

Equity Research

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Financials

Ally Financial, Inc.

Share Price Pullback Due to Overblown Headwinds Creates Buying Opportunity Ahead of 1Q17 Report

The Ally Financial (ALLY) story as the company prepares to report its 1Q17 results is one of evolution both in terms of the company's capital structure and its business model, with the potential result being higher earnings, and expanded multiple, and significant share price appreciate to be realized over the next few years. But as the quarterly report approaches, many investors are focused on factors they view as threatening to ALLY's transformation, including rising credit losses and declining used-vehicle prices.

ALLY **\$19.24**

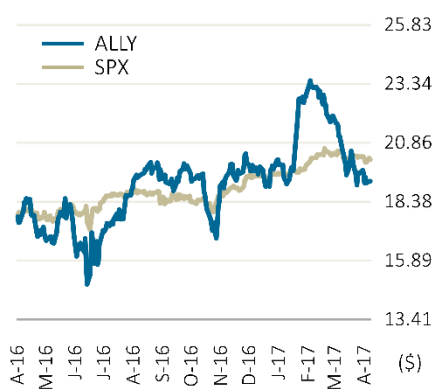
12 month target \$30.00

BUY

52 week range \$14.90 - \$23.48

Market Cap (m) \$9,129

Price Performance



Source: IDC

- ▶ Those challenges had been pushed to the back burner after the U.S. presidential election as ALLY shares were swept up in the "Trump trade" and by mid-February had risen by more than 39% in just over three months. However, investor worries about consumer credit and the impact of falling used-vehicle prices then began to take a toll on ALLY, which proceeded to decline by more than 17% during the next two months.
- ▶ As a consequence, ALLY now trades at 0.74x the company's tangible book value as of YE16. If there is a silver lining to the stock's pullback it is that as of last June the company is able to buy back its shares at a discount, a nicely accretive opportunity that it took advantage of during 2H16 in repurchasing 3.5% of its float.
- ▶ ALLY is scheduled to report its 1Q17 results on Thursday, April 27 at 7:30am ET with a conference call slated for 9am ET on that day. We are reducing our estimate of the company's 1Q17 adjusted earnings per share to \$0.50 (from \$0.55) based on an increase in our estimate of the company's provision for loan losses during the quarter to \$281mm (from \$251mm). Our estimate is in line with the guidance provided by ALLY management during the company's March 21 conference call. The increased provision was partly due to lower used vehicle prices, which management said had been falling at a "manageable" pace, and also due to some credit deterioration in subprime loans during the quarter attributed to delayed tax refunds this year.
- ▶ **Valuation:** Our \$30 price target is based on 0.9X FY18E tangible book value of \$33.43.

Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 E	2Q17 E	3Q17 E	4Q17 E	FY17 E	FY18 E
Diluted EPS (Adj.)	0.52	0.54	0.56	0.52	2.15	0.50	0.56	0.60	0.60	2.27	2.73
Tangible BVPS	27.01	27.92	28.19	28.07	28.07	28.87	29.41	30.00	30.60	30.60	33.43

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

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

- ▶ The bull thesis for ALLY is particularly compelling in the context of the company's discount valuation, in our view. ALLY during the next four years has \$12bn in unsecured debt maturing with a weighted-average cost of 4.7%, part of which may be accelerated to boost its earnings per share growth and ROE. Instead of refinancing that debt, ALLY is well positioned to replace it with low-cost deposits: management expects the company to grow its deposit base by \$40bn over the next four years, helping to drive \$800mm in incremental revenue and \$1.20 to \$1.40 in incremental annual EPS.
- ▶ At the same time, ALLY has been working to diversify its business model and thereby reduce its concentration in auto finance, which some observers believe has weighed on the company's valuation. In theory, ALLY's forays into mortgages, credit cards and wealth management when fully realized should result in multiple expansion.
- ▶ However, much of the potential upside associated with ALLY's transformative actions will occur over time, with much of it set to be realized beyond 2017. The company's near-term outlook became somewhat shakier on March 21 when management during a business update call guided to 2017 adjusted earnings per share growth in a range of 5% to 15%, a more specific outlook than the less than or equal to 15% guidance for the year that they had provided in conjunction with ALLY's 4Q16 report on January 31.
- ▶ Meanwhile, ALLY management on March 21 reiterated their medium-term outlook of an adjusted EPS CAGR of more than 15%. While we don't think most investors would have a problem looking through the company's uncertain near-term outlook for upside in the next few years, we do think many have held off on buying the inexpensive stock due to concerns about the company's exposure to borrowers on the lower end of the credit spectrum and the recent flurry of media reports about falling used car prices.
- ▶ ALLY as of YE16 had approximately \$9.1bn of exposure to nonprime loans, with \$211mm of those in the nonperforming category. However, we believe many investors' perceptions of the company's risk profile have been overblown as they are focused on the risks while largely ignoring the magnitude of the potential rewards. Management during the March 21 call provided some important perspective on the impact (or lack thereof) of the anticipated higher losses that they expect ALLY to incur during 2017. While they expect the loss rate of the company's retail auto portfolio to increase to 1.4% to 1.6% in 2017 from 1.24% in the prior year, they also expect the portfolio's retail auto yield to grow to 5.8% to 6.0% in 2017 versus 5.52% in 2016.
- ▶ The upshot is that management expects ALLY's risk-adjusted yield to increase to come in between 4.2% and 4.6% in 2017 versus the 4.28% in 2016. If the year plays out as management expects, then ALLY would have been well compensated for the incremental risks it faces, which bodes well for its profitability. Moreover, ALLY management during the March 21 call noted that concerns about auto lending

