Specialty finance
Opportunities for transformative deals

September 2014

Non-bank lending continues to thrive

Specialty finance companies provide funding to consumers and businesses for a variety of uses, such as (i) used or new automobile sales, (ii) equipment finance, (iii) aircraft, rail, container and other transportation leasing, (iv) credit card offerings, (v) education loans to students, (vi) payday cash advances, and (vii) other specialty offerings which include purchasing and financing of future payment streams, asset-based financing and other specialty lending.

These specialty finance companies have continued to be an attractive target for various strategic and private equity buyers. The specialty finance market has experienced more transformative deals in the last two years, such as acquisitions of International Lease Finance Corporation (ILFC), PHH Vehicle Management Services, Progressive Financial Holdings, LLC and Ally Financial Inc. businesses, indicating a strong M&A appetite for acquiring these types of institutions. From analyzing recent trends in the market, we expect to see an increase in the volume and value of specialty finance deals in the second half of 2014.

Overall industry trends

Auto finance

• Favorable macroeconomic factors seen – Continued low interest rates and increasing credit availability are keeping the demand for both new and used vehicles high. Additionally, improvements in the US economy, unemployment rate and household debt/income ratios are continuing to allow consumers to take on new borrowings. This market trend has resulted in auto loan outstanding balances to be at the highest level since 2007 and the loan default rates are at historic lows.

• Captives driving banks from new car market – Increased lending by automakers (combined with subsidies from manufacturers, lower monthly payments and extended loan terms) has resulted in major banks increasing their investments into riskier parts of the auto market to gain market share, increasing non-prime market lending from 16.2% in 4Q2012 to 24% in 1Q2014.

• Loan amount, term and average monthly payment hit record highs – Average auto debt outstanding per borrower and average loan terms have increased, resulting in higher average monthly new-vehicle payments for the borrowers.

• Lenders loosen standards – Lenders are willing to take on more credit risk for new car loans to the subprime segment. Credit scores for borrowers have reached the lowest level since 2007.

Equipment finance

• Banks and equipment finance independents collaborate – To diversify, banks are also buying a growing number of asset pools from independent equipment finance companies, but the focus is prime investments. Independents are more focused on subprime and providing service to the clients that banks cannot match. Banks are also dealing with regulation and scrutiny which is an advantage for independents.

• Increased truck orders – Truck orders have reached an eight-year high due to rising cargo rates and increased confidence to expand existing aged fleets. Active truck utilization has also stayed close to capacity due to an increase in the amount of cargo being transported.

Rail-car leasing

• Boom in oil production benefits rail-tank car leasing – Rail-tank car leasing companies are benefitting from the current boom in oil production in the US and Canada because soaring demand is allowing them to extend the length of contracts and raise prices. Further, scarcity of pipelines and the increase in shale oil have made tank cars the transportation of choice, thereby driving up their demand.

• Increasing lease rates and lengthening lease terms, high utilization – The high demand for tank cars in North America has resulted in increasing lease rates and lengthening lease terms. The demand continues to be weak for certain freight-car types, such as coal, resulting in keeping terms shorter. Utilization rates have remained strong.

Other specialty finance

• Growth in asset-based lending (ABL) – Continued growth in the use of ABL is expected for not only refinancing needs but also supporting business investment in acquisitions and new projects for corporates. There has also been a pronounced growth in ABLs secured by intangible assets, such as intellectual property, which is expected to continue.
M&A activity

- The two largest disclosed deal values in 2013 and 2014 were related to equipment lenders. AerCap Holding N.V.’s acquisition of ILFC, for a total consideration of $7.6b, will transform AerCap from a small second tier player in the business into the second largest aircraft leasing company in the world. GE will remain the largest aircraft leasing company through GE Capital Aviation Services (GECAS). Element Financial Corporation acquired PHH’s leasing business for $1.4b, positioning the company both financially and strategically to expand its domestic fleet management business into the US markets.

- Between January 2011 and June 2014, 64% of all deals were completed by strategic acquirers and 36% by private equity (PE) acquirers (which include Prospect Capital Corporation, Apollo Global Management, Blackstone Group and Carlyle Group).

- Although the majority of deals involved small-to mid-sized businesses, average deal size in equipment and other specialty finance sectors (excluding three deals over $1.0b) increased from $68.7m in 2013 to $264.9m in 2014.

- In auto finance, two significant deals at the end of 2012 (for a total disclosed deal value of $8.0b) were from the sale of Ally Financial businesses to General Motors and Royal Bank of Canada.

- Deal activity in the payday lending sector decreased due to ongoing regulatory uncertainty. The two largest deals in the sector were Grupo Elektra S.A. de C.V.’s acquisition of Advance America (the largest payday lender in the US) for $659.1m in 2012, and the acquisition by Lone Star Global Acquisitions (a PE fund) of DFC Global Corp. (an international non-bank provider of alternative financial services) for $376.6m in 2014.

- In April 2014, Aaron’s, Inc. announced its transformative acquisition of Progressive for $700m, allowing Aaron’s to supplement its payment solutions business to subprime customers and enter the growing virtual rent-to-own market.

