

Credit Acceptance Corporation

Moderator: Doug Busk
April 29, 2010
4:00 p.m. CT

Operator: Good day everyone, and welcome to Credit Acceptance Corporation's First Quarter 2010 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. Please begin.

Doug Busk: Thank you, Shawn. Good afternoon and welcome to the Credit Acceptance Corporation First Quarter 2010 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.

This afternoon, Brett Roberts, our Chief Executive Officer, and I will provide some comments relating to our operational and financial results as well as our liquidity position. After we've concluded our prepared remarks, we have set aside some time for questions.

To assist us in answering your questions, we also have Ken Booth, our Chief Financial Officer, with us today.

At this time, I'd like to turn the call over to Brett.

Brett Roberts: Thank you Doug and thanks to everyone who has joined us this afternoon.

In our earnings releases, we report both GAAP and adjusted results. Internally, we focus almost exclusively on adjusted results as we believe the adjusted results more closely reflect our true economic performance. The results I will refer to in the next few minutes are all on an adjusted basis.

For the most recent period, we earned \$35.5 million compared to \$24.7 million for the same period in 2009. Earnings per share were \$1.12, a 41.8 percent increase over the 79 cents reported last year.

We think about our results in terms of the amount of capital invested in the business and the return we earn on that capital. Average capital invested for the quarter was just over \$1 billion which is up 1.4 percent from the prior year same period.

Although we intend to grow the size of our business over time, growth was not the reason for our strong results during the quarter. Instead, our results improved because we improved the return on capital.

For the quarter, our after tax return on capital was 17 percent compared to 12 percent for the same period of 2009. As we discussed in the release, our return on capital improved as a result of higher yields on our loan portfolio

and, to a lesser extent, lower operating expenses. The higher yields are a result of both favorable pricing and strong loan performance.

Our primary financial performance metric is economic profit. Economic profit is a function of three variables, the return on capital, the cost of capital, and the amount of capital invested.

Our incentive plans are based on growing economic profit. Growing economic profit requires us to either improve the spread between our return on capital and the cost of capital or grow the amount of capital invested. Over the last nine years, we've been successful at both growing the amount of invested capital and improving the spread between our return and cost of capital.

As a result, economic profit improved from a negative \$5 million in 2001 to a positive \$79 million in 2009. During the most recent period, economic profit was \$23 million, a 54.7 percent increase over the \$14.9 million reported in the same period of last year.

As I mentioned in our last conference call, if we are successful in growing economic profit in future periods, it is much more likely to come from increasing the size of our business rather than from increasing our return on capital. The return on capital produced in the most recent period is at the high end of our historical range and reflects a very favorable competitive environment that is not expected to continue. In fact, in late 2009 and so far this year, we're seeing competition return to the market as capital is now less constrained than it was during 2008 and much of 2009.

In both the fourth quarter of 2009 and during the most recent quarter, we have made pricing changes that have reduced the return we are earning on new business in exchange for more volume. The objective of these pricing changes is not to achieve a fixed growth target but instead they are intended to maximize the amount of economic profit we generate on new originations.

This requires us to appropriately balance unit volume and profitability per unit. We are confident that the pricing changes we have made thus far have been consistent with this objective. Our ability to grow economic profit in the

future will depend in large part on to what degree competition returns to the market.

At this time, Doug will provide some additional comments on our operating and financial results, as well as on our liquidity position.

Doug Busk: Thanks Brett. The first thing I would like to discuss is consumer loan performance.

Consumer loan performance is one of the most important variables that determine our financial results. The most important time to assess consumer loan performance is at the time of origination since that is when we determine the amount of the advance to the dealer. If we're able to accurately assess consumer loan performance at the time the loan is originated, we will likely attain our target return on capital and produce acceptable financial results.

Since assessing consumer loan performance at the time of origination with precision is difficult, we set advance rates so that even if the loan performance is less than we expect the loans that we originate are still highly likely to be profitable.

Overall, consumer loan performance for the three months ended March 31, 2010 was consistent with our forecast at December 31, 2009. Forecasted collection rates for loans originated in 2009 increased while the forecasted collection rates declined slightly for loans originated during 2007 and 2008.

Moving to loan volume. The dollar and unit volume of consumer loan originations increased 21.6 percent and 11.2 percent, respectively, during the first quarter of 2010 as compared to the same period in 2009. These increases were due primarily to pricing changes implemented during the last four months of 2009 and the first quarter of 2010.

