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NASHVILLE NOTES

Maybe Santander Consumer goes out cheaper than it debuted

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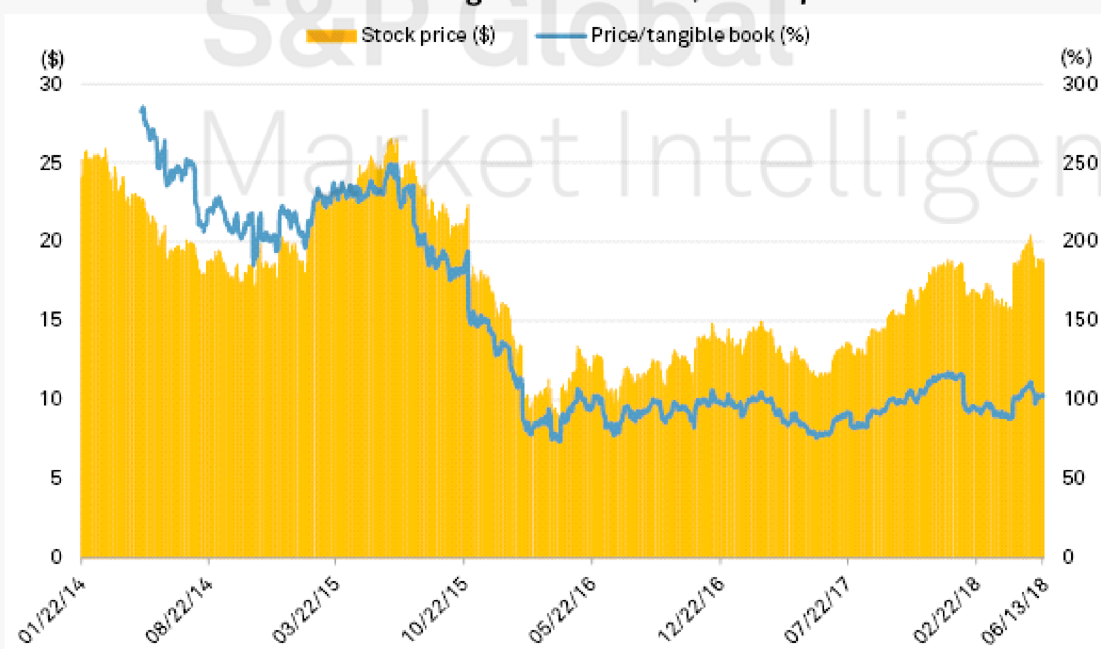
Irony is a theme that periodically surfaces as a narrative with specialty finance auto lender Santander Consumer USA Holdings Inc. It has resurfaced again.

One would not know it from looking at the chart of Santander Consumer over the past year, but its shares have been a tough stock since the IPO priced in January 2014 at $24.00 per share. The shares closed at $18.93 per share on June 12, 2018, down by 21% from the IPO, but up 65% over the past year. Timing is not an overrated attribute for investors.

Santander Consumer USA trading well below its $24 IPO price



Data compiled June 14, 2018.
Stock price measured from the $24.00 initial offering price per share to the $18.69 closing price per share June 13, 2018.
Santander Consumer USA Holdings Inc. began trading on the NYSE Jan. 23, 2018.
Data for price/tangible book is not available before May 1, 2014.
Source: S&P Global Market Intelligence

A cursory review of the financial metrics implies the shares should have done better and trade at a higher valuation than the current paltry multiples just over tangible book value and 8.3x the 2018 consensus estimate of $2.28 per share. Fears of Armageddon for subprime auto lenders the past few years notwithstanding, the company is solidly profitable, albeit at a lower ROE that was 14.7% in the first quarter compared to over 20% the last several years as less leverage was employed.

Aside from having never awarded subprime auto lenders much of a multiple over the years as best I can remember (the group blew up in the late 1990s when the securitization markets for funding froze) a core valuation principal may be at work, too: Customer concentrations are risky.

The irony in the recent run is that the gain was even greater until news surfaced in late May that Fiat Chrysler Automobiles NV, which ironically dropped Ally Financial Inc. in favor of Santander Consumer as its preferred credit provider in 2013, is seeking to develop its own U.S. captive auto finance company either by starting a new company or exercising an option for Chrysler Capital. The decision is not inconsequential because Fiat Chrysler accounted for more than 60% of Santander Consumer's first-quarter loan and lease originations.

If the option is exercised, it appears there will be an appraisal process involving three investment banks to determine the price for Chrysler Capital based upon comments made by management during a June 1 conference call to discuss the matter. The process is geared to ensure Santander Consumer receives a fair price (i.e., good or at least good enough) for Chrysler Capital. Proceeds and any excess capital arising from a smaller balance sheet could be used to fund a buyback or special dividend. The potential one-time distribution may account for the support the shares seem to have since the initial drop on the Fiat Chrysler news.

What then? Banco Santander SA owns about 68% of the shares via its wholly owned unit Santander Holdings USA Inc. To the extent a special dividend is paid it would receive two-thirds of the proceeds, or own a greater percentage in a buyback scenario assuming it does not tender. Post-dividend or post-buyback the shares should decline all else equal given the distribution of excess capital and lower earning power of the company in a post-Chrysler Capital world.

There is some speculation that Banco Santander could elect to acquire the 32% minority interest it does not own. I have no special insight on their thinking, but the timing would be interesting as a value play. Sell shares in an IPO at $24.00 per share and then acquire the public minority shares at a lower price several years later if shareholders do not raise too much hell.

The market would of course establish a value for the company before and after any special capital action. How that value might line up with fundamentals, projected future earnings and the like is unknown, but the company's trading history implies cheap may be thematically correct even if some premium is implicitly included for a possible bid by the majority owner. If investors are more worried about subprime consumer credit quality than is the case today (past-due and loss rates for the industry have been rising for several years, though less so for the company), then "dirt-cheap" may be the appropriate description.

Shareholders who dissent will be entitled to fair value under Delaware law because Santander Consumer is incorporated there. Many corporate transactions have been contested in Delaware about fair value and the process a board undertook to determine the price that led to dissenting shareholder actions. Offers by controlling shareholders are subject to particularly intense scrutiny.

All of this is conjecture on my part about future events that are not preordained to occur. Nonetheless, Santander Consumer's shares may become an interesting name for special situation funds to work.

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