THE BEAR TRAPS REPORT
INVESTMENT NEWSLETTER
In Cooperation with ACG ANALYTICS

04/10/2017

A Turn in the Credit Cycle

In this Note:

- After years of robust growth, the U.S. car market is showing considerable signs of stress. The growth in prior years was driven primarily by cheap financing and auto credit, which has surged dramatically. A deadly cocktail is closing in. A period of rising interest rates - with a wall of leases rolling off (approaching the used car market); these forces are moving the U.S. auto market near a vicious cycle of lower sales and lower prices. There are substantial macro economic side effects from a highly levered consumer, we get into them.

- In this scenario, the rental companies (Hertz $HTZ, Avis $CAR) and financing companies (Ally Financial $ALLY, Santander USA $SC) are the prime victims, but US exposed dealers and manufacturers are also vulnerable.

- Tesla TSLA is a screaming, short term trading sell. Up 40% this year with the average car maker off 19% from the 2017 highs, Tesla is priced for perfection.

- Oversold auto markers and sector finance companies are soaked in a very crowded short trade. We are well bought into the secular short trade in this space, just looks overdone at the moment. Any and all bounces should be sold in our view, **especially in Santander SC equity (Target $6).**

- We believe Q4 will mark the turn in the consumer credit cycle. We're seeing substantial evidence of meaningful credit deterioration. This is a first in a series of notes we will be putting out for clients on this important topic.

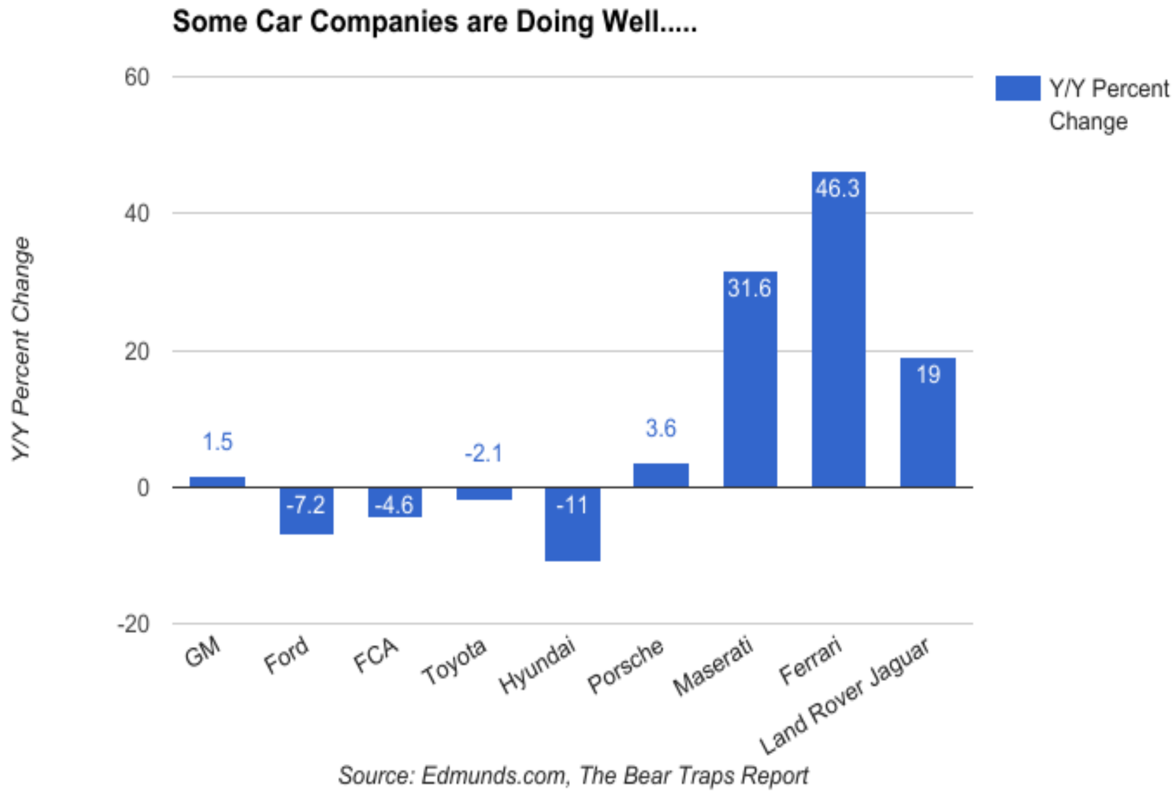
Santander's ABS (Asset Backed Securities) Conveyer Belt, Masks Debt Profile

If we look at Santander's debt profile, at first glance it appears that they do not have debt. Of course this is ***<u>not true</u>*** *and what makes these concerns even more intense is, all the debt is warehoused. We have seen this before, in 2007 New Century's debt looked to be very small if any, but if you looked at their warehousing totals, it was over $26 billion. We believe this is the case for Santander which has total debt of $31 billion. This sort of financing structure works if you can continue to securitize the* *instruments, in this case auto loans, fast enough to prevent the massive leverage from appearing on your balance sheet. As the auto bull market has been fierce over the past few years, these threats have not materialized. However, we believe the market has reached a tipping point. The conveyer belt is at risk of a red light off in the distance. Santander's ability to move the debt off it's balance sheet at today's pace is highly unsustainable. If the company cannot maintain the current pace of securitization, this will create substantial massive leverage problem for the company. They have relied on an asset backed security conveyer belt to run in perpetuity, it will not and the stock will suffer.*

The growth in prior years in the auto market was driven primarily by cheap financing and auto credit which has exploded in the last few years. The mean reversion is coming as the secular shift has arrived. A period of rising interest rates and a wall of leases rolling off and hitting the used car market, can push the US auto market into a vicious cycle of lower sales and lower prices. In this scenario, the rental companies (Hertz, Avis) and financing companies (Ally Financial, Santander USA) are the prime victims, but U.S. exposed dealers and manufacturers are also very vulnerable.

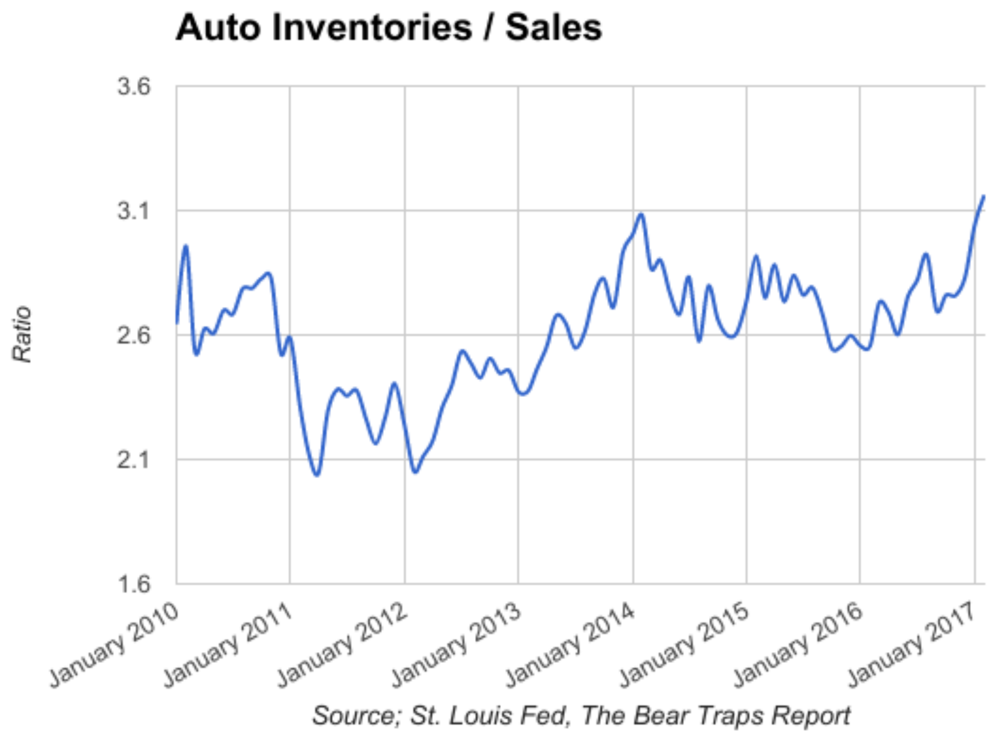
March Auto Sale Numbers Disappointed

March light vehicle sales equate to 16.62 million seasonally adjusted annualized rate of cars sold, this is the lowest pace in 25 months. This data is confirming a much feared negative trend for U.S. auto sales, as they've declined on a year-over-year basis in nine of the last 13 months. Auto sales were sluggish **DESPITE THE BIGGEST INCENTIVES IN 8 YEARS,** over $3500 per vehicle for U.S. automakers.



