

Equity Research

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Financials

Santander Consumer USA Holdings

Higher Provision Stemming from Troubled 2015 Vintage Drives 4Q16 EPS Miss as SC Resets for 2017

While we believe Santander Consumer USA (SC) has chosen a prudent course in adopting disciplined underwriting standards amidst a competitive auto lending market, the company continues to pay the price for the more aggressive approach it had taken in the past. SC's 2015 vintage loans, which featured a mix tilted more heavily toward subprime borrowers, during 4Q16 continued to be responsible for a disproportionate percentage of the losses it incurred as they had been in the prior quarter.

- Largely as a consequence of the losses stemming from that troubled 2015 vintage, SC this morning reported a 4Q16 earnings miss driven by a higher-than-expected provision for credit losses. The company during the quarter generated adjusted earnings per share of \$0.21, trailing the consensus estimate of \$0.30 and our estimate of \$0.28.
- SC's provision of \$686mm outpaced the consensus estimate of \$637mm and our estimate of \$643mm. The difference between the reported provision figure and the consensus estimate translated into about \$0.14 per share, accounting for the miss. Meanwhile, SC during 4Q16 posted 4Q16 total loan originations of \$4.5bn, a 24% decline versus the prior year period, driven by a 48% drop in Chrysler Capital loans to \$1.54bn.
- **We are reiterating our Buy recommendation on SC and price target of \$17** based on 7x our 2018E EPS of \$2.39. While the company faces well-known challenges – balancing loan growth and credit quality, maximizing recoveries in the face of declining used car prices, reviving its Chrysler Capital volumes and finding a buyer for its held-for-sale personal lending portfolio – we believe that with the shares trading at just 5.4x FY18E adjusted EPS those issues are already baked into its stock valuation.
- **Valuation:** Our price target of \$17 for SC is based on 7x our 2018E EPS of \$2.39. Our 7x multiple reflects what we believe is an appropriate discount to the company's publicly traded peers given the volatility of its earnings profile.

SC **\$13.80**

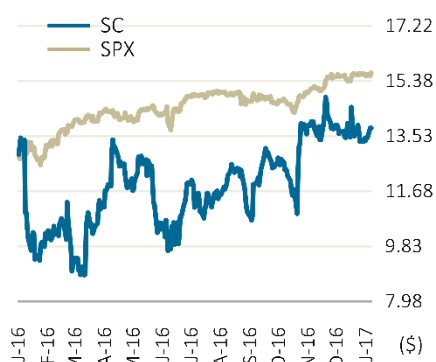
12 month target \$17.00

BUY

52 week range \$8.87 - \$14.84

Market Cap (m) \$4,972

Price Performance



Source: IDC

Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 E	2Q17 E	3Q17 E	4Q17 E	FY17 E	FY18 E
Net Income (Adj.)	208	283	214	61	766	150	250	205	163	769	875
Diluted EPS (Adj.)	0.58	0.79	0.59	0.17	2.13	0.42	0.69	0.56	0.45	2.12	2.39
Tangible BVPS	12.56	13.31	13.98	14.31	14.31	14.68	15.34	15.87	16.28	16.28	18.45

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

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

- ▶ SC during the conference call this morning offered guidance for 1Q17 that included a 2-3% decline in non-interest income driven by an accounting policy change related to treatment of troubled debt restructuring (TDR) loans and a provision for loan losses sequentially lower by \$20mm to \$60mm given an expectation that net charge-offs (NCOs) would be lower by \$100mm to \$120mm, offsetting an allowance for loan losses expected to be higher by \$60mm to \$80mm.
- ▶ In light of this guidance and incorporating trends in SC's business and operating environment, we are reducing our estimate of the company's 1Q17 adjusted EPS to \$0.42 from \$0.56, our estimate of its FY17 adjusted EPS to \$2.12 from \$2.26 and our estimate of its FY18 adjusted EPS estimate to \$2.39 from \$2.44.
- ▶ Management said they are focused on completing a critical agreement to flow assets to parent and 58.9% owner Banco Santander (SAN SM) during 1Q17, as they believe that arrangement – combined with the company's focus on its dealer VIP program with Fiat-Chrysler (FCA IM, Not Rated) dealers and the dealer floorplan lending it offers through Santander Bank – will help to boost Chrysler Capital's volume. Insofar as SC's penetration rate with Chrysler Capital declined to 17% in 4Q16 from 29% in the prior year period, we believe stabilizing that relationship will be a key to a prospective rebound in the company's operating performance during 2017.
- ▶ Another key to that potential 2017 turnaround for SC is a change in its portfolio mix as recent originations featuring higher credit quality help to lessen the impact of the challenged 2015 vintage. Management's focus on the risk-return trade-off in subprime originations drove it to tighten its loan underwriting standards early in 2016. SC during the conference call highlighted early indications that the 1H16 vintage is meaningfully outperforming the 1H15 vintage in terms of credit performance.
- ▶ SC during 4Q16 reported weaker credit metrics stemming from the 2015 originations and slower portfolio growth. Auto loan NCOs increased sequentially to 9.4% from 8.7% in 3Q16, while 61+ day delinquencies rose to 4.6% from 4.2% in the prior quarter.
- ▶ Another area that offers room for improvement for SC is operating expenses. The company during 4Q16 reported a 15% year-over-year increase in expenses of \$296mm, higher than the consensus estimate of \$280mm and our estimate of \$286mm. Net of non-recurring expenses of \$13mm, the year-over-year increase was still 10%, a rise that management attributed to higher compensation expenses and higher repo expenses.

