## Equity Research
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# Financials

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# Santander Consumer USA Holdings

## With Potential for Huge Capital Return on Horizon, SC Looks Like a Bargain Ahead of 1Q18 Earnings Report

Shares of Santander Consumer USA (SC) have slumped since management on January 31 in conjunction with the release of SC's 4Q17 report offered a somewhat confusing picture of the company's outlook with regard to credit quality. While they pointed to a "leveling off" of troubled-debt restructurings (TDRs) and made constructive comments about the macroeconomic environment and the positive impact of U.S. tax reform on SC's subprime auto loan customers, they also did little to lift the uncertainty caused by a $562mm provision for credit losses that was higher than the guidance they had provided during the company's 3Q17 conference call.

- Such uncertainty weighed even more heavily on SC's stock price in recent weeks when media reports emerged about smaller subprime auto lenders either declaring bankruptcy or shutting down after banks pulled their funding. We believe such concerns are misplaced: SC is in a different class altogether than these smaller lenders as evidenced by its sophisticated technology-driven credit-decisioning models, its $40.3bn in total committed funding as of YE17 and the backing of parent Banco Santander (SAN SM, Not Rated) which owns more than 68% of the company's shares.

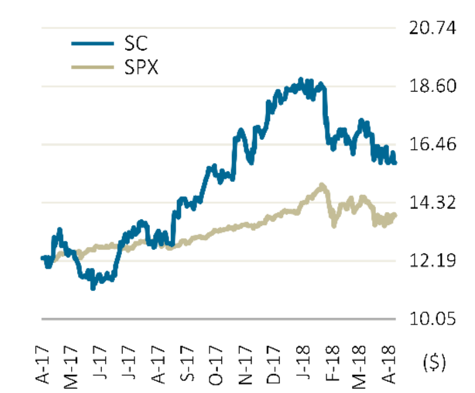
- We believe the sell-off in shares of SC during the past two and a half months has created a buying opportunity in an undervalued stock, particularly in light of the company's ample excess capital and the potential for its parent to buy out the remaining shares that it doesn't own.

- SC trades at just 6.7x the consensus FY19E adjusted earnings per share, and the overweening focus on the company's essentially stable credit quality has drawn attention away from its ample excess capital and its potential for returning it to shareholders.

- **Valuation:** Our $21 price target for SC is based on 10x the company's FY18E earnings per share of $2.13. The multiple we employ reflects what we believe to be an appropriate discount to the company's publicly traded peers given the volatility of its earnings profile.

| SC | $15.79 |
|---|---|
| 12 month target | $21.00 |
| **BUY** | |
| 52 week range | $11.17 - $18.85 |
| Market Cap (m) | $5,690 |

**Price Performance**




*Source: IDC*

## Estimates

| | 1Q17 A | 2Q17 A | 3Q17 A | 4Q17 A | FY17 A | 1Q18 E | 2Q18 E | 3Q18 E | 4Q18 E | FY18 E | FY19 E |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Net Income (Adj.) | 143 | 265 | 199 | 580 | 1,188 | 149 | 241 | 240 | 142 | 771 | 959 |
| Diluted EPS (Adj.) | 0.40 | 0.74 | 0.49 | 0.27 | 1.74 | 0.41 | 0.67 | 0.66 | 0.39 | 2.13 | 2.64 |
| Tangible BVPS | 14.79 | 15.50 | 16.07 | 17.70 | 17.70 | 18.06 | 18.71 | 19.36 | 19.73 | 19.73 | 22.26 |

*Source: BTIG Estimates and Company Documents ($ in millions, except per share amount)*

***Please Read: Important disclosures and analyst's certification appear in Appendix***

- SC's strong capital position should put it in particularly good stead as it goes through then upcoming CCAR process. Management has said they believe a Common Equity Tier 1 (CET1) ratio of 12.5% would be an appropriate level at which to run the company versus the 16.3% CET1 ratio that it reported as of YE17.

- **We estimate that SC's excess capital above management's 12.5% Tier 1 target as of 2Q18 will be $1.814bn, or 100% of the value of the company's shares owned by public shareholders.** Assuming that the CCAR process goes well for SC this year and in the next couple of years, we believe the company could effectively cause its parent to own 100% of the company within a three-year period.

