 10-Q that it's going to have a material impact on the way our financials are presented. But precisely what that means, it's impossible to say.

Leslie Vandegrift: Okay. Thank you.

Operator: Thank you and our next question comes from Jack Micenko from SIG. Your line is now open.

Jack Micenko: Just one quick follow-up. The story has been, on the positive development, the purchased loans have been trending, it seems, a bit better than expected, certainly this quarter and I think in the prior quarter or two as well. Just curious as what you're attributing that to? It would seem like you maybe were a little more conservative on the view. And as you look back, what's driving that better performance, you think?

Brett Roberts: Yes. I guess, the thing I haven't been able to convey is you just have to look at our net cash flow number. It's a very small number. So I don't think there's any other way to view the numbers other than the collection forecast has been very stable since we made the changes a year ago. So taking that small number and trying to parse it even further, I think, is not a productive conversation to have. The numbers are stable at this point. The dealer loans decreased a little bit. Purchased loans increased a little bit. But on $6 billion of cash flows, it's just not a whole lot of movement to try to explain.

Jack Micenko: Okay. Fair enough. Thanks.

Operator: Thank you and our last question in queue comes from Randy Heck from Goodnow Investment. Your line is now open.

Randy Heck: Brett, I just want to go back to your comment earlier that you noted that the pricing changes that took place; I think it was September of '16 where you reduced advance rates. So for this quarter just reported, your dollar loan volume is basically flat; it's down 0.5%. You said that because of the adjustments and also the collection performance so far this year, I think you said you've written better business. Can you quantify how much more profitable the business you did this quarter is, the September '17 quarter versus the September '16 quarter? Is that something that is quantifiable? I mean, obviously, earnings are up 20% year-over-year, but that has something to do with the prior couple years of production. But if we could just isolate the third quarter this year versus last year?

Brett Roberts: Yes. All those numbers are in the Q. So there's real good disclosure that shows the average advance, the expected cash flows, the accretable yield is what we call it in the Q per contract. I know we were up Q3 versus same quarter last year in terms of the total accretable yield that we generated. I want to say it's somewhere between 0% and 5%. I don't have the number written down. But it's all in the Q. So we had modest growth in terms of the expected future revenue. And again, anytime you look at those numbers, you want to be cautious that those are assuming we hit our initial forecast exactly. Obviously, any of those numbers will change to the extent that we have variances going forward.

Randy Heck: Okay, terrific. And thanks again for a great quarter.

Operator: Thank you and with no further questions in the queue, I'd like to turn the conference back over to Mr. Busk for any additional or closing remarks.

Douglas Busk: We would 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: Ladies and gentlemen, this does conclude today's conference. We thank you for your participation.

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