Income Statement

Santander Consumer Holdings USA - Operating Model (\$ in millions)	Dec-14 2014A	Dec-15 2015A	Mar-16 1Q16A	Jun-16 2Q16A	Sep-16 3Q16A	Dec-16 4Q16A	Dec-16 2016A	Mar-17 1Q17E	Jun-17 2Q17E	Sep-17 3Q17E	Dec-17 4Q17E	Dec-17 2017E	Dec-18 2018E
Interest on finance receivables and loans	4,493.41	5,031.83	1,286.20	1,271.74	1,246.39	1,222.47	5,026.79	1,209.81	1,222.84	1,256.33	1,287.01	4,975.98	5,097.50
Leased vehicle income	651.59	1,037.79	329.79	368.36	388.50	401.02	1,487.67	417.06	429.57	433.87	438.21	1,718.71	1,844.19
Other finance and interest income	8.07	18.16	3.91	3.89	3.64	3.70	15.14	-	-	-	-	-	-
Total finance and other income	5,153.07	6,087.78	1,619.90	1,643.99	1,638.53	1,627.18	6,529.60	1,626.87	1,652.41	1,690.20	1,725.22	6,694.69	6,941.70
Interest expense	523.20	628.79	184.74	198.59	207.18	216.98	807.48	225.66	225.88	226.45	230.98	908.97	971.04
Leased vehicle expense	476.25	726.42	221.36	243.14	252.73	278.23	995.46	289.36	290.08	290.81	291.53	1,161.78	1,258.93
Net finance and other interest income	4,153.62	4,732.57	1,213.80	1,202.26	1,178.62	1,131.97	4,726.65	1,111.85	1,136.44	1,172.94	1,202.70	4,623.94	4,711.72
Provision for credit losses	2,521.27	2,785.87	660.17	511.92	610.40	685.71	2,468.20	635.93	526.41	619.85	696.22	2,478.41	2,654.55
Net finance and other interest income after provision for credit losses	1,632.35	1,946.70	553.63	690.33	568.22	446.26	2,258.45	475.92	610.03	553.09	506.48	2,145.53	2,057.17
Profit sharing	74.93	57.48	11.39	17.85	6.40	12.18	47.82	9.52	12.20	11.06	10.13	42.91	61.72
Net finance and other interest income after provisions and profit sharing	1,557.43	1,889.22	542.24	672.49	561.82	434.09	2,210.64	466.40	597.83	542.03	496.35	2,102.62	1,995.46
Investment gains (losses)	113.15	(95.21)	(69.06)	(101.31)	(106.05)	(168.34)	(444.76)	(85.00)	(75.81)	(80.55)	(84.17)	(325.54)	-
Servicing fee income	72.63	131.11	44.49	42.99	36.45	32.20	156.13	35.42	37.20	39.06	41.01	152.68	172.40
Fees, commissions and other	374.13	385.74	102.12	95.62	96.29	88.14	382.17	105.18	98.49	99.17	90.79	393.64	395.60
Total other income	559.90	421.64	77.56	37.30	26.68	(48.00)	93.55	55.61	59.87	57.68	47.62	220.78	568.00
Compensation expense	482.64	434.04	119.84	123.34	128.06	126.98	498.22	122.24	125.81	130.62	129.52	508.19	528.52
Repossession expense	201.02	241.52	73.55	68.35	75.92	75.54	293.36	69.87	64.93	72.12	67.99	274.91	288.66
Other operating costs	312.54	345.69	97.47	80.53	80.51	93.38	351.89	98.44	82.14	82.12	95.25	357.96	399.41
Total operating expenses	996.19	1,021.25	290.86	272.23	284.48	295.91	1,143.47	290.55	272.89	284.86	292.76	1,141.05	1,216.58
Income before income taxes	1,121.14	1,289.61	328.94	437.56	304.02	90.19	1,160.71	231.46	384.82	314.85	251.22	1,182.34	1,346.88
Income tax expense	395.85	465.57	120.64	154.22	90.47	28.91	394.25	81.01	134.69	110.20	87.93	413.82	471.41
Net income	725.28	824.04	208.30	283.35	213.55	61.27	766.47	150.45	250.13	204.65	163.29	768.52	875.47
Earnings Per Share	2.08	2.32	0.58	0.79	0.60	0.17	2.14	0.42	0.69	0.57	0.45	2.13	2.40
Diluted Earnings Per Share	2.04	2.31	0.58	0.79	0.59	0.17	2.13	0.42	0.69	0.56	0.45	2.12	2.39
Common shares outstanding	348.72	355.10	357.97	358.22	358.34	358.58	358.28	359.48	360.38	361.28	362.18	360.83	364.45
Diluted shares outstanding	355.72	356.16	358.84	359.87	360.09	360.32	359.78	361.22	362.13	363.03	363.94	362.58	366.22
Tax rate	35.3%	36.1%	36.7%	35.2%	29.8%	32.1%	34.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%
Book value per share	10.11	12.48	12.86	13.61	14.28	14.61	14.61	14.98	15.64	16.16	16.57	16.57	18.74
Tangible book value per share	9.79	12.18	12.56	13.31	13.98	14.31	14.31	14.68	15.34	15.87	16.28	16.28	18.45

Source: BTIG Estimates and Company Reports

BTIG Covered Companies Mentioned in this Report

SANTANDER CONSUMER USA HOLDINGS (SC, Buy, \$17.00 PT; Current Price: \$13.80; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

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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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Company Valuation and Risk Disclosures

Santander Consumer USA Holdings (SC, Buy, \$17.00 PT)

Valuation: Our price target of \$17 for SC is based on 7x our 2018E EPS of \$2.39. Our 7x 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.

Santander Consumer USA Holdings (SC)

(\$)



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

Other Disclosures

Additional Information Available Upon Request

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