trends had caused some of the banks with which it competes to pull back from the space, providing the company with opportunities to gain market share while benefitting from firmer pricing.

- ▶ The decline in used vehicle prices is ongoing, as the NADA Used Car Guide's seasonally adjusted used vehicle price index fell by 7.2% in March. That was the ninth straight month of declines and dropped the index to its lowest level since September 2010. Such declines are of concern to ALLY insofar as used vehicle pricing impacts the company's recoveries on defaulted loans as well as on leased vehicles that are returned to it.
- ▶ ALLY's 2017 guidance includes management's assumption that used vehicle pricing will decline by 5% during the year. Management has also noted that every additional 1% decline in used vehicle pricing beyond management's assumption would result in a \$50mm decline in the company's 2017 revenue. They added that the figure would decline to between \$25mm and \$30mm in 2018 given the expected reduction in its portfolio.
- ▶ While we acknowledge that \$50mm in revenue is a material figure, we believe it should be put into perspective: ALLY generated \$3.96bn and \$1.58bn in net financing revenue and pre-tax income during 2016. Moreover, if the margin expansion in retail and commercial lending that management anticipates this year is realized, that could serve as a significant mitigant to larger-than-expected declines in used vehicle prices.

Income Statement

Ally Financial - Operating Model	Dec-13	Dec-14	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Dec-18
\$ millions	2013A	2014A	2015A	1Q16A	2Q16A	3Q16A	4Q16A	2016A	1Q17E	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
Interest and fees on finance receivables and loans	4,529	4,457	4,570	1,235	1,265	1,307	1,355	5,162	1,398	1,417	1,432	1,450	5,697	1,473	1,489	1,502	1,518	5,982
Interest on loans held-for-sale	20	1	40	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest on trading assets	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest and dividends on available for sale investment securities	325	367	381	102	99	101	109	411	111	112	113	114	449	115	115	116	116	462
Interest bearing cash	10	8	8	3	4	3	11	21	-	-	-	-	-	-	-	-	-	-
Operating leases	3,209	3,558	3,398	769	701	649	592	2,711	565	557	549	540	2,211	527	514	501	488	2,029
Total financing revenue & other interest	8,093	8,391	8,397	2,109	2,069	2,060	2,067	8,305	2,074	2,085	2,094	2,104	8,357	2,114	2,118	2,119	2,122	8,473
Interest on deposits	654	664	718	193	203	212	222	830	228	231	234	236	928	239	242	245	248	974
Interest on short-term borrowings	63	52	49	13	12	14	18	57	18	18	18	18	72	18	18	18	18	72
Interest on long-term debt	2,602	2,067	1,662	442	436	430	434	1,742	402	396	390	384	1,572	378	373	367	362	1,480
Total interest expense	3,319	2,783	2,429	648	651	656	674	2,629	648	645	641	638	2,572	636	633	630	627	2,526
Depreciation expense on operating assets	1,995	2,233	2,249	510	434	408	417	1,769	411	405	399	393	1,606	381	369	358	348	1,456
Pre-provision net finance revenue	2,779	3,375	3,719	951	984	996	976	3,907	1,015	1,036	1,054	1,073	4,178	1,098	1,116	1,130	1,147	4,492
Provision for loan losses	501	457	707	220	172	258	267	917	281	210	277	306	1,074	299	231	300	330	1,160
Post-provision net finance revenue	2,278	2,918	3,012	731	812	738	709	2,990	734	826	777	767	3,104	799	885	831	817	3,331
Servicing fees	126	31	45	13	18	17	15	63	-	-	-	-	-	-	-	-	-	-
Servicing asset valuation and hedge activities	(213)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total servicing income (loss)	(87)	31	45	13	18	17	15	63	-	-	-	-	-	-	-	-	-	-