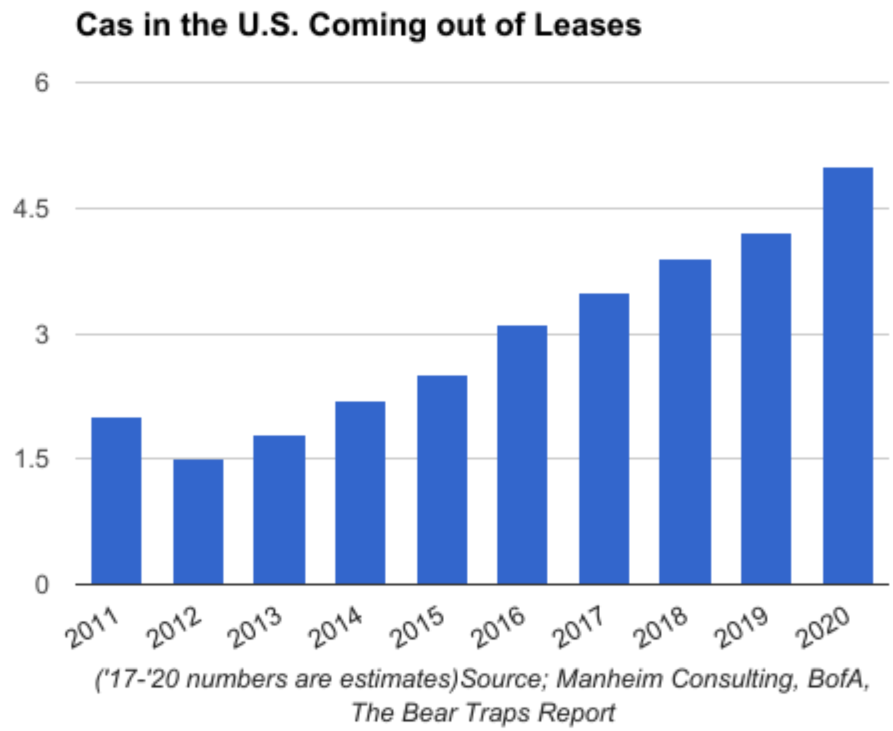
March vehicle sales missed expectations and came in at the lowest level in two years. Besides the high-end segment, every major car maker missed expectations despite a record high level of incentives. Dealer inventories also surged to almost 100 days at GM and Chrysler. While the big three car companies (GM, Ford, FCA) showed year over year declines in car sales, and other more mainstream brands such as Toyota and Hyundai, also displayed weakness, Ferrari and Maserati did not have much of the same issues. Of course, the numbers for luxury automakers are much more volatile as they sell only a fraction of the cars, but to us it is noteworthy to see Ferrari's sales rise by almost 50%, while the majors struggle. The inequality decade rolls on.

Car Prices Look Set to Fall



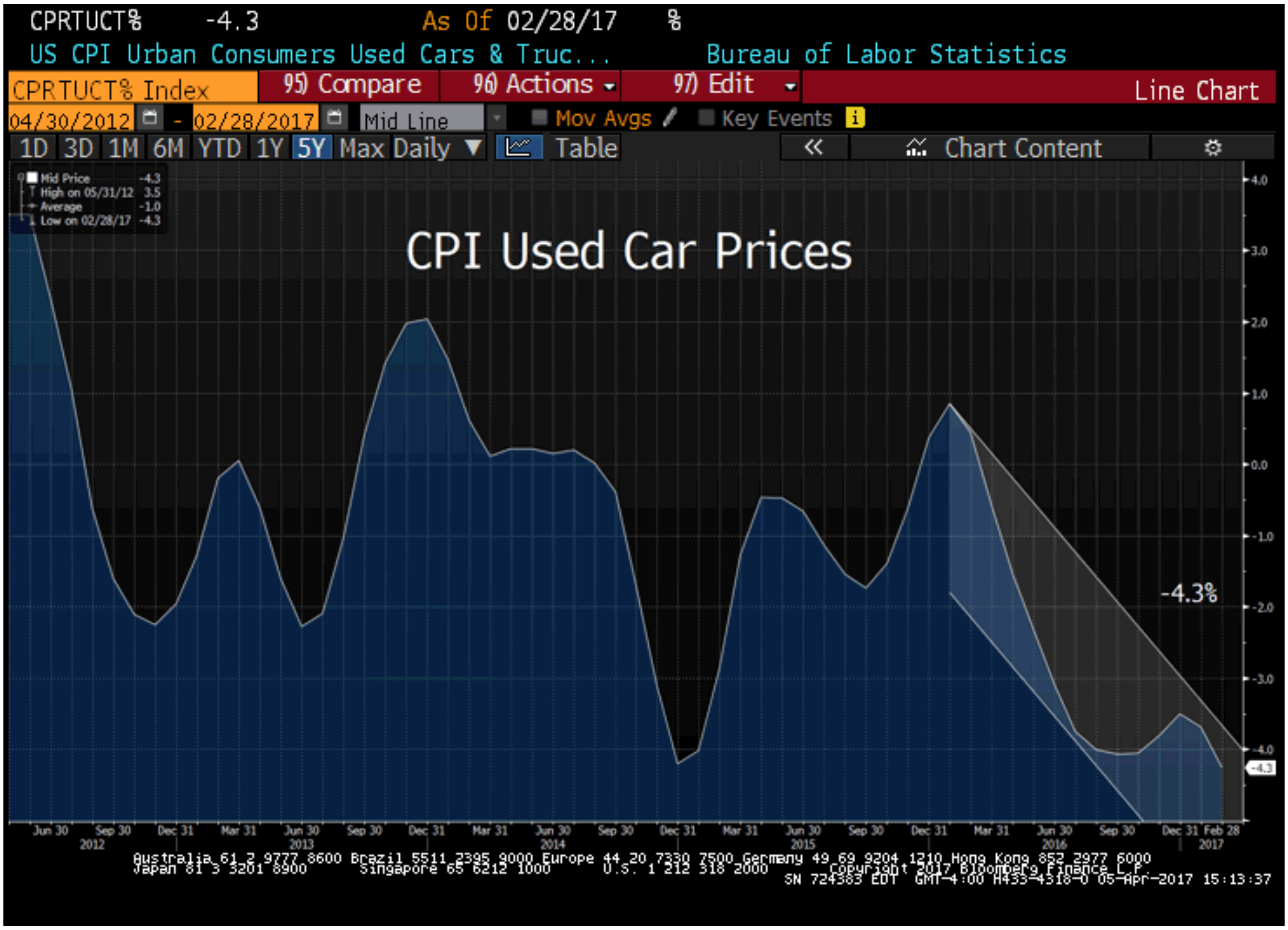
Inventory levels for the autos continues to grow as the majors (Ford, GM, Chrysler) are left with a massive stock of cars on their lots. The inventory buildup will have to weigh on future prices, leading to earnings reductions for many mainstream car companies. As we have stated in previous reports, the consumer looks maxed out. Delinquencies are rising, discretionary income is falling and high debt levels persist; car demand will continue to slow in the coming months. This means auto makers will see their EPS hit as they deal with this massive inventory glut.