- Meanwhile, investors will be focused on whether SC's 1Q18 provision expense comes within management's guidance of 4Q17's provision of $562mm plus or minus $20mm, or $542mm to $582mm. This figure is not simply a signal of whether SC's credit quality is deteriorating; it is also a function of new loan origination volume. Management noted during the company's 4Q17 conference call that the primary driver of the 40bps and 20bps year-over-year increases in net charge-offs (NCOs) and 30+ day delinquencies during the quarter was its lower portfolio balances.

- SC intentionally slowed its loan origination activity in 2H16 by imposing tighter underwriting standards given a more competitive lending environment and losses stemming from its troubled 2015 loan vintage. The company continued to employ that disciplined approach through 2017 when loan originations declined by 8% versus the prior year.

- Management during the 4Q17 call noted that the 2016 vintage has outperformed the 2015 vintage in terms of NCOs and that its performance has been in line with the benign 2014 vintage. They also observed that while the 2017 vintage is still early in its life cycle it is performing between the 2015 and 2016 vintages on a credit basis.

- Management said they have been working on optimizing their credit and pricing models and that they expected to be growing subprime loan originations relative to 4Q17 – subprime originations of $1.47bn during the quarter were down 14% versus the prior year period – "as we move forward." However, it was not clear that they expected such growth to be evident during 1Q18.

- One caveat on SC worth noting: unlike many financial firms including regional banks and insurance companies, the company would not benefit from increases in interest rates. SC is liability sensitive given that it funds itself through securitizations and term financings while its asset base is largely fixed rate. When interest rates rise SC's liabilities reprice faster than its assets, putting downward pressure on its net interest margin.

- To put this risk into perspective we would point to SC's 2017 10-K in which it disclosed the result of its interest rate sensitivity analysis. The 12-month impact of a 100bps parallel increase in the interest rate curve would be a decrease in the company's net interest income of $11mm.

- SC is scheduled to report its 1Q18 results on Tuesday, April 24 before the market open with a conference call slated for that morning at 9am ET. We estimate that the company will report 1Q18 adjusted earnings per share of $0.41 versus the consensus estimate of $0.42.