Insurance premiums and service revenue earned	1,012	979	940	230	236	248	241	955	235	241	253	246	974	239	246	258	251	994
Gain on mortgage and automotive loan	55	7	45	1	3	-	7	11	7	7	7	7	28	7	7	7	7	29
Loss on extinguishment of debt	(59)	(202)	(357)	(4)	-	-	(1)	(5)	-	-	-	-	-	-	-	-	-	-
Other gain on investments	180	181	155	54	39	52	39	184	41	41	42	42	166	44	45	45	46	180
Other income (losses)	383	280	250	82	77	81	91	331	91	92	93	94	334	95	96	97	98	338
Total other revenue	1,484	1,276	1,078	376	373	398	392	1,539	374	381	395	389	1,503	386	393	407	401	1,540
Compensation and benefits expense	1,019	947	963	252	242	248	250	992	256	260	264	267	1,047	269	271	272	273	1,085
Insurance losses and loss adjustment expense	405	410	293	73	145	69	55	342	74	131	70	56	331	75	132	71	57	335
Other operating expenses	1,981	1,591	1,505	385	386	418	416	1,605	426	429	431	431	1,716	435	437	439	442	1,753
Total noninterest expense	3,405	2,948	2,761	710	773	735	721	2,939	757	819	765	753	3,095	779	840	782	772	3,173
Income (loss) from continuing operations before taxes	357	1,246	1,329	397	412	401	380	1,590	351	388	407	403	1,513	405	438	455	447	1,699
Income tax expense (benefit)	(59)	321	496	150	56	130	134	470	116	128	134	133	511	134	145	150	148	576
Net income (loss) from continuing operations	416	925	833	247	356	271	246	1,120	235	260	272	270	1,002	271	294	305	300	1,123
Income (loss) from discontinued operations	(55)	225	392	3	3	(52)	2	(44)	-	-	-	-	-	-	-	-	-	-
Net income (loss)	361	1,150	1,225	250	359	219	248	1,076	235	260	272	270	1,002	271	294	305	300	1,123
Adjusted EPS (diluted)		\$ 1.64	\$ 2.01	\$ 0.52	\$ 0.54	\$ 0.56	\$ 0.52	\$ 2.15	\$ 0.50	\$ 0.56	\$ 0.60	\$ 0.60	\$ 2.27	\$ 0.62	\$ 0.68	\$ 0.72	\$ 0.72	\$ 2.73
Diluted shares outstanding (millions)		481.93	483.93	486.06	487.52	483.58	474.51	482.18	467.51	460.51	453.51	446.51	457.01	439.51	432.51	425.51	418.51	429.01
Tangible book value per share		\$ 24.43	\$ 26.28	\$ 27.01	\$ 27.92	\$ 28.19	\$ 28.07	\$ 28.07	\$ 28.87	\$ 29.41	\$ 30.00	\$ 30.60	\$ 30.60	\$ 31.22	\$ 31.92	\$ 32.67	\$ 33.43	\$ 33.43

Source: BTIG Estimates and Company Documents

BTIG Covered Companies Mentioned in this Report

ALLY FINANCIAL, INC. (ALLY, Buy, \$30.00 PT; Current Price: \$19.24; Analyst: Mark.Palmer)

Appendix: Analyst Certification and Other Important Disclosures

Analyst Certification

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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Company Valuation and Risk Disclosures

Ally Financial, Inc. (ALLY, Buy, \$30.00 PT)

Valuation: Our \$30 price target is based on 0.9X FY18E tangible book value of \$33.43.

Risks: Primary risks to our recommendation include the potential negative impact of ALLY's loss of exclusivity privileges with General Motors (GM, Not Rated), dependence on the performance and prospects of the U.S. automotive finance market, dependence on capital and liquidity such that disruption of funding sources and access to the capital markets could negatively impact its business, dependence on ability to maintain relationships with dealers, regulatory restrictions that could impede Ally Bank's ability to grow deposits and thereby reduce the company's funding costs, and Federal Reserve stress tests that could impede the company's future ability to return capital if failed.

Ally Financial, Inc. (ALLY)

(\$)



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

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
10-Apr-14	23.98	31	Mark Palmer	Buy
06-Jan-15	23.06	32	Mark Palmer	Buy
11-Jan-17	20.15	30	Mark Palmer	Buy

Other Disclosures

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