Leased Cars Hitting the Used Car Market will Crush Prices



The volume of lease cars hitting the used car market has doubled since 2013 and is expected to rise by another 80% in the next three years, to 5 million cars in 2020. This is putting pressure on used car prices, which declined by 5% y/y in February. Lower used car prices equals lower residual values for cars. This causes lease rates, which are already rising due to Fed tightening and rising LIBOR, to go up further. For example, +200bp in APR vs 2016 and a 5% decline in residual values causes lease rates to increase by $100 per month, or +23%. This is a massive figure given how much of the car market is predicated on financing. About 85% of all new cars and 55% of used cars have been financed or leased, and financing rates are therefore a critical factor driving auto sales.

Falling Used Car Prices (from CPI) is Big Problem



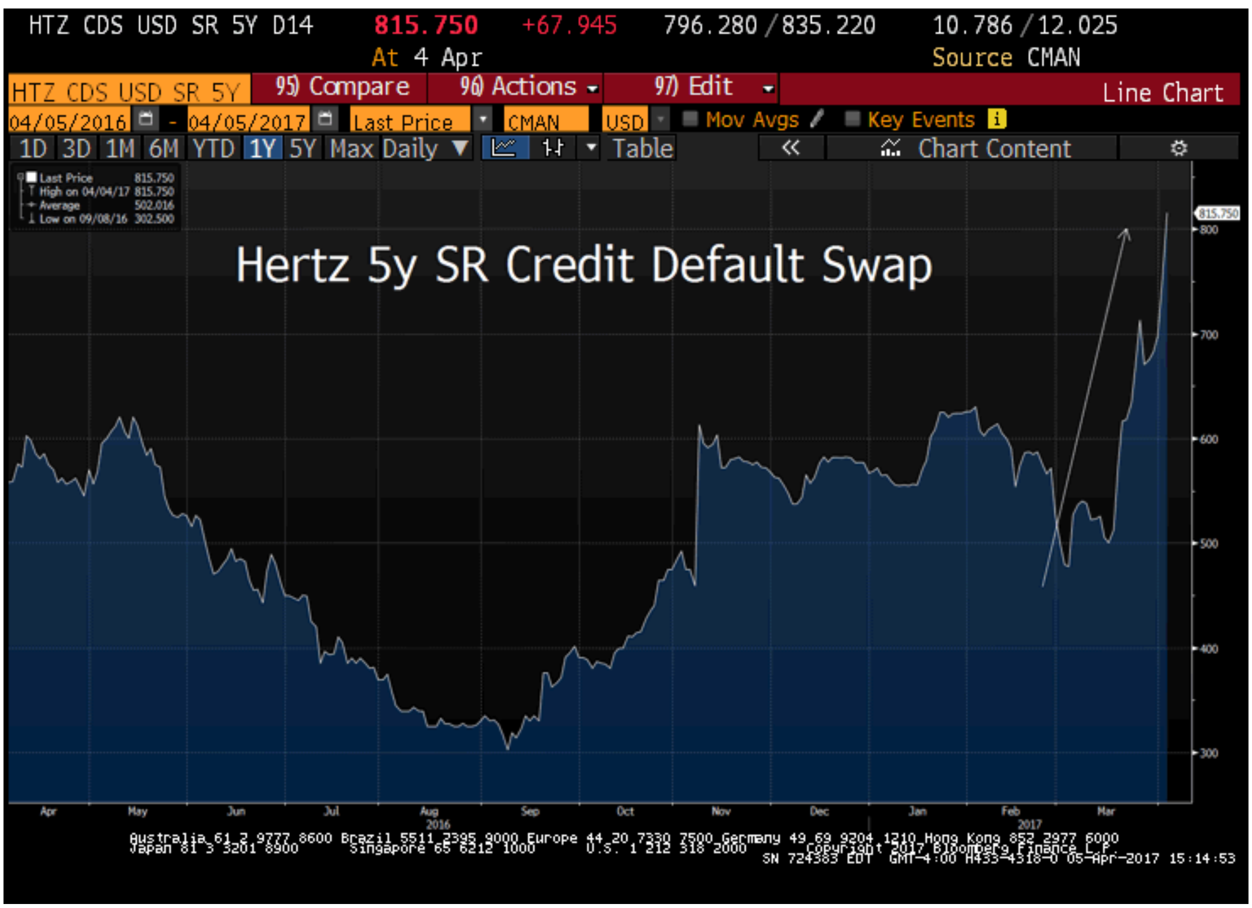
As we showed above, lower used car prices equals lower residual values for cars. This is a massive problem especially for rental car companies that are heavily exposed to residual values. As the supply does not look to be waning and considering the amount of leases that are poised to roll off over the next few years, used car prices will continue to decline. This problem is amplified by how levered some of these rental car companies are, as we explain below.

Rental companies (Hertz and Avis) and financing companies (Ally Financing and Santander USA) are the most vulnerable in such a vicious cycle.

Rental Car Companies Rely on Used Car Market

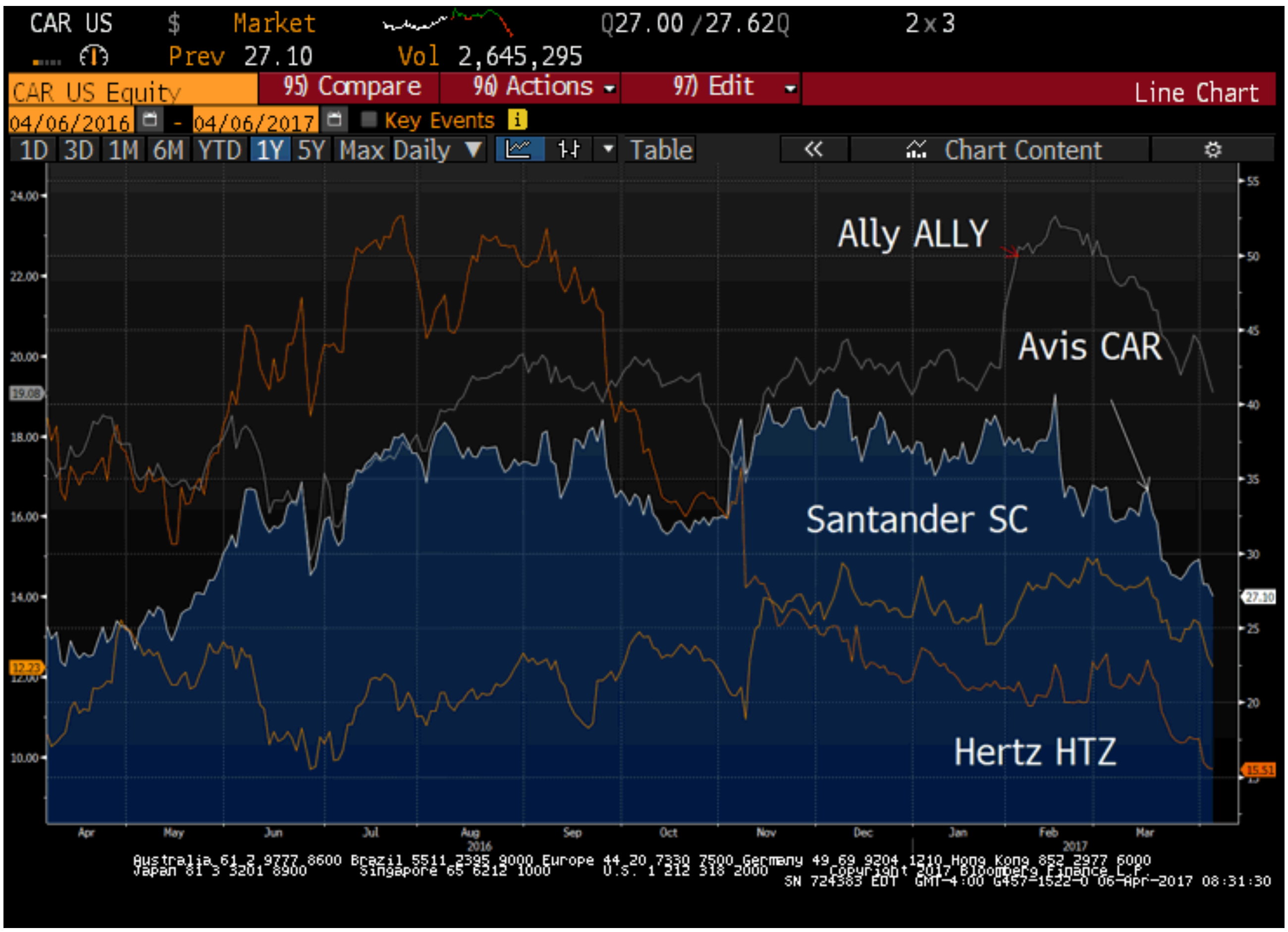
Cars coming out of rental fleets are mostly sold in the used car market. Hertz discloses that every 1% decline in residual values is a $60m (10%) hit to EBITDA. Avis has a similar fleet size as Hertz (650K cars) and their sensitivity to EBITDA should be comparable. Despite a 5% year over year decline in used car prices, the street still forecasts EBITDA of both companies to increase this year. The vulnerability is amplified by their (mostly asset backed) leverage; Hertz has $17 billion in debt and $1 billion of equity while Avis has $18 billion in debt and $600 million in equity.