Moving to financial results. We recorded strong financial results for the first quarter of 2010. We reported consolidated GAAP net income of \$32 million or \$1.01 per diluted share compared to net income of \$29 million or 93 cents per diluted share for the same period in 2009.

As Brett mentioned, we also disclosed adjusted financial results. We do so to help shareholders better understand our financial performance. Our adjusted results include several adjustments to our reported GAAP results. An explanation of each of these adjustments is contained in our earnings release.

On an adjusted basis, consolidated net income for the quarter was \$35.5 million or \$1.12 per diluted share compared to \$24.7 million or 79 cents per diluted share for the same period in 2009. The increases in both GAAP and adjusted net income for the quarter were due to an increase in the yield on more recent consumer loan originations and, to a lesser extent, a reduction in operating expenses.

Partially offsetting this was an increase in interest expense due to an increase in our pretax cost of debt as a result of the \$250 million senior notes offering completed on February 1 of this year and the impact of fixed fees on lower average outstanding debt balances during 2010.

In addition, our GAAP results were negatively impacted by an increase in the provision for credit losses. The provision for credit losses increased to \$6.4 million for the quarter ended March 31, 2010 from \$164,000 for the same period a year ago. Under GAAP, when forecasted future cash flows decline relative to the cash flows expected at the time of a loan origination, a provision for credit losses is recorded immediately as a current period expense and a corresponding allowance for credit losses is established.

For purposes of calculating the allowance, dealer loans are grouped by dealer partner and purchased loans are grouped by month of purchase. As a result, regardless of the overall performance of the portfolio of consumer loans, a provision can be required if any individual loan pool performs worse than expected.

During the most recent period, overall consumer loan performance was consistent with our expectations at the start of the period. However, a \$6.4 million provision for credit losses was recorded consisting of \$3.4 million related to specific dealer loan pools and \$3 million related to certain

purchased loan pools that experienced a decline in forecasted cash flows during the period.

The last topic I want to discuss today is our liquidity. As a result of the securitization completed in the fourth quarter of 2009 and the senior note offering that was completed in the first quarter of 2010, we are in a very strong liquidity position.

We have two revolving credit facilities that we hope to renew in the near future. If we are successful at renewing these facilities, we believe that we'll have the capital that we need to consistently grow our business and will consider returning excess capital to shareholders as we have in the past.

And now, I'd like to turn it back over to Brett.

Brett Roberts: Thanks Doug. This concludes our prepared remarks for this afternoon. We would now like to welcome your questions.

Operator: Thank you. Ladies and gentlemen, if you have a question at this time, please press star then 1 on your touchtone telephone. If your question has been answered and you wish to remove yourself from the queue, you may press the pound key. Again, ladies and gentlemen, to queue up for a question, please press star then 1 on your touchtone telephone. One moment for the first question.

Operator: Again, ladies and gentlemen, to queue up for a question, please press star then 1.

Our first question comes from Brett Johnson with Rocket Capital.

Brett Johnson: Hey gentlemen.

Male: Hi.

Operator: Your line is open.

Brett Johnson: Right. Hey gentlemen, good quarter.

Doug Busk: Thank you.

Brett Johnson: I have a couple of questions -- couple of housekeeping questions related to the P&L and then a couple other more general items.

In terms of expenses, can you comment on -- I know you had some lower items in operating expenses. Can you comment on why that was such a large change from last quarter or Q4?

Brett Roberts: I don't know that it was such a large change. I guess, we've been sort of trending downward in terms of operating expenses. We look at that as a percentage of capital. For the first quarter, we are at 10.9 percent, last quarter 11.2.

The second quarter of '09 was 10.7 percent, so we kind have been in that range of around 11 percent. It's going to vary a little bit from period to period, and then what we would like to see going forward as we start to grow the amount of capital that we get some leverage into that number.

Brett Johnson: OK. I guess, I was looking specifically at your G&A line. Q4 it was \$7.6 million and it dropped down to 6.5, so that's a normal kind of occurrence then?

Brett Roberts: Yes, it's going to fluctuate from period to period. We could answer that in the Investor website if you want to know what exactly was in the number for Q4 which looks like the outlier to me.

Brett Johnson: OK, OK. That's helpful.

Operator: Our next question comes from William Matthews with Post Advisory.

William Matthews: Hey guys. Could you just give us a little color around the disclosure you have regarding change in consumer loan unit volume and active dealers that consumer loan volume from new dealer partners dropped a little bit?

And I don't know if that's significant or it dropped quite a bit down 21 percent. Is that significant or how should we look at that if you calculate this attrition rate? What should we take away from this?

