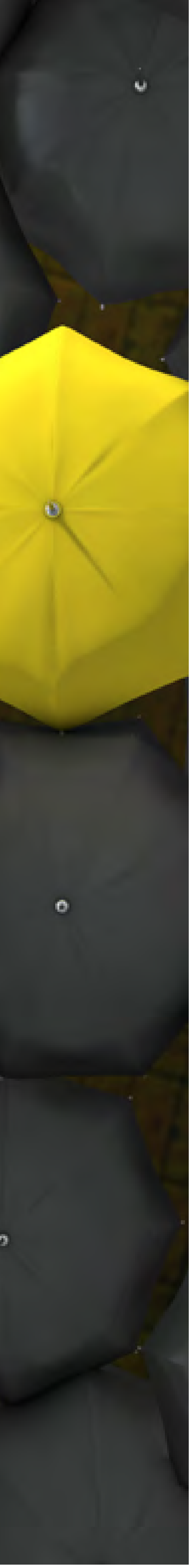
Specialty finance

Trends and M&A outlook

September 2018

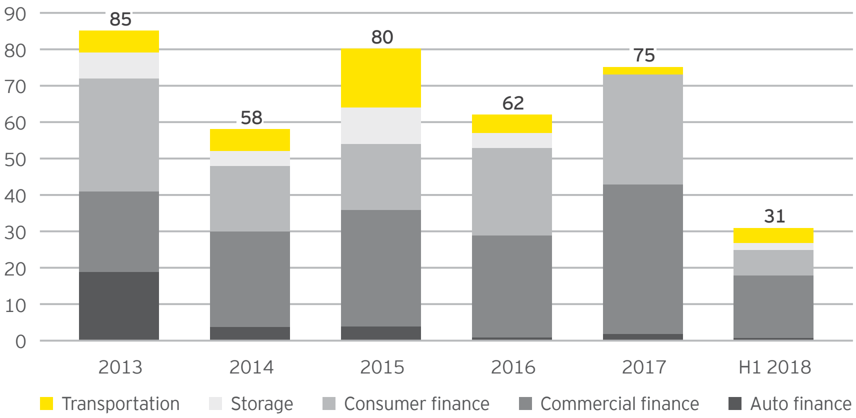
Building a better working world



Specialty finance trends and M&A outlook

EY defines specialty finance as any financing activity that takes place outside of the traditional banking system. Our analysis focuses on two distinct subsectors: consumer finance and commercial finance.

Review of M&A activity — number of deals



$4.2b disclosed deal value

16% fewer deals than first half of 2017

23% of deals involve private equity

Specialty finance remains an active market for M&A with both private equity (PE) and strategic acquirers attracted to high-yield opportunities across the sector. Although high valuations make it difficult for PEs to compete, their appetite to acquire specialty finance businesses remains strong and is expected to increase as quality assets are identified and valuations normalize.

The US market will continue to attract foreign investment as a number of foreign financial institutions look for a less regulated entry point into the US market. The relative strength of the US economy, low interest rates in foreign countries, continued uncertainty in Europe (e.g., Brexit) and overall trends in global monetary policies are all factors that we expect will lead to an increase in the demand for US specialty finance businesses from foreign investors.

Banks are expected to become strong buyers of finance companies due to their advantage of a lower cost of capital. Recently, however, very few equipment finance deals were completed by banks.

Consumer finance

Auto finance: After seven years of growth, automakers experienced their first decline in annual US sales in 2017, and rising interest rates could worsen the situation. The decline in sales was likely a result of shifting consumer preferences toward keeping vehicles longer and buying used, rather than new vehicles. Used sales had a record year due to the increased availability of high-quality off-lease vehicles. Rising new vehicle prices were likely also a factor as new vehicle amounts financed continued to hit new highs in 2017. According to Equifax, subprime originations continue to decline, dropping 8.5% year over year through mid-June 2018.[1] TransUnion attributes part of this decline to a reduction in the number of consumers classified as subprime.[2] Nonbank subprime auto loan delinquencies have also trended upward over the past few years and are experiencing the highest default rates since 2010. As subprime originations decline, prime-plus and super-prime originations continue to grow.

Our view on M&A: A number of banks have recently reduced their exposure to auto finance, creating opportunities for specialty finance auto lenders to gain scale through organic growth and M&A.

The introduction of tariffs on imported steel is likely to increase raw material costs for auto manufacturers, resulting in higher prices for new car customers. In this scenario, we could see an increase in demand for used cars and used car financing from specialty finance lenders. Activity in this space will also be influenced by the investor risk tolerance around subprime lending, which has continued to decline since 2016.

According to Bloomberg, a number of PE firms have been looking to exit this segment by way of an IPO,[3] however, the downward pressure on profits from increasing levels of delinquencies is making this very challenging.

Together, these auto finance sector trends are expected to lead to a re-emergence of the M&A appetite in this sector.