Credit for Big Rental Car Companies is Scary



Credit default protection spreads are pricing in big problems for rental car companies such as Hertz. As we see in the chart above, in recent weeks, Hertz's 5 year default protection spread is up over 300 bps. As used car prices continue to fall, residual values will leave Hertz and other big rental car companies facing massive losses, still even bigger than the street estimates.

Lenders with High Percentage of Loan Book in Subprime Auto will Struggle



The space that we are looking at shows a bloodbath of sorts. The auto recovery bubble has clearly peaked. The next part of this story for the financial companies with such a high percentage of their loan book in auto loans, specifically in lower grade credit, those share prices will need to react further. We think as the fall in car prices accelerates and the *weakness in repayments continues, these equities could continue to get crushed.*

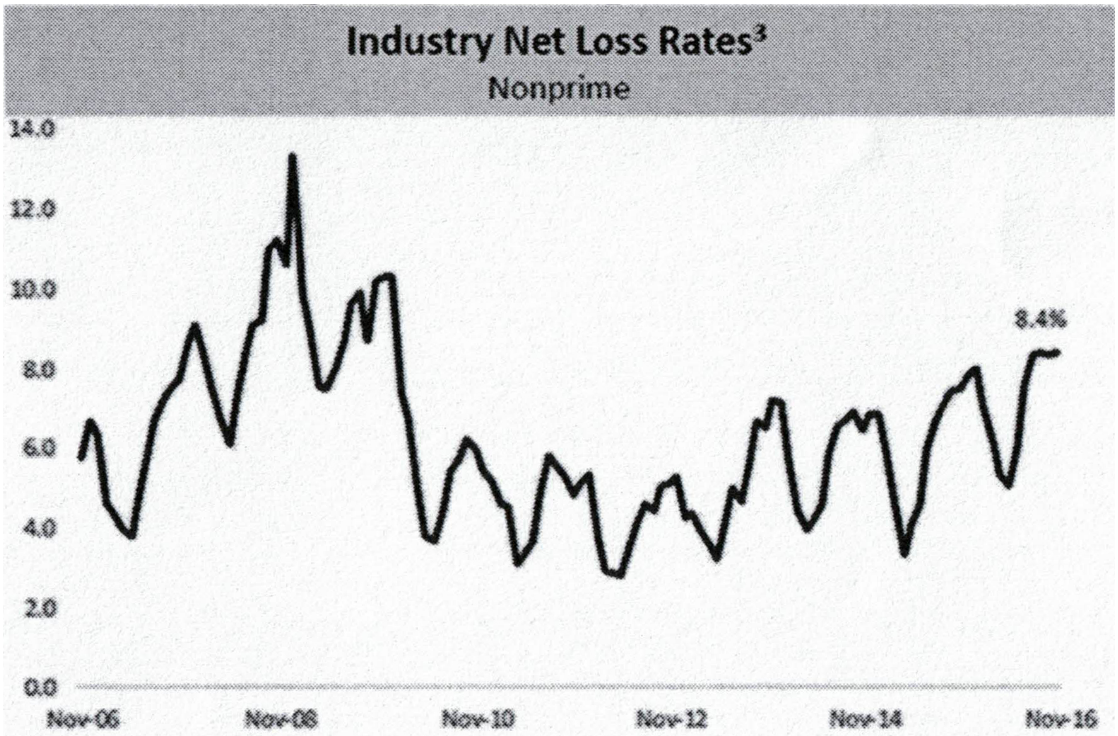
Share Performance since 2017 Equity Price High

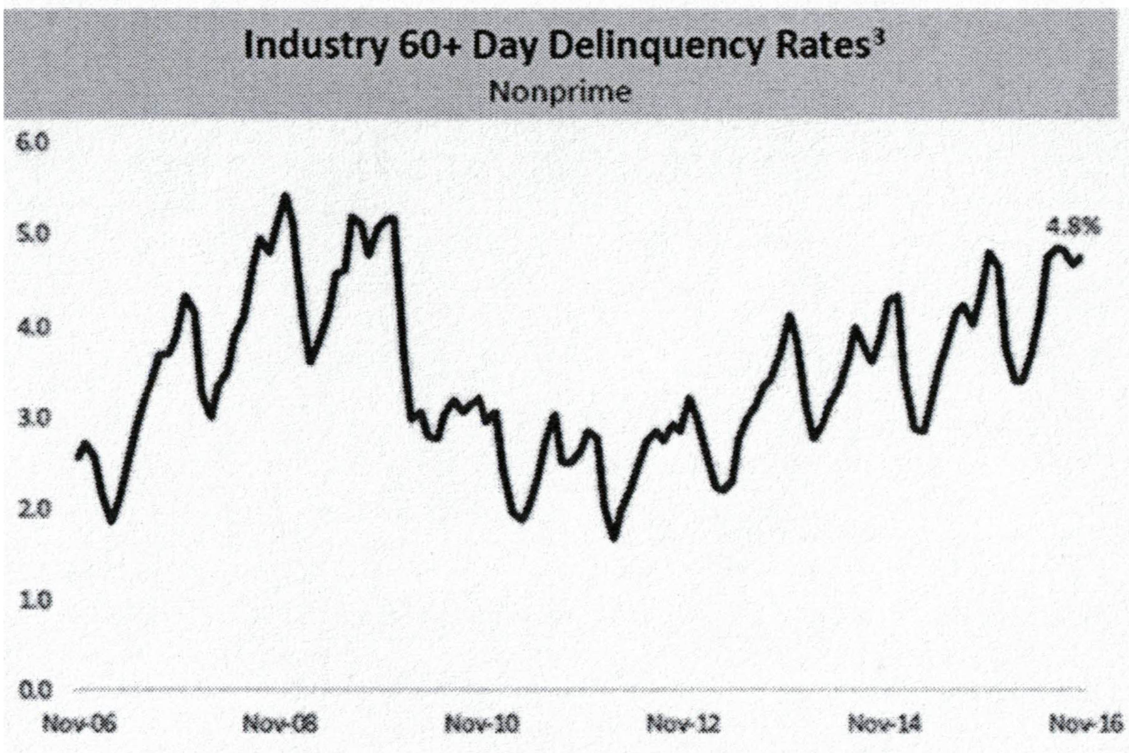
Hertz: -35.6%
Avis: -33.4%
Santander: -21.1%
Ally: -19.7%
Ford: -15.2%
GM: -11.5%
Tesla: +36%

