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Q2 2023 Credit Acceptance Corp Earnings Call

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Kenneth S. Booth *Credit Acceptance Corporation - CEO, President & Director*

CONFERENCE CALL PARTICIPANTS

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John J. Rowan *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*
Raymond Cheesman *Anfield Group, LLC, Asset Management Arm - Analyst*
Robert Henry Wildhack *Autonomous Research US LP - US Capital Markets Specialty Financials Analyst*
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PRESENTATION

Operator

Good day, everyone, and welcome to the Credit Acceptance Corporation Second Quarter 2023 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 Chief Treasury Officer, Doug Busk.

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Thank you. Good afternoon, and welcome to the Credit Acceptance Corporation Second Quarter 2023 Earnings Call. As you read our news release posted on the Investor Relations section of our website, at ir.creditacceptance.com, and as you listen to this conference call, please recognize that both contain forward-looking statements within the meaning of federal securities laws.

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.

Our GAAP and adjusted results for the quarter include:

A decrease in forecasted collection rates, which decreased forecasted net cash flows by $89 million, or 0.9%, compared to a decrease in forecasted collection rates during the second quarter of 2022, which decreased forecasted net cash flows by $43 million, or 0.5%. The $89 million decrease this quarter included the impact of an adjustment to our forecasting methodology, which decreased our estimate by $45 million, or 0.5%.

In addition, forecasted net cash flow timing slowed, primarily as a result of the decrease in consumer loan repayments to below-average levels. Changes in the amount and timing of forecasted net cash flows are recognized in our GAAP results in the period of change through provision for credit losses and in our adjusted results, prospectively over the remaining forecast period of the loans through finance charges.

Unit and dollar volumes grew 12.8% and 8.3%, respectively, as compared to the second quarter of 2022. The average balance of our loan portfolio on a GAAP and adjusted basis increased 4.3% and 8.6%, respectively, as compared to the second quarter of 2022.

The initial spread on consumer loans assigned increased to 21.2%, compared to 20% on consumer loans assigned in the second quarter of 2022. Adjusted net income decreased 26% in the second quarter of 2022 to $140 million. Adjusted earnings per share decreased 23% from the first quarter of 2022 to $10.69.

At this time, Ken Booth, our Chief Executive Officer; Jay Martin, our Senior Vice President, Finance and Accounting, and I will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Arjun Tuteja from Jarislowsky, Fraser.

Arjun Tuteja ***Jarislowsky, Fraser Limited - Research Analyst***

Ken, you assumed the CEO position approximately two years ago. Could you discuss a couple of things? First being, what has been your strategic focus during the past two years? And second, what are your expectations regarding your areas of focus for the upcoming years?

Kenneth S. Booth ***Credit Acceptance Corporation - CEO, President & Director***

Yes. Our long-term strategy here really has been the same as it was even before I took over. We're trying to build a better business. We're trying to increase intrinsic value. And we do that really by continuously growing our dealer base and our loan base and doing that in a way that we get acceptable returns on those loans. I wouldn't say much has changed. There are obviously different strategies that we use to try to do that. I'm not going to really go into the actual strategies that we use, but ultimately, it's the same thing we've been trying to do for a number of years here.

Arjun Tuteja ***Jarislowsky, Fraser Limited - Research Analyst***

I agree, but I'm just thinking that with Brett leaving and you coming on, have there been some changes maybe culturally or strategically? Or do you think nothing has changed at all?

Kenneth S. Booth ***Credit Acceptance Corporation - CEO, President & Director***

We're investing more in technology. We're trying to do some things that make our product more valuable to the dealers and the consumers, but right now, we're in the investment stage. I'm not sure we've seen any returns on that yet. We're hoping to in the future. I would say probably one of the bigger things that we've done is invest in the technology.

Operator

Our next question comes from the line of John Rowan from Janney Montgomery Scott.

John J. Rowan ***Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance***

Can you discuss a little bit more as to what the change in forecasting methodology means? Trying to get a handle on if it's just the change in the slope of the collection curve or if it's something else that is away from the historical model?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

The change to the absolute amount of forecasted collections was really just due to us incorporating more recent loan performance data in our forecast. We're always looking at the historical performance of loans with similar attributes, and this quarter we updated our forecast enhancement by including more recent loan performance data.

John J. Rowan ***Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance***

Okay. So there is no real wholesale shift though?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

No, I don't think so. I mean it's a similar methodology, just updated.

