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Ally Financial — Price cures price

By Jeff K. Davis

Wall Street may sense a new theme for investors in financials: the return of monoline specialty finance companies. The 1980s, 1990s and to some extent the early years of the prior decade saw specialty finance companies — especially in the card space — reward investors with big gains. Investors rode earnings growth that was powered by the secular trends of expanding consumer credit and increasing card usage. Other sub-sectors proved to have periodic issues, such as sub-prime auto lending in 1998 when the securitization markets froze.

During the past few years, Discover Financial Services, which was spun-out of Morgan Stanley in 2007, and American Express Co. have produced big gains, but these are large companies with brand recognition and strong technological edges.

Investors may get the opportunity to price pure credit stories again. Last month *The Wall Street Journal* reported that General Electric Co. may spin-out via an IPO its $50 billion consumer installment and revolving card portfolio as part of its ongoing effort to shrink General Electric Capital Corp., which had $521 billion of assets at June 30, 2013, compared to $559 billion a year earlier. The assets have to be funded, which was tough for GE Capital to do in 2008 until GE obtained backstop funding support from the government (unlike CIT Group Inc.). I have no idea where the unit might price as a stand-alone entity, but GE's timing appears to be good when funding costs are rock bottom and year-to-date annualized net charge-offs are in-line with peers at 4.8%. The P/E may be moderate given limited growth prospects, but I suspect the unit produces a high ROE. Therefore a relatively high P/B multiple should be expected.

On July 3, Santander Consumer USA Holdings Inc. (SCUSA) filed an S-1 for an IPO. The company is owned by Banco Santander SA and funds that are controlled by Centerbridge Partners LP, Kohlberg Kravis Roberts & Co. LP, Warburg Pincus LLC and others. SCUSA primarily is an auto finance lender. It has pushed beyond subprime used car financing into prime lending for new vehicle purchases. Subprime lending that produces mid-to-high teen yields when funding and credit costs are low can be a great business. The company produced net income of $289 million in the first quarter of 2013 compared to $256 million a year earlier. ROA was 6.1%, while ROE was 48%. SCUSA's growth has been stout too; receivables increased over three-fold to $17 billion at March 31 from $5 billion at year-end 2008. If the IPO occurs, it will be interesting to see where the Street values SCUSA. Strong earnings growth potentially implies a better than average P/E, which when combined with the ROE implies a sporty P/B multiple; however, there may be enough investors who remember 1998 to limit the valuation.

But the specialty finance company that has garnered the most press is Ally Financial Inc., the successor to General Motors Acceptance Corporation that became a bank holding company in late 2008 with the injection of TARP capital. The long road Ally has been travelling to reposition its business and capital structure in the wake of the disaster known as Residential Capital LLC (ResCap) appears to be coming to a head. The conclusion may entail an IPO (an S-1 was filed in March 2011 that has been updated several times since).

The U.S. Treasury invested $16.3 billion in Ally in 2008 and 2009 to ensure financing continued to flow to TARP recipients General Motors Company and Chrysler Group LLC. Including $884 million of GM debt that was converted into Ally common equity, the total investment was $17.3 billion. If Wells Fargo & Co., JPMorgan Chase & Co., Huntington Bancshares Inc., Fifth Third Bancorp and other banks were inclined to complain about the government propping up a weak competitor, they could not because they too were TARP recipients.

The restructuring of Ally's business this year has seen it exit the mortgage origination and servicing businesses, settle with creditors of ex-subsidiary ResCap for $2.1 billion of cash as part of its bankruptcy and sell most of its international financing operations to General Motors Financial Co. Inc. and Royal Bank of Canada. Ally's core revenues are now derived from auto originations (about $10 billion per quarter; $76 billion of on-balance sheet loans), commercial lending mostly related to dealer floor-plans ($30 billion) and insurance underwriting. The other transformational aspect of Ally is the growing reliance on stable, low-cost deposits to fund subsidiary Ally Bank. Retail deposits totaled $40 billion at June 30 ($49 billion with brokered deposits). Heavy advertising seems to be building a brand around a bank without a costly branch network.

Are a deposit-centric funding model and the clearing of most legacy mortgage issues enough to make a difference for Ally? I do not know. The auto finance business is highly competitive and cyclical. Ally reported core pretax income of $201 million in the second quarter compared to $263 million a year ago on $150 billion of assets. The earning asset yield of 4.48% and net interest margin excluding OID amortization was 2.04%; neither is comparable to SCUSA, though maybe SCUSA has downside potential and Ally has upside because its cost of funds are poised to decline further.

But Ally may have an emerging issue because Chrysler let its subvention program (i.e., manufacturer subsidy) expire in April. It then entered into a 10-year agreement with SCUSA. Also, the preference agreement with GM expires in December. GM acquired AmeriCredit Corporation in October 2010 for $3.3 billion (1.5x TBV and 15x last-12-months core earnings) and rechristened it General Motors Financial Company. Although AmeriCredit is a sub-prime lender, it may push deeper into Ally's turf. Ally will have to fight for profitable market share as its subvented GM and Chrysler assets (about 14% at June 30) trend lower.

So what now? Boost capital in anticipation of resubmitting a capital plan that was rejected by the Fed earlier this year as part of the CCAR process and redeem Treasury's remaining investment, which consists of $5.9 billion of convertible preferred and 73.8% of the 1.33 million common shares. Most of the rest of the common shares are held by Cerberus Capital Management LP and the GM Common Equity Trust.

On Aug. 20, Ally announced that it will raise $1 billion of common equity in a private placement, which on a pro forma basis including proceeds from pending asset sales should push its tier one common ratio to nearly 10%. Presumably that will be plenty of core equity to get the Fed to approve the capital plan. The new equity combined with existing parent liquidity then will be used to redeem Treasury's convertible preferred.

The additional equity was not cheap from Ally's perspective. The $1.0 billion raise for 11.1% of the equity valued the company at $9.0 billion (outstanding common shares increased to 1.50 million from 1.33 million). The post-raise implied book multiple was 83% of common equity and 100% net of $188 million of goodwill and $1.7 billion of OID associated with past debt issues.

The hedge funds that invested — and Street commentary implies Cerberus did too — drove a hard bargain. If it is not clear what they see in Ally, then maybe the fixed-income dictum is appropriate: there are no bad bonds, only bad bond prices. Invest cheap enough and "price cures pricing." CEO Michael Carpenter noted hedge funds were receptive to the financing given the discount to book value as reported by *The Wall Street Journal* in an Aug. 28 article on the matter.

Treasury will now wait for a better valuation in an IPO or private market transaction before it sells its shares if it intends to make money on the investment. It will need pricing that approximates book value so that the taxpayers' investment will be redeemed near the cost basis before any consideration for dividend income received. Among the auto-related investments, Ally will be the best. I do not know if a better valuation will be forthcoming, though I see one irony: the government surprisingly invested at the bottom of the cycle and will cash out near the top in a highly cyclical business. The only other comparable move that I am aware of is the establishment of the FDIC to insure deposits after the Depression was well underway and banks' loan-to-deposit ratios had collapsed.

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