Bloomberg data

Financials with Big Auto Exposure

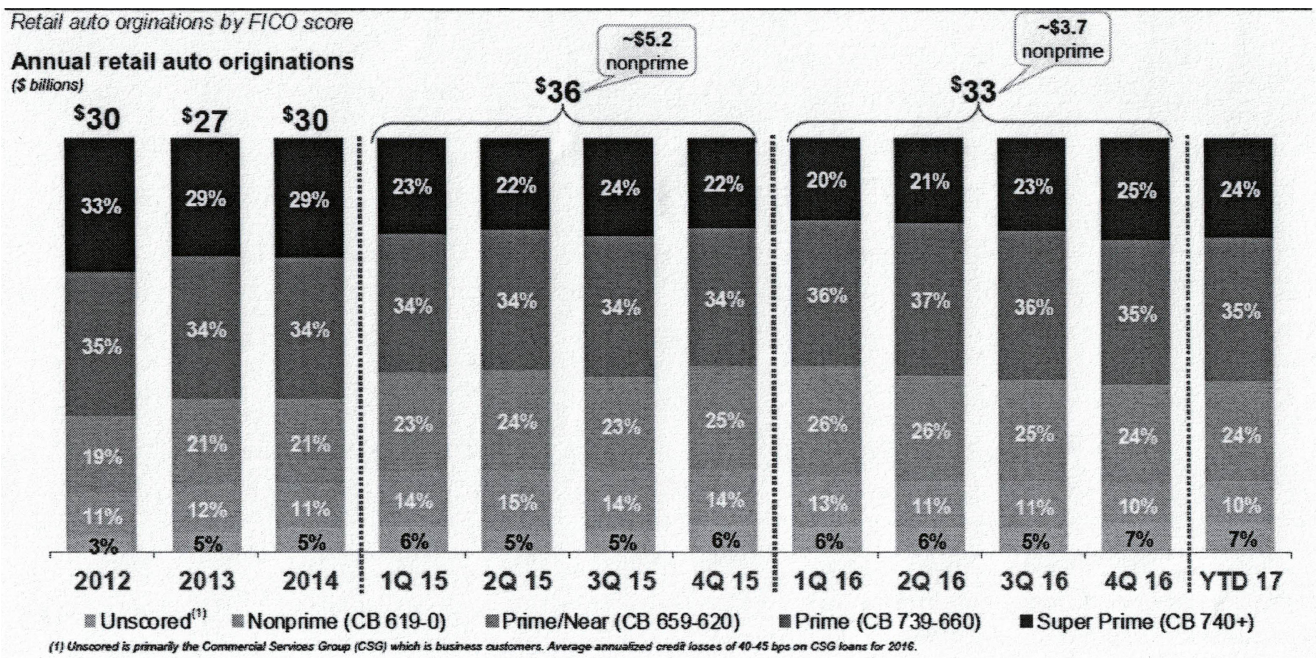
Ally Financial (ALLY) and Santander USA (SC) are the largest independent U.S. lenders for auto purchases and leases. Ally used to be GMAC and finances mostly GM cars while Santander USA finances mostly Chrysler cars. Higher delinquency and repossession rates (chart below) means less income from existing leases and more cars in ownership. The declining used car prices means the repossessed cars they sell get lower prices, which forces them to raise charge offs. The slowing new car sales means revenues are going down.


Industry Net Loss Rates3
Nonprime
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
8.4%
Nov-06
Nov-08
Nov-10
Nov-12
Nov-14
Nov-16

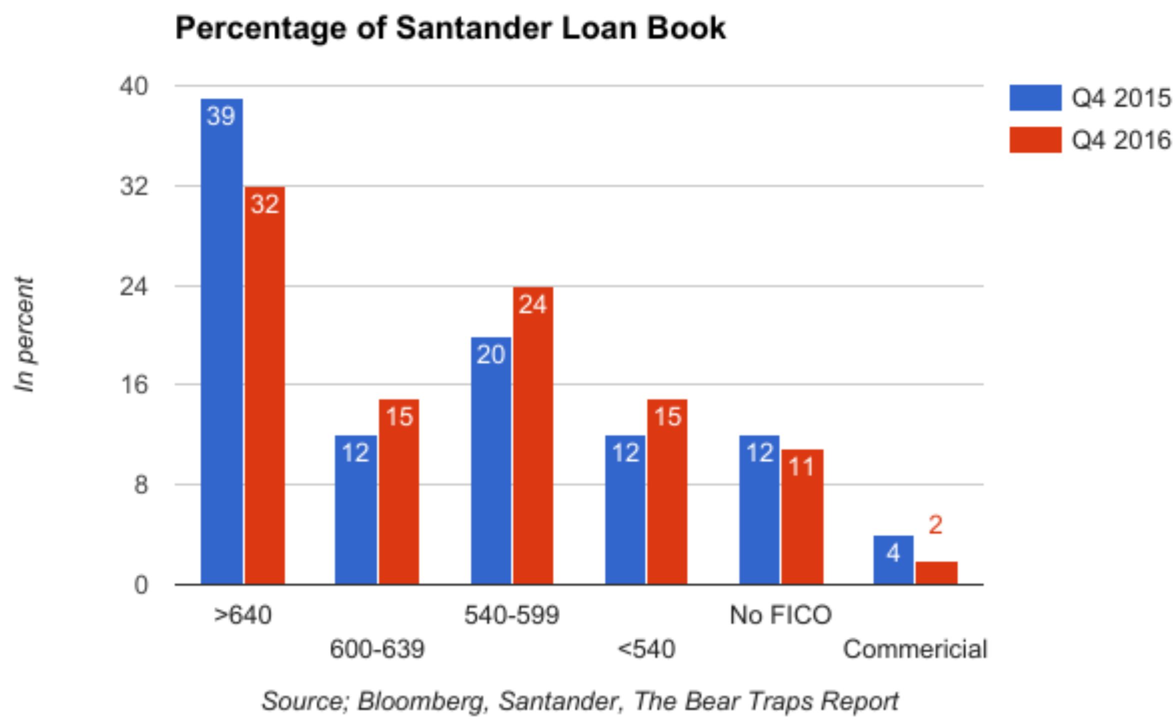

Industry 60+ Day Delinquency Rates3
Nonprime
6.0
5.0
4.0
3.0
2.0
1.0
0.0
4.8%
Nov-06
Nov-08
Nov-10
Nov-12
Nov-14
Nov-16

If charge offs go up by 20% it would cut Ally EPS by 20%, while Santander USA EPS would decline by almost 40%. Both companies tend to service the lower end of the market; 50% of Ally's loan book is subprime while 70% of Santander USA is subprime. Both companies are leveraged 10:1 with loan books 10x the size of their equity.