John J. Rowan ***Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance***

Okay. And then I guess just trying to read between the lines, you talked about some collections being below-average. Where are the loans marked now? Would you consider the cash that you're looking to come out of the portfolios reverting to the mean over time? And the current marks are below-average? I'm just trying to understand if you were being cautious enough previously and how cautious you are going forward? Are you below historical averages now on the portfolio marks going forward?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Well, I think we used the term below-average relative to the prepayment rate. That's another thing that happened during the quarter. The timing of our collections slowed, and it was really just due to continued decline in prepayment rates for the quarter that were below the historical average. The words below-average really relates to the timing of the cash flows, not the absolute amount. I will say every quarter, we try to put our best estimate on it. I think the forecasted cash flows that we have on the books at June 30 is our best estimate of what's ultimately going to transpire.

John J. Rowan ***Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance***

Okay. And then just to touch on the competitive environment a little bit. I was hoping you would talk a little bit about what you're seeing out of the smaller competitors in your space? Are they retrenching? And again, I want to go down market a little bit here with the guys that you compete with. How is their funding looking? And just trying to understand where you sit? Competitively speaking.

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

The market for used vehicles financed to subprime consumers is very large and very fragmented. The top 5 industry participants account for maybe 25% of the business, the top 20, somewhere around 50%, but the other 50% consists of hundreds if not thousands of firms. I don't really have terribly insightful observations about what's happening at any individual competitor. I think it's still fair to say that the competitive environment is more favorable than it was 12 or 15 months ago.

Operator

Our next question comes from the line of Robert Wildhack from Autonomous Research.

Robert Henry Wildhack ***Autonomous Research US LP - US Capital Markets Specialty Financials Analyst***

Doug, just on that last point. When you say the competitive environment is more favorable than it was 12 or 15 months ago, that means more favorable, i.e., better for Credit Acceptance?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Correct.

Robert Henry Wildhack ***Autonomous Research US LP - US Capital Markets Specialty Financials Analyst***

Great. And then I wanted to ask about the 2022 vintage. Expected collection is there now 3.2 percentage points below the initial forecast, which is a very significant delta for you historically. What is it about that vintage that's performing so poorly?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Simply put, the loans are just performing worse than loans with similar characteristics have historically. What we saw this quarter is a continuation of the trend that we observed in the last three quarters of 2022. We didn't see that trend in the first quarter. It's difficult to say why. It could be unique seasonal factors that occur during tax season, but it's a continuation of the trend that we saw for most of 2022.

It's impossible to say exactly why this has occurred, but it's probably due to a few factors. The early '22 loans were originated in a pretty intense competitive environment, which generally hurts loan performance. We've seen some decline in used car prices. As we know, I think inflation, though it has moderated, has an impact on the subprime consumer. I think that all those things are probably contributing to the relatively poor performance that we've seen on the '22 originations.

Robert Henry Wildhack ***Autonomous Research US LP - US Capital Markets Specialty Financials Analyst***

Sorry, just one more, if I could. The provision for new loans this quarter was less than $1,000 per unit, and that's the second quarter in a row where that's been pretty low historically because I think it's usually like $1,300, $1,400, $1,500. Does that mean you've tightened the underwriting criteria at all?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

No, it's just due to the mechanics of the calculation. What drives the upfront provision is just a difference between the contractual and expected yield. The expected yield will be what we expect to earn based on the forecasted cash flows at origination. The contractual yield is just what the yield would be if the customer made all the payments on time. We've seen a higher initial spread on the recent loan originations, which has reduced the difference between the contractual and expected yields, and that's resulted in a decline in the provision that we record when we originate a loan; a bit of a mechanical answer.

Robert Henry Wildhack ***Autonomous Research US LP - US Capital Markets Specialty Financials Analyst***

Okay. And lower difference between contractual and expected equals a lower provision, all else equal?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

That's correct.

Operator

Our next question will come from the line of Vincent Caintic from Stephens.

Vincent Albert Caintic ***Stephens Inc., Research Division - MD & Equity Research Analyst***

First one on the prepayment rates and the adjustment there. You highlighted that it had to do primarily with the timing of the cash flows and not the change in the absolute amount. I would think that lower prepayment speeds may be a positive in the sense that if the loan lasts for longer, you're able to charge more and you're able to get more interest income so there might be a higher lifetime value to that loan. I'm just curious how that works-your thoughts on that, and how that maybe works mechanically, where maybe you're collecting more interest income, but your forecasted collections come down.