Brett Roberts: What we're doing there is we have a strategy to try to be more selective about the dealers we're enrolling in the program. And the reason that we're doing that is we didn't like what we are seeing in terms of dealers enrolling in the program and then not being successful, so we're trying to slow ourselves down, select the right dealers and have a higher percentage of the dealers that join our program achieve success.

So what you're seeing there, is -- and we'd like to be able to accomplish that without seeing lower volumes, and so far we've been unsuccessful at that so we're trying to have a lower failure rate, if you will, on new dealers and we're still a lot of work internally on how we achieve that and still get the volume that we'd like to get from new dealers.

William Matthews: Got it, OK. And then despite those numbers, kind of, year-over-year being down, what you talked about in the release was that the strategy you kind of embarked on was a reduction in pricing to favor higher volumes that you instituted the end of '09 and in the beginning of 2010.

And is that resulting in a market share increase that you guys are getting or just more people are grasping the concept of going out to use your product to finance the purchase?

Brett Roberts: What we mean by pricing changes is we adjust the advance that we give the dealer at the time of the origination, so the higher the advances the more volume we're going to get, the lower the advances the less volume we'll get. So now that we have capital and we're ready to grow the business, we've increased advance rates and that has, in fact, resulted in higher volumes.

Does that mean higher market share as well? Yes, for sure because the overall market isn't changing that much. So we advance more to drive higher volume. It's as simple as that.

William Matthews: OK. You're advancing more to drive higher volume but your return on equity and return on capital also increased. So is that a function of just kind of the loans you made in the past collecting above what you thought they would make or...

Brett Roberts: Yes, there's the timing issue there you have to be cognizant of. The new loans we're making now, we expect those have about a 3 percent lower yield than the loans that are on the books right now.

William Matthews: Right.

Brett Roberts: So as the new loans, you know, replace the old loans, you will see the yield on the portfolio decline so that will affect the yield by 3 percent or the after tax returns by 2 percent. And then we think we can make up some of that as we grow capital, we'll achieve some operating efficiencies so the impact on the after tax return on capital will hopefully be less than the 2 percent number I just gave you.

And then the most important thing to remember is the loan performance will have a lot to do with whether the actual impact on revenue is 3 percent or some other number. If we can continue to outperform our initial estimates with the 3 percent, it could be much less than that, and of course, the opposite is true as well.

William Matthews: OK, that's very helpful. Thank you.

Operator: Again, ladies and gentlemen, if you have a question, please press star then 1. Our next question comes from Randy Heck with Goodnow Investment.

Randy Heck: Thank you. Brett, on the last call or the last release, you guys indicated that January, despite adjustments in pricing or advance rates, January was off to a minus 7 start. I can't remember if it was the whole month or just a couple of weeks. But can you -- are you comfortable talking about how the quarter tracked? And perhaps try to explain why it was negative 7 in the early going? Thanks.

Brett Roberts: In January, was actually, I think, minus 5 from a unit volume perspective. February was positive 12 and March was positive 20.

A couple of things there, one, we made a pricing change in February which had a positive impact on February and March, and we also think the tax

season was a little slower this year than it was last year, so January was worse than it would have been were it not for that factor.

Randy Heck: OK. That's it. Thank you.

Operator: Our next question comes from Brett Johnson with Rocket Capital.

Brett Johnson: Hey guys. I had a couple more questions. Can you make any comments on your average loan size in the quarter?

Brett Roberts: Average loan size was up about 10 percent.

Brett Johnson: OK. And then in terms of the provision for loss, you said that you had -- \$3.4 million was related to one piece and then \$3 million was related to another. Is that a little higher? So the \$6.4 million, is that may be a little high run rate for the year? Or is that something we should look forward in the other quarters going forward?

Brett Roberts: I think the best advice we can give you there, is to focus on the adjusted results and that's what we look at. The provision has been volatile...

Brett Johnson: Right.

Brett Roberts: ...and it's tough to predict. It's a mechanical calculation, and it can result in a large provision even when consumer loan performance is in line with our expectations. So that's why we give you the adjusted numbers, just a little bit easier way to think about the business.

Doug Busk: Again, over time, the adjusted results and GAAP results, result in the same level of earnings. It's all just timing and eliminates -- you know the inconsistent way in which GAAP treats positive and negative adjustments to forecasted cash flows.

Brett Johnson: OK. That's all I have.

Operator: With no further questions in the queue, I would like to turn the conference back over to Mr. Busk for any additional closing remarks.

Doug Busk: We'd like to thank everyone for their support and for joining us on our conference call today. If you have any additional followup 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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