Ally Financial Loan Book is 50% Subprime (from company fillings)



Santander Loan Book is 70% Subprime



It looks like that much of the post crisis lessons were lost on Santander as they continue to reach further down the credit curve to lend. The rate of change from last year's level in isolation is staggering, as of now 70% of their loan book has subprime exposure. This will not end well, especially as the macro conditions of falling inflation adjusted incomes and weaker used car prices, will weigh on these loans. Santander is in a pickle, defaults are moving higher in the space and the collateral of the used car is weakening as prices fall, this is a massive problem for this equity.

Hertz and Avis Share the Pain

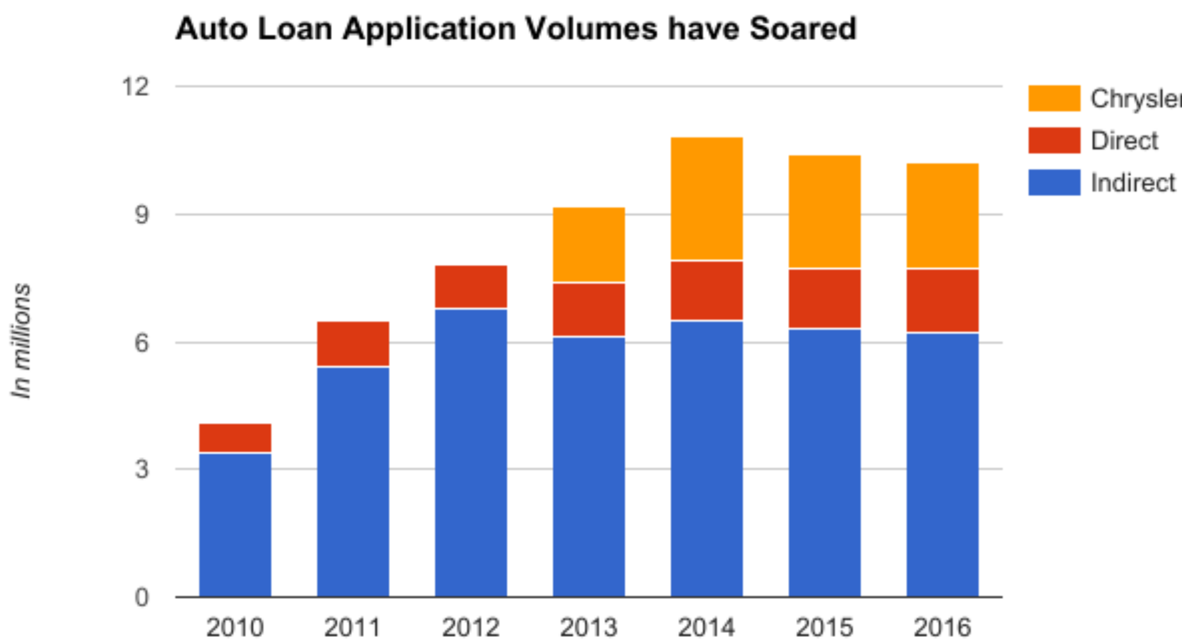
While Avis's bonds continue to take a beating, Hertz credits are in free fall. The problem for these rental car companies is, their balance sheet is completely levered to this auto recovery we have seen since 2012, especially in the used car market. As auto loans begin to fail at a faster pace and residual values of an already depreciating asset fall, these credit will continue to trade under pressure.

Auto Loans Have Skyrocketed Since the Crisis

Auto loans outstanding, owned and securitized reached over $1 trillion in 2015, and has kept climbing. We are probably at a peak as loan standards are tightening (finally!) and demand for car loans is falling. This staggering chart shows the lessons of 2008 were not learned. Wall Street and big car companies went back to pushing car loans on lower end creditors, and created a monster. It is not housing big but, auto loans outstanding have gone up by $400 billion and the credit quality they rely on has gotten worse. What makes this problem worse is the autos are innately an asset that depreciates, and now any value lenders would get from repossessions is also falling dramatically as used car prices collapse.

So, lets get this straight. We have an economy near full employment in what every economist on Wall St. calls a strong jobs market, we have surging auto loan defaults? This is moral hazard gone bad, the Fed has kept interest rates so low for so long – the net result? We have an ugly pile of bad loans on our hands. In 2006, clueless economists lectured us "we cannot have a surge in home mortgage defaults with the labor market as strong as it is." A similar dynamic is playing out today, nearly 178,000 (three month average) new jobs are being created each month in the U.S. while at the same time we're seeing an uptick in consumer credit defaults.

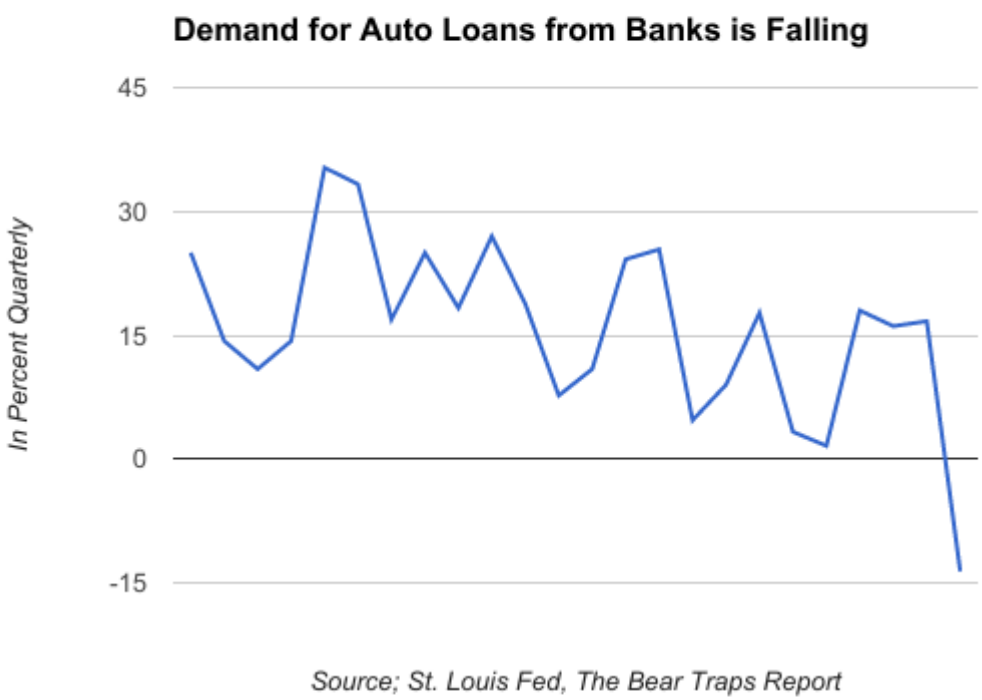
Auto Application Loans at Historic Highs