## Income Statement

| Santander Consumer Holdings USA - Operating Model | Dec-13 | Dec-14 | Dec-15 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Dec-18 | Dec-19 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ($ in millions) | 2013A | 2014A | 2015A | 2016A | 1Q17A | 2Q17A | 3Q17A | 4Q17A | 2017A | 1Q18E | 2Q18E | 3Q18E | 4Q18E | 2018E | 2019E |
| Interest on finance receivables and loans | 3,703.5 | 4,493.4 | 5,031.8 | 5,026.8 | 1,209.2 | 1,232.3 | 1,185.1 | 1,129.2 | 4,755.7 | 1,132.4 | 1,155.2 | 1,163.2 | 1,160.7 | 4,611.5 | 4,704.9 |
| Leased vehicle income | 122.8 | 651.6 | 1,037.8 | 1,487.7 | 418.2 | 429.3 | 457.9 | 483.0 | 1,788.5 | 507.2 | 519.9 | 532.9 | 546.2 | 2,106.1 | 2,324.7 |
| Other finance and interest income | 6.0 | 8.1 | 18.2 | 15.1 | 3.8 | 5.2 | 6.4 | 4.5 | 19.9 | - | - | - | - | - | - |
| **Total finance and other income** | **3,832.3** | **5,153.1** | **6,087.8** | **6,529.6** | **1,631.2** | **1,666.7** | **1,649.4** | **1,616.7** | **6,564.0** | **1,639.6** | **1,675.1** | **1,696.0** | **1,706.9** | **6,717.5** | **7,029.6** |
| Interest expense | 408.8 | 523.2 | 628.8 | 807.5 | 227.1 | 233.4 | 250.7 | 236.6 | 947.7 | 241.3 | 246.2 | 251.1 | 256.1 | 994.7 | 1,063.4 |
| Leased vehicle expense | 89.4 | 476.3 | 726.4 | 995.5 | 290.2 | 298.2 | 339.6 | 370.5 | 1,298.5 | 379.8 | 387.4 | 391.3 | 395.2 | 1,553.7 | 1,620.6 |
| **Net finance and other interest income** | **3,334.1** | **4,153.6** | **4,732.6** | **4,726.7** | **1,114.0** | **1,135.1** | **1,059.1** | **1,009.5** | **4,317.8** | **1,018.4** | **1,041.5** | **1,053.7** | **1,055.6** | **4,169.2** | **4,345.6** |
| Provision for credit losses | 1,713.9 | 2,521.3 | 2,785.9 | 2,468.2 | 635.0 | 520.6 | 536.4 | 562.3 | 2,254.4 | 577.1 | 510.1 | 527.5 | 599.6 | 2,214.3 | 2,300.1 |
| **Net fiance income after provision for credit losses** | **1,620.2** | **1,632.4** | **1,946.7** | **2,258.5** | **479.0** | **614.6** | **522.7** | **447.2** | **2,063.4** | **441.3** | **531.4** | **526.2** | **456.0** | **1,954.9** | **2,045.5** |
| Profit sharing | 78.2 | 74.9 | 57.5 | 47.8 | 7.9 | 8.4 | 5.9 | 7.2 | 29.6 | 6.6 | 8.0 | 7.9 | 6.8 | 29.3 | 30.7 |
| **Net finance income after provisions and profit sharing** | **1,542.0** | **1,557.4** | **1,889.2** | **2,210.6** | **471.0** | **606.1** | **516.7** | **440.0** | **2,033.8** | **434.7** | **523.4** | **518.3** | **449.1** | **1,925.6** | **2,014.8** |
| Investment gains (losses) | 41.7 | 113.1 | (95.2) | (444.8) | (76.4) | (99.5) | (52.6) | (137.9) | (366.4) | (72.6) | (54.7) | (28.9) | (82.8) | (239.0) | (95.6) |
| Servicing fee income | 25.5 | 72.6 | 131.1 | 156.1 | 31.7 | 32.0 | 28.7 | 26.0 | 118.3 | 27.3 | 28.7 | 30.1 | 31.6 | 117.8 | 129.8 |
| Fees, commissions and other | 245.4 | 374.1 | 385.7 | 382.2 | 100.2 | 92.0 | 82.9 | 74.2 | 349.2 | 101.2 | 95.6 | 87.8 | 81.6 | 366.3 | 368.1 |
| **Total other income** | **312.6** | **559.9** | **421.6** | **93.5** | **55.5** | **24.4** | **58.9** | **(37.7)** | **101.1** | **56.0** | **69.6** | **89.0** | **30.5** | **245.1** | **402.3** |
| Compensation expense | 305.1 | 482.6 | 434.0 | 498.2 | 136.3 | 127.9 | 134.2 | 182.7 | 581.0 | 129.4 | 128.5 | 134.8 | 133.5 | 526.3 | 529.0 |
| Reposession expense | 147.5 | 201.0 | 241.5 | 293.4 | 71.3 | 67.3 | 66.9 | 70.3 | 275.7 | 71.7 | 67.6 | 67.2 | 70.6 | 277.1 | 278.5 |
| Other operating costs | 253.7 | 312.5 | 345.7 | 351.9 | 97.5 | 87.3 | 96.9 | 173.1 | 454.7 | 98.5 | 88.1 | 97.8 | 93.9 | 378.3 | 380.2 |
| **Total operating expenses** | **706.3** | **996.2** | **1,021.2** | **1,143.5** | **305.1** | **282.4** | **297.9** | **426.0** | **1,311.4** | **299.6** | **284.3** | **299.9** | **298.0** | **1,181.7** | **1,187.6** |
| **Income before income taxes** | **1,148.3** | **1,121.1** | **1,289.6** | **1,160.7** | **221.4** | **348.1** | **277.8** | **(23.8)** | **823.5** | **191.1** | **308.8** | **307.5** | **181.7** | **989.0** | **1,229.5** |
| Income tax expense | 427.1 | 395.9 | 465.6 | 394.2 | 78.0 | 83.4 | 78.4 | (603.9) | (364.1) | 42.0 | 67.9 | 67.6 | 40.0 | 217.6 | 270.5 |
| **Net income** | **721.2** | **725.3** | **824.0** | **766.5** | **143.4** | **264.7** | **199.4** | **580.1** | **1,187.6** | **149.0** | **240.9** | **239.8** | **141.7** | **771.4** | **959.0** |
| **Earnings Per Share** | **2.08** | **2.08** | **2.32** | **2.14** | **0.40** | **0.74** | **0.49** | **0.27** | **1.74** | **0.41** | **0.67** | **0.66** | **0.39** | **2.14** | **2.64** |
| **Diluted Earnings Per Share** | **2.08** | **2.04** | **2.31** | **2.13** | **0.40** | **0.74** | **0.49** | **0.27** | **1.74** | **0.41** | **0.67** | **0.66** | **0.39** | **2.13** | **2.64** |
| Common shares outstanding | 347.2 | 348.7 | 355.1 | 358.3 | 359.1 | 359.5 | 359.6 | 360.3 | 359.6 | 360.6 | 361.0 | 361.3 | 361.7 | 361.2 | 362.6 |
| Diluted shares outstanding | 347.2 | 355.7 | 356.2 | 359.8 | 360.6 | 359.8 | 360.5 | 361.4 | 360.6 | 361.8 | 362.1 | 362.5 | 362.9 | 362.3 | 363.8 |
| Tax rate | 37.2% | 35.3% | 36.1% | 34.0% | 35.2% | 24.0% | 28.2% | 2538.0% | -44.2% | 22.0% | 22.0% | 22.0% | 22.0% | 22.0% | 22.0% |
| Book value per share | - | 10.11 | 12.48 | 14.61 | 15.09 | 15.80 | 16.37 | 17.99 | 17.99 | 18.35 | 19.00 | 19.65 | 20.02 | 20.02 | 22.55 |
| Tangible book value per share | - | 9.79 | 12.18 | 14.31 | 14.79 | 15.50 | 16.07 | 17.70 | 17.70 | 18.06 | 18.71 | 19.36 | 19.73 | 19.73 | 22.26 |