Marketplace lending: Many marketplace lending platforms have shifted toward securitizing loans in-house, instead of leaving investors to resell whole loans on their own. Although the majority of marketplace lending is targeted at prime or near prime consumers, there have been a number of lenders that have expanded their focus to "emerging prime markets" (FICO scores below 640). This represents a growth opportunity for marketplace lenders as lower credit customers generally result in higher yields, albeit with a corresponding increase in credit losses.

Our view on M&A: There has been limited consolidation in the sector, however, investment opportunities remain as buyers look to further expand their customer base as their existing lending operations (i.e., regulatory and underwriting functions) mature. We expect to see new investors move into the sector as platforms continue the trend of securitizing loans in-house. Lenders are looking to focus on emerging prime markets, which will likely increase the default rates of such products. If the sector is able to achieve an increase in yields that compensates for the increase in defaults, we expect this trend will drive an increase in M&A interest from PEs.

Commercial finance

Commercial and equipment finance: A recent Equipment Leasing and Finance Association (ELFA) report indicated that investments in equipment and software increased by 4.9% in 2017. According to the ELFA, "Capital spending [in equipment finance] will have its strongest performance in six years."[4] The positive outlook is underpinned by the strength of the US economy, lower taxes and a credit market that is enabling businesses to make capital expenditure investments to fund future growth.

We have seen strong increases in the financing of heavy equipment and commercial truck and trailer transportation as both segments benefit from the strength of the US economy, the construction market, and increased activity in domestic mining and oil and gas exploration. Ward's reported that US retail sales of Class 8 trucks jumped 23.3% in June 2018 to the highest point this year.[5] Conversely, financing is becoming more challenging in agriculture due to factors such as commodity prices and, more recently, the potential impact of tariffs.

Our view on M&A: The passing of the Tax Cuts and Jobs Act in December 2017 will impact the commercial finance sector. The legislation reduced the federal corporate tax rate to 21%, made 100% bonus depreciation available for certain qualifying assets, imposed interest expense deduction limitations and eliminated like-kind exchanges. These changes could have a significant impact on the underlying products of equipment finance companies (lessors) and lessees. Tax reform may also encourage corporations to increase capital expenditures as a result of lower corporate tax liabilities and rules around repatriation of foreign cash to the US.

As banks are becoming more active in the space, there is increased competition with specialty finance lenders. Previously, many banks only targeted super-prime and prime customers, but are now moving into lower credit segments typically served by nonbank lenders. Increased M&A activity could arise from banks looking to gain greater market share through acquiring established specialty finance lenders.

Construction equipment: Spending on construction equipment hit an all-time high in 2017, primarily as a result of increased spending in the private residential construction space. We expect spending to increase into 2019 as billions of dollars in aid are allocated to rebuild infrastructure and housing in areas of the country that were affected by natural disasters, such as Hurricane Harvey in Texas.

Our view on M&A: There continue to be discussions regarding a multibillion-dollar infrastructure bill. If successful, this could lead to a significant increase in demand for equipment financing in the near term and drive M&A in the sector by strategic and PE acquirers.

Railcar: The railcar equipment leasing industry has experienced headwinds during 2017 as it continues to undergo cyclical industry patterns. Analysts believe the industry is currently at trough levels as a result of demand remaining below replacement levels, resulting in an oversupply of railcar equipment. In addition, the US railcar fleet is as young as it has been in roughly a decade, which will likely further exacerbate industry demand in the near term.

Our view on M&A: M&A is expected to remain muted until the cyclical downturn passes. Opportunities exist, but only if sellers are willing to be opportunistic and patient.

Key contacts:

Pamela Crawford
New York
+1 212 773 8863
pamela.crawford@ey.com

Devashish Jain
New York
+1 212 773 5867
devashish.jain@ey.com

Nadine Mirchandani
New York
+1 212 773 0090
nadine.mirchandani@ey.com

Geoffrey Mize
Charlotte
+1 704 350 9038
geoffrey.mize@ey.com

Tyler Smith
Charlotte
+1 704 331 2040
tyler.smith@ey.com

Jack Wagler
Charlotte
+1 704 338 0612
jack.wagler@ey.com

End notes:

[1] *Quarterly U.S. Consumer Credit Trends*, Equifax, May 2018.

[2] *Q4 2017 Industry Insights Review*, TransUnion, February 2018.

[3] "Subprime Auto Defaults Are Soaring, and PE Firms Have No Way Out," *Bloomberg*, December 2017.

[4] *Top 10 Equipment Acquisition Trends for 2018*, Equipment Leasing and Finance Association, January 2018.

[5] "U.S. Truck Sales and Inventory by Weight Class, July 2018," *WardsAuto*, http://subscribers.wardsintelligence.com/datasheet/us-truck-sales-and-inventory-weight-class-july-2018, July 2018.

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