Source; Santander, RoadLoans.com, The Bear Traps Report

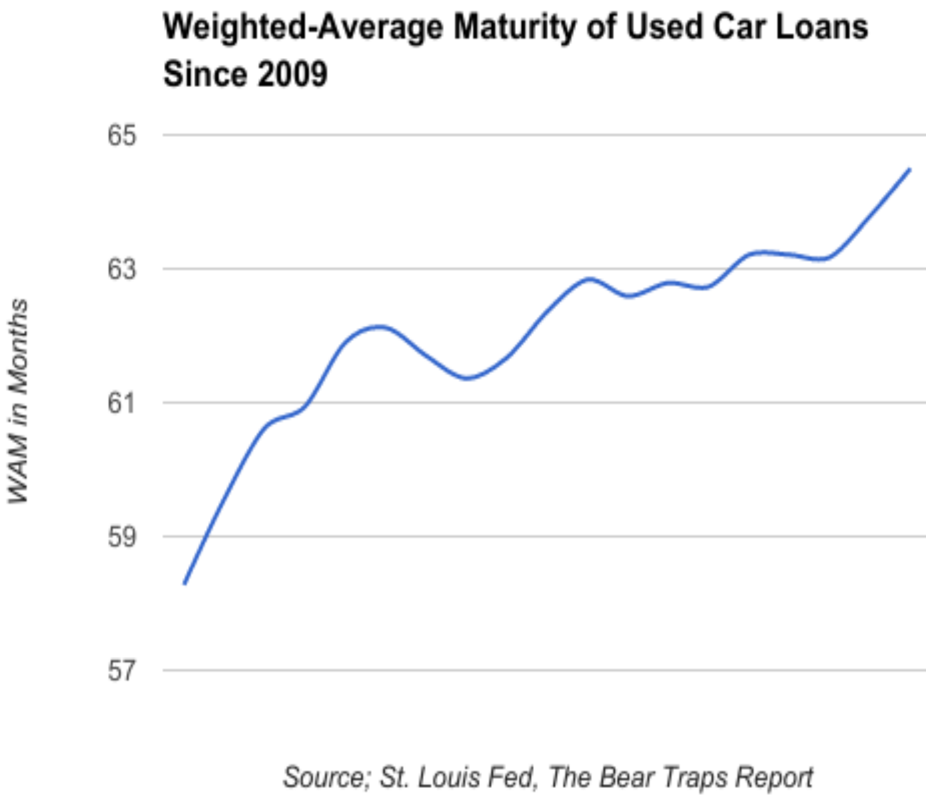
Since 2010, auto loan applications have skyrocketed, but now seem to have peaked. The consumer was greatly incentivized to buy cars in the post crisis landscape. Banks were willing to push out maturities, in some cases up to 96 months and the car companies pushed big incentives. The storm was also fostered by a tremendously low interest rate environment thanks to the Fed. The question now for the auto market, who is left to buy a car? The market has become dependent on trade ins and pushing consumers on new cheap financing options. If people stop *doing trade ins, as we will see with the wall of leases coming due over the next five years, these financiers will be in trouble.*

Net Percentage of Domestic Banks Reporting Stronger Demand for Auto Loans



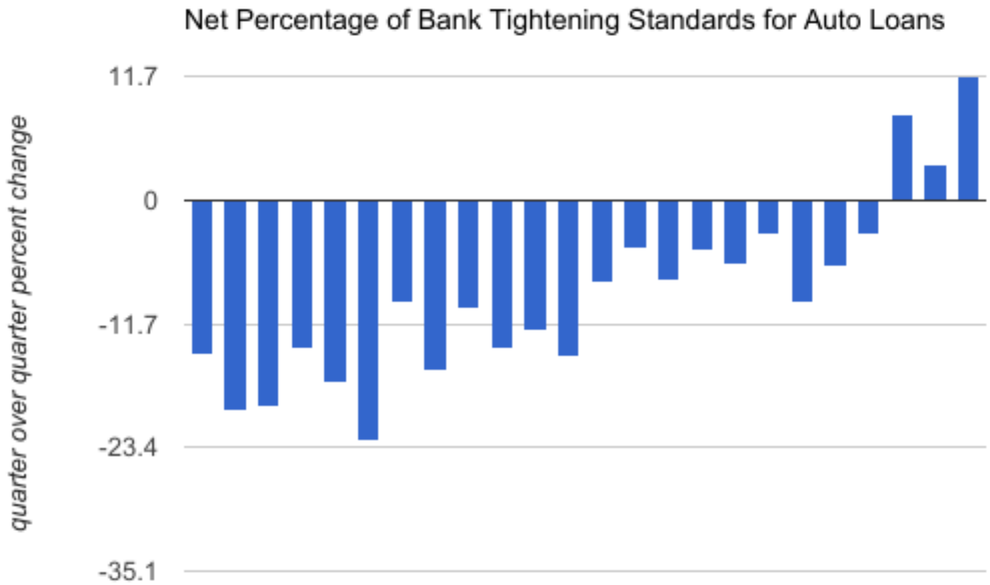
Auto loan demand went negative towards the end of last year. As we showed above, this is a problem for car companies especially who are left with massive amounts of supply on their lots. The inventory/sales number will only increase if people are not demanding loans for autos, as usual car purchases in the U.S. are almost 85% done through financing.

Weighted Average Maturity of Used Car Loans at Auto Finance Companies



To support sales growth and keep monthly car payments affordable, lenders have been extending the terms of loans to consumers, in many cases as long as seven years, as we see above with weighted average maturities. So to push these auto loans, the Santander's of the world pushed subprime borrowers with extended maturities to make their monthly payments "affordable." The problem now is that as auto loan delinquencies rise and the value of these used car prices falls, these lenders get hit by a double whammy.

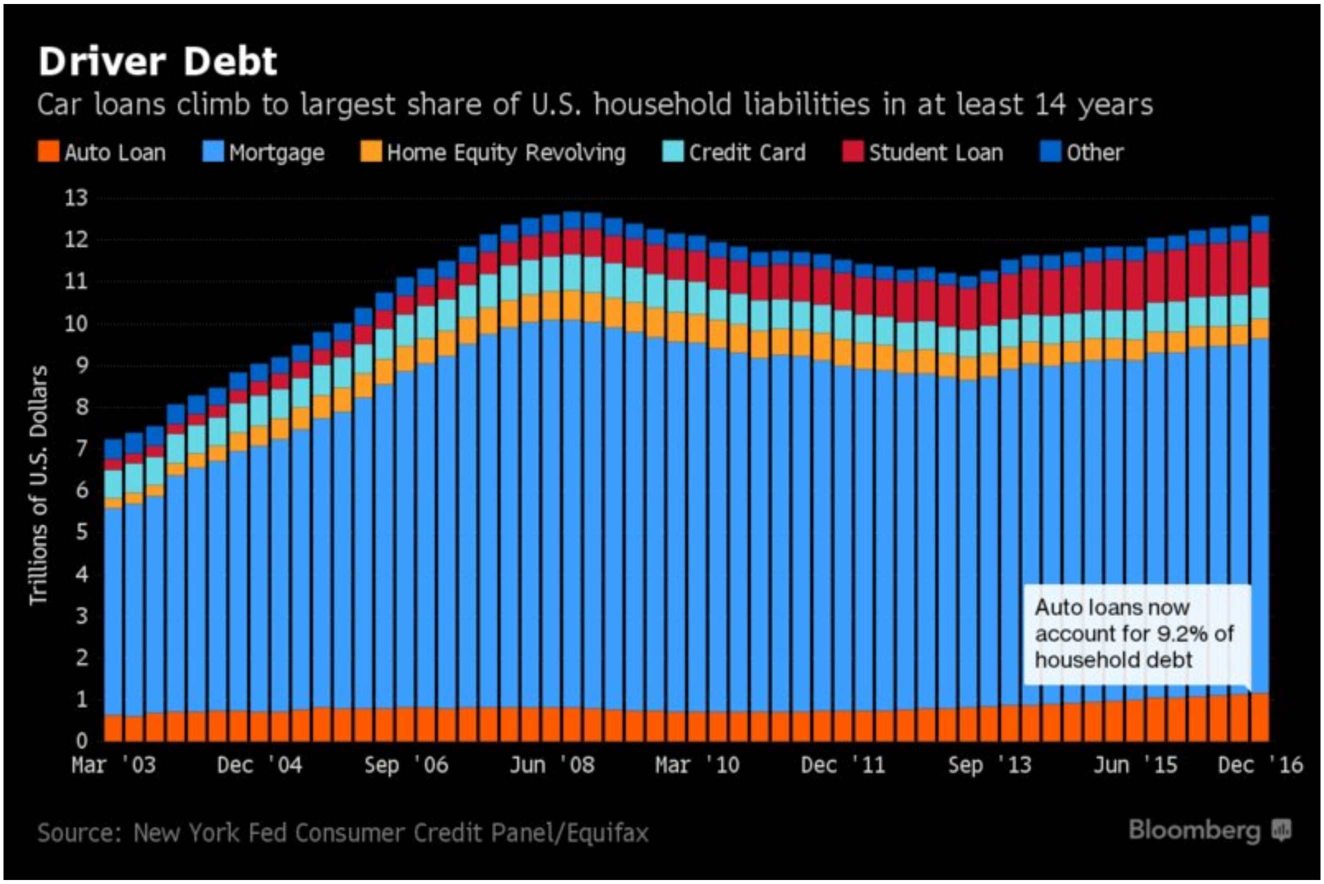
Bank Tightening Standards for Auto Loans