*Source: BTIG Estimates and Company Reports*

## BTIG Covered Companies Mentioned in this Report

SANTANDER CONSUMER USA HOLDINGS (SC, Buy, $21.00 PT; Current Price: $15.79; Analyst: Mark.Palmer)

# Appendix: Analyst Certification and Other Important Disclosures

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I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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### Santander Consumer USA Holdings (SC, Buy, $21.00 PT)

**Valuation:** Our price target of $21 for SC is based on 10x our 2018E EPS of $2.13. Our 10x multiple reflects what we believe is an appropriate discount to the company's publicly traded peers given the volatility of its earnings profile.

**Risks:** Primary risks to our recommendation include reduced access to funding; higher-than-expected default rates, particularly on nonprime receivables; poor portfolio performance that triggers credit enhancement provisions on the company's revolving credit facilities or secured structured financings; inability to meet certain milestones and metrics that could result in the termination of the company's agreement with Chrysler; adverse changes in interest rates; adverse economic conditions; and regulatory risks.


*Note: Closing Price and Target Price have been adjusted for corporate actions.*

| Date | Closing Price ($) | Target Price ($) | Analyst | Rating |
|---|---|---|---|---|
| 22-Jan-14 | 25.25 | 31 | Mark Palmer | Buy |
| 04-Nov-14 | 17.29 | 26 | Mark Palmer | Buy |
| 28-Apr-15 | 24 | 28 | Mark Palmer | Buy |
| 30-Jul-15 | 24.18 | 30 | Mark Palmer | Buy |
| 25-Jan-16 | 13.40 | 21 | Mark Palmer | Buy |
| 14-Nov-16 | 13.93 | 17 | Mark Palmer | Buy |
| 04-Dec-17 | 17.76 | 21 | Mark Palmer | Buy |

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