- In July 2014, CIT Group Inc. agreed to buy OneWest Bank NA for $3.4b in the largest bank acquisition announced so far in 2014. This acquisition will allow CIT to both diversify and lower the cost of funding, in addition to accelerating CIT’s ability to utilize its cumulative net operating loss carryforwards.

Capital markets activity

There has been an increase in specialty finance companies looking to tap into the equity markets:

- October 2013 – J.G. Wentworth, which specializes in purchasing structured settlements and annuities from individuals, raised $136m from an initial public offering (IPO) of common stock. Proceeds were to be used to repay existing debt.

- January 2014 – Specializing in subprime and near-prime vehicle finance and unsecured consumer lending products in the US, Santander Consumer USA raised $2.0b from an IPO as its private equity stakeholders cashed out. The company is controlled by the Spanish bank Santander, which retained approximately 61% of the ownership following the listing.

- March 2014 – TPG Specialty Lending, Inc. (TSL), a specialty finance company focused on lending to middle-market companies, announced plans to raise between $150m-200m from an IPO and concurrently sell $50m of its common stock to certain existing investors. As of December 31, 2013, TSL’s portfolio had a fair value of approximately $1b and consisted of 27 portfolio companies.

- June 2014 – Irish aircraft lessor Avalon Holdings Ltd. filed for an IPO in the US. There is increased interest in the sector from longer-term investors, such as insurers and pension funds, which are looking to boost weak returns.

M&A outlook

- Macroeconomic impact on M&A – The M&A activity in the US will be further impacted by the tapering of the quantitative easing program by the US Federal Reserve, which is expected to bring additional investments in the US.

- Deal volumes – Deal volumes and values in the last three years appear to spike during the second half of the calendar year. If this trend continues, we should expect more specialty finance deal announcements in the second half of 2014.

- Likely targets – There continues to be an increased M&A appetite for nontraditional lenders. Greater efficiencies and lower costs are expected to help drive alternative non-bank lenders to grow their loan portfolios in specialty finance businesses, potentially making them attractive targets for acquirers looking to build assets.

- Foreign interest in US companies – There continues to be significant interest from foreign corporations/PE firms that are looking to invest in US direct and indirect specialty finance companies.

- Banks entering the sector – There is the potential for banks to achieve growth from specialty finance through acquisitions to improve decreasing yields and alleviate pressures to achieve profit growth. Banks have shown interest in finance companies to achieve higher returns on available capital.

- Bank acquisitions – Non-bank specialty finance companies may look to acquire banks in order to access a lower cost source of funding.

- Health care equipment financing – Leasing and financing of medical equipment has seen an upsurge due to increased demand for sophisticated equipment required to diagnose and treat chronic illnesses and continuously evolving technology, making purchasing a nonviable option. The medical equipment leasing industry is expected to grow, with the potential for increased M&A in this space.

- Consumer product businesses – Retail businesses are acquiring financing companies to strengthen their operations through the expansion of their customer base, to accelerate growth opportunities and to create synergies. This trend could continue and be an attractive option for other consumer retail businesses.

- Auto finance captives – The US market is likely to see some larger investments in subprime financing companies from existing global auto finance captives.
What you should know

EY’s Transaction Advisory Services (TAS) professionals work with corporate and private equity clients at every stage of a transaction, including strategic and pre-transaction planning, pre-acquisition due diligence and supporting the negotiation process, as well as transaction integration or separation. Depending on your resources and needs, we can help support you throughout the entire process, or focus on individual aspects of the transaction. The following are key matters that should be considered in a specialty finance transaction:

Universal considerations

• Macroeconomic environment – The specialty finance business has benefited from a low interest rate environment where traditional lenders tightened their lending standards. It is imperative for any buyer to understand the macro factors that may have a broad impact on the capital markets and, by extension, the auto and equipment finance markets.

• Regulatory impacts – Understanding potential implications of changes in the regulatory environment is imperative for specialty finance companies. Basel III, Dodd-Frank and oversight from the Consumer Financial Protection Bureau (CFPB), which has the authority to regulate non-bank consumer lenders, will be critical for an M&A transaction.

• Underwriting practices and credit quality – Loss expectations are different for auto, equipment and transportation assets, and for different segments of the credit base (e.g., prime, mid-prime and subprime). Therefore, it is important to have a predictive credit approach (whether model, manual or hybrid) that produces losses in expected ranges. Too low a loss rate may mean that the company is being too conservative and missing good risk/return opportunities, while an unexpectedly high loss rate could lead to earnings surprises and/or challenges with funding partners.

• Portfolio servicing complexities – Due to the large number of smaller-sized loans in the specialty finance business, a proper servicing department with trained staff is critical. Servicing of these loans to control quality issues, comply with regulatory requirements and meet portfolio performance requirements maximizes lender and investor returns.

• Understanding and improving the cost of funding – At its core, the returns of a specialty finance business are driven by achieving a spread above its cost of funds, expenses and losses. As the “raw material” of a specialty finance company is cash, it is important that it secures a predictable and diversified supply of funding and manages any potential mismatches between its assets and liabilities (e.g., due to interest rate, FX or tenure mismatch).