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Yes. That may in fact occur where the loan doesn't prepay and you end up collecting more than you otherwise would because generally, the people that prepay are the ones that were fairly likely to repay their loan in full anyway, i.e., they are the more creditworthy customers. The amount of the provision is the amount required to reduce the net asset value, so gross loan less the allowance for credit losses to the discounted value of future net cash flows, so collections less dealer holdback. And that discount rate is in the neighborhood of 20%. If you have a longer stream of cash flows and you're discounting it back at 20%, it's easy to see how that could result in an increase in provision, even if on certain loans you might be forecasting more total collections.

Vincent Albert Caintic ***Stephens Inc., Research Division - MD & Equity Research Analyst***

Okay. That's helpful. And that illustrates the timing differences, so I appreciate that.

Second question on the spreads or the yields. You talked a little bit earlier about the competitive environment easing a bit. Are you able to talk about the pricing that you're able to charge the consumer? Any change on that in terms of improving spreads?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

We don't really price our products by varying the interest rate on the retail installment contract with the consumer. We price our product to maximize the amount of economic profit that our loans originate. So economic profit per loan times the number of loans we originate. Obviously, one of the things that determines the amount of economic profit per loan is just the relationship between what we expect to collect and what we pay for the loan at origination. As you can see, we had a little higher initial spread this year than we had last year, but we're pricing to maximize economic profit and there's a lot of things that go into that, including our cost of capital and timing of the cash flows and expenses and things like that.

Vincent Albert Caintic ***Stephens Inc., Research Division - MD & Equity Research Analyst***

Okay. And then last one for me. Nice to see the active dealer counts and the activity growing year-over-year. Anything you can share in terms of the discussions you're having with your dealer customers in terms of what might be driving the increased engagement and increased volume you're getting from the dealers?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Yes. I mean I think the competitive environment that I mentioned earlier likely has something to do with it. I think the fact that we're originating more higher-quality loans has something to do with it as well. I think it's fair to say that interest from dealers has increased over the course of the last 12 months. I think it's primarily due to those two factors.

Operator

(Operator Instructions) Our next question comes from the line of Ray Cheesman from Anfield Capital Management.

Raymond Cheesman ***Anfield Group, LLC, Asset Management Arm - Analyst***

Doug, when you just mentioned a minute ago, higher-quality loans, does the better competitive environment referenced earlier mean that you get more volume at, let's call it, a static FICO score? Or has it allowed you to actually move up market slightly while maintaining your economics?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

That's a complicated question, especially after three years of the pandemic. We are originating a higher credit-score customer. Part of that is just due to the fact that elevated used car prices and inventory shortages have caused it to be very difficult for the deeper subprime consumer to purchase vehicles in certain respects. We've seen an increase in the credit quality of our bread-and-butter business, if you will, due to that phenomenon. Those returns are expected to be consistent with what we expected five years ago or so.

The other thing that's contributing to an increase in credit quality is we've intentionally rolled out a program targeted at a little higher credit-quality borrower. The idea behind that program is to provide us with incremental volume. Now that incremental volume is at a return that's somewhat lower than our bread-and-butter business, but still above our cost of capital. That's the conceptual thinking behind it. Obviously, whether those statements about returns prove to be true will be dependent on loan performance.

Raymond Cheesman ***Anfield Group, LLC, Asset Management Arm - Analyst***

Along the same lines, I believe I saw it in the press release that it said that when consumer credit tightens, prepayments slow. And then we also have the phenomenon that the '22 class was the last group that bought with kind of the 68% used car value surge that gets talked about in the press a lot. And now of course, that's rolling over. When you say that you updated your loan assumptions during the quarter, I'm guessing those were some of the things you took into account so that we shouldn't see another one of those in, say, Q3 or Q4, or do you rethink things every single quarter? You said you make your best guess.

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

Yes. We think we've put our best guess forward here. We're using more recent loan performance data, and we're comfortable with our forecast. But obviously, if you look at our track record, we're never perfectly accurate. Sometimes the loans perform better than expected and some perform worse. We'll periodically adjust our models and update our assumptions, but we're putting our best foot forward here.

Raymond Cheesman ***Anfield Group, LLC, Asset Management Arm - Analyst***

Can I ask just one more? Do you guys do electric vehicles or have any plans to?

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

We do electric vehicles, not a significant amount of them, and the chief barrier there is just price. It creates affordability issues for our targeted customer.

Operator

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

Douglas W. Busk ***Credit Acceptance Corporation - Chief Treasury Officer***

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

Once again, this does conclude today's conference. We thank you for your participation. Everyone, have a great day.