(Data set is quarterly since 2011) Source; Federal Reserve System's Senior Loan Officer Opinion Survey, The Bear Traps Report

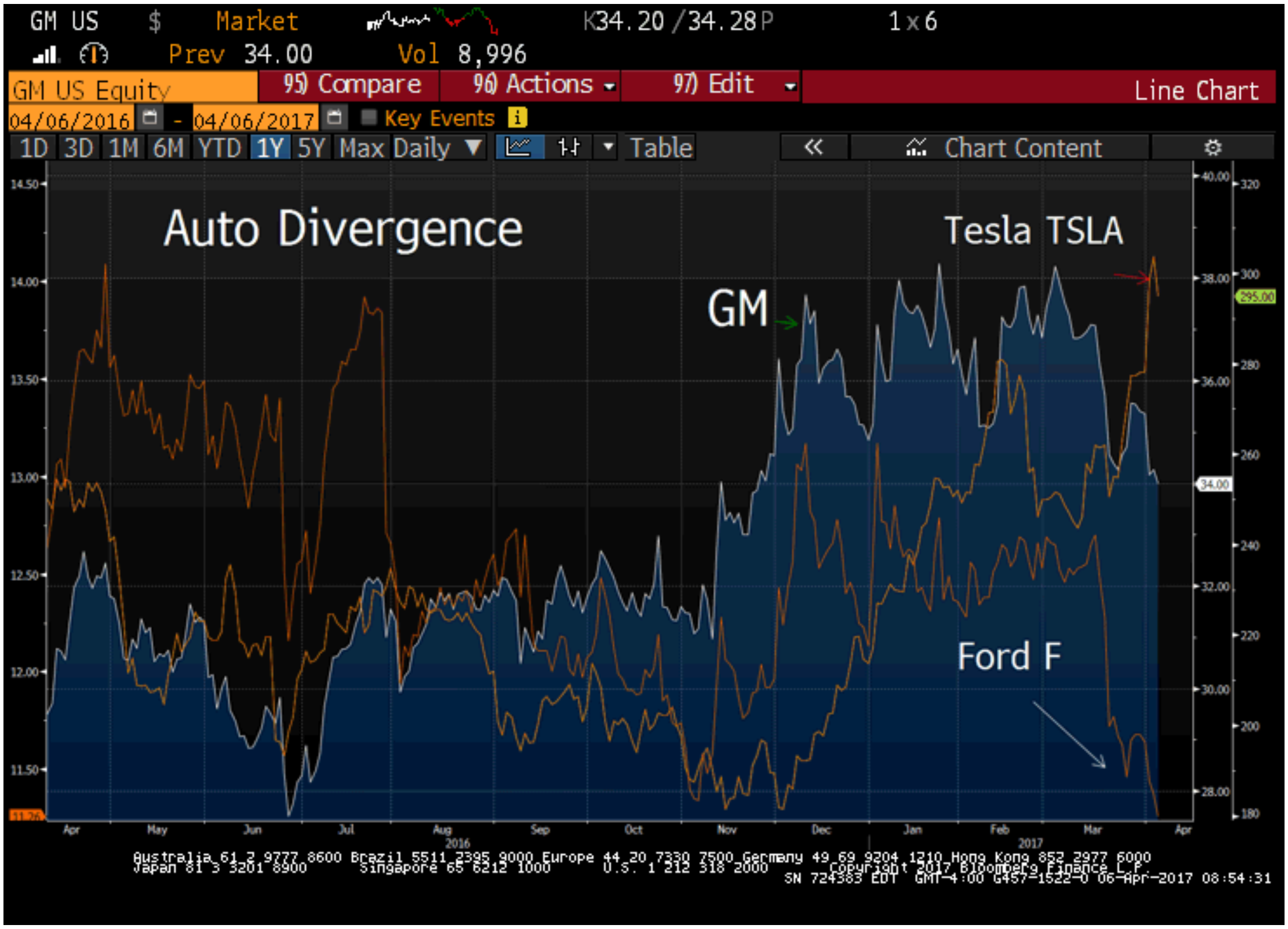
It looks like the jig is up as banks are finally beginning to take closer notice. Standards for borrowers trying to get auto loans is increasing for third quarter in the row. After a massive easing of standards, banks are finally adjusting to the realization of this problem. It is noteworthy that the fourth quarter was the highest tightening of loans standards since the crisis. Banks are figuring out the auto loan bubble is over and they need to adjust to make sure they do not add to their losses.

Becoming Bigger Part of Household Debt Profile



U.S. auto loans in the fourth quarter reached about 9.2% of all household debt, the highest share in data going back more than a decade. the average amount used to finance a new-car loan also reached a record $29,469, according to Bloomberg. To support sales growth and keep monthly car payments affordable, lenders have been extending the terms of loans to consumers, in many cases as long as seven years, as we see above with weighted average maturities. It's pure comedy, an asset that depreciates faster than a summer vacation is receiving longest term financing ever?!

Tesla Soars While Majors Suffer



While the market slams GM and Ford for having too much supply in a consumer finance market that is worsening, Tesla share price is making record highs. In time this trend will reverse, just from a valuation perspective, but it does convey striking messages about the current market. First, the Tesla narrative seems to have pushed investors away from companies that are priced more than 100 points lower on an P/E basis, in hopes of capturing Elon Musk generated hype. The other thing it says is, the higher end market is better equipped to handle supply problems and a slowdown in consumer credit.

GM CFO and Head of IR Address Analysts

In damage control mode, GM brought the sell-side together last Thursday. The Street came away comforted with the bull thesis.

Points of Interest

- 2017 guidance remains in place (with GM confidence),
despite industry challenges that have suppressed their equity price this year.
- GM stressed further self-help opportunities post the pending Opel sale- these opportunities are incremental to the company's current cost savings program.
- GM's North America product cycle should continue driving net pricing tailwinds this year and prospectively into 2018 as roughly two-thirds of the company's vehicle lineup (crossovers and trucks) undergo a redesign.

Enterprise Value (not counting cash)

Ford	\$125B (\$45B Equity + \$80B Debt)
GM	\$93B \$51B Equity + \$42B Debt)
Tesla	\$56B (\$49B Equity + \$7B Debt)

Tesla for sure has the strongest balance sheet, but it's an equity trading very very rich to its peer group.

The Street's Bullish estimates for Tesla are out of Touch with Reality

- Some street analysts have current EV/EBITDA for the company at 15x 2021 earnings and discount the result at 15%, gives you a price target of \$368.
- The street is using 2021 as its reference year because that is when they expect volume growth to taper and margins will normalize.
- Against much of their more technological peer group, not even fellow auto companies, this represents at least 3x EV/EBITDA premium.
- The question is, can Tesla sustain these projections going into 2021, we think not.

- The September $300 / $225 Put Spread on TSLA is attractive in our view, solid risk reward in our view (institutional investors only).

Tesla Short Interest

Nearly 30% of Tesla shares are short, covering has contributed to the recent surge in price per share.

Best Regards,

The Bear Traps Report Team

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