• Asset valuation and residual analysis – The biggest issue with operating long-lived assets with regards to M&A and economic return is a detailed understanding of the asset value drivers and performance through the life cycle. In auto, equipment and transportation finance, it is critical to understand the value of the asset and the costs of a potential recovery if there is a default. In “hard asset” lending, the amount of any funding above the expected net asset recovery value is dependent on the credit profile of the borrower. Additionally, when writing a lease with a residual, it is important to understand and forecast the expected residual value at lease end so as not to experience a loss. Residual realization can occur with sales of the assets to third parties, sales of the asset in place (to the borrower) and/or lease renewal.

• Structuring the deal – Proper structuring of deferring a portion of the deal price to future periods through contingent considerations/earn-outs allows the purchase price to be in line with the future performance of the business.

• Information technology – The automation of the origination, underwriting and credit check process at a specialty finance company should be evaluated to determine the scalability of the business. A strong IT infrastructure can allow a company a competitive advantage in (i) winning solid performing opportunities, while minimizing credit losses, (ii) reducing expenses (e.g., less manual involvement in underwriting and origination using such technologies as optical character recognition), and (iii) improving the customer experience (e.g., with real-time 24/7 online portals), which also reduces costs.

• Cultural integration – Potential acquirers need to ascertain that its culture mixes well with the culture of a target.

• Carve-out – Acquisitions of specialty finance businesses that are commingled with parent or other operations of the seller reduce transparency and require an understanding of interdependencies, shared services and analysis of carved-out “deal-basis” financials.

Auto/equipment finance or lease-specific considerations

• Actuarial implications on value – Financing businesses have the ability to tap into additional revenue streams from insurance (e.g., total loss and liability), which may result in complex assumptions regarding losses on auto insurance products. Consideration should be given to cancellations, repossessions and incurred but not reported (IBNR) claims.

• Accounting implications – Due to differences in lease accounting rules between US generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) (particularly around the capitalization of leased assets), understanding potential differences in financial reporting is critical for foreign buyers/sellers.

• Lease accounting – The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have proposed accounting standards requiring lessees to recognize assets and liabilities arising from their involvement in most leases, and lessors to potentially de-recognize large pools of assets from their balance sheets. While the proposed standard on leasing is uncertain, it could have significant impacts on equipment finance companies and may impact customer behaviors. The likely direction and timing of revenue recognition from the changes are yet to be finalized.

• Valuation of the core assets of the business – For companies providing operating leases (e.g., auto and rail cars), costs incurred on the upkeep of the leasing assets will need to be evaluated. The nature of the leasing assets, utilization of leased assets and timing of lease expirations must be evaluated.

• Tax implications – Determination of the tax owner on the leased asset generally impacts tax liability. Also, consideration should be given to evaluating GAAP and tax differences due to accelerated depreciation on leased assets for tax purposes, which is not anticipated to change as part of the IASB/FASB joint lease accounting proposal.

• Transportation finance – Many transportation leasing companies lease their assets on terms that are substantially shorter than their economic useful lives (which, in some cases, can last 50 years). In analyzing these businesses, it is important to understand the re-leasing function (including structuring with a blend of lease tenures to span any potential down cycles). Also, certain transportation leasing businesses experience an imbalance of flow of leased assets (e.g., more containers shipped west to east), thereby requiring the need to understand contract terms and the company’s management of asset returns.

We have the right teams that are made up of industry professionals who have worked together on significant financial services transactions, particularly in the specialty finance sector. These teams have deep, hands-on experience planning and advising on transactions, including assessing deal opportunities, analyzing transactions from both a strategic and tactical perspective, helping set up and optimize new operations, restructuring and integrations.
Why EY?

- **Extensive Financial Services industry experience and learnings** – The Financial Services Office (FSO) practices bring together Assurance, Tax, Advisory and TAS professionals across the Americas, Europe, Middle East, India, Africa and Asia. From this platform, EY firms provide the profession’s most globally connected services.

- **Globally integrated provider** – EY is the only Big Four organization whose TAS has been recognized as having a global reach across the range of services to support transactions.

- **Deep experience across industries, transaction types and deal sizes** – EY TAS teams served on 1,000+ transactions for all types of domestic and global clients, including Fortune 500 companies, PE portfolio companies and privately held businesses. Deal values range from $10m to $50b.

- **Buy and sell-side experience** – EY’s dedicated transaction teams understand the needs of potential buyers (private equity, strategic – public vs private) and their lenders. EY has worked on a wide range of specialty finance transactions involving global auto/captive financing companies, subprime auto finance lenders, business services companies, commercial equipment leasing companies, diversified, managed health care companies, servicer and originator of reverse mortgage loans, international container and transportation leasing companies, and other specialty lenders.

- **Strategic advice and tactical execution across the transaction life cycle** – We work closely with your team on all aspects of a transaction work plan (financial, tax and operations) through an integrated delivery model. Our teams have experience with assisting clients in conducting a market assessment to enter new markets, current-state assessment of an institution’s operational systems, developing carve-out strategies and planning for separation, pre-acquisition related diligence, post-acquisition integration and synergy identification.