



Santander Consumer USA Holdings Inc.

First Quarter 2017 Earnings Call

April 26, 2017

C O R P O R A T E P A R T I C I P A N T S

Evan Black, *Vice President, Investor Relations*

Jason Kulas, *President and Chief Executive Officer*

Ismail “Izzy” Dawood, *Chief Financial Officer*

C O N F E R E N C E C A L L P A R T I C I P A N T S

John Hecht, *Jefferies*

Jack Micenko, *SIG*

Mark DeVries, *Barclays*

Jeff Adelson, *Morgan Stanley*

Steven Kwok, *KBW*

Eric Wasserstrom, *Guggenheim Securities*

David Ho, *Deutsche Bank*

Moshe Orenbuch, *Credit Suisse*

Chris Donat, *Sandler O'Neill*

Charles Nabhan, *Wells Fargo*

P R E S E N T A T I O N

Operator:

Good morning and welcome to the Santander Consumer USA Holdings First Quarter 2017 Earnings Conference Call. At this time all parties have been placed into listen-only mode. Following today's presentation the floor will be open for your questions. Please dial star, one to enter the Q&A queue.

It is now my pleasure to introduce your host Evan Black, Vice President of Investor Relations. Evan, the floor is yours.

Evan Black:

Good morning and thank you for joining the call. On the call today we have Jason Kulas, President and Chief Executive Officer, and Izzy Dawood, Chief Financial Officer.

Before we begin, and as you are aware, certain statements made today such as projections for SC's future performance are forward-looking statements. Actual results could be materially different from those projected. SC has no obligation to update the information presented on the call. For further information concerning the factors that could cause these results to differ, please refer to our public SEC filings.

Also on today's call, our speakers may reference certain non-GAAP financial measures that we believe will provide useful information for investors. A reconciliation of those measures to US GAAP is included in the release issued today, April 26, 2017

For those of you listening to the webcast, there are a few user-controlled slides to review as well as a full Investor Presentation on the website.

I'll turn the call over to Jason Kulas. Jason?

Jason Kulas:

Thank you and good morning everyone. Today I'll discuss our first quarter highlights and provide an update on our key strategic priorities. I'll then turn the discussion over to Izzy for a detailed review of the quarter's results, and then open the call for questions.

Turning to Slide 3 to share some of the key highlights from the first quarter of 2017, we are pleased to report solid results for the first quarter of 2017. Our assets are producing solid risk adjusted cash flows. Our capital base is solid and our focus on keeping our business simple, personal and fair is positioning us for continued success.

During the quarter, SC earned net income of \$143 million or \$0.40 per diluted common share. Net income was impacted by a few unique items this quarter, including accrued interest related to TDR loans, writedowns on loans in bankruptcy and expenses. Izzy will discuss these items during his more detailed commentary on Q1 performance.

Return on average assets for the quarter was 1.5%. Auto originations including loan and lease totaled \$5.4 billion this quarter, down from the prior year quarter due to our disciplined underwriting standards and a competitive market. During the first quarter we executed an agreement to flow prime retail loans to Banco Santander. We expect this strategy to further strengthen our relationship with FCA and positively influence Chrysler Capital by providing a stable framework for originations.

Our track record of rating agency upgrades continued, demonstrating the strength of our ABS platforms. In total, 49 ABS tranches were upgraded this quarter, positively impacting more than \$4 billion in securities.

Turning to Page 4, here are some key economic indicators that influenced our originations and credit performance. US auto sales remain elevated but are ticking down versus recent highs, and consumer confidence remains high. US GDP growth is in line with the recent historical range and unemployment levels continue to be very low. These metrics are strong indicators of the health of the economy and the US consumer.

On Page 5 there are a few key factors that can influence our loss severity and credit performance. As expected, our auction only recovery rates are trending down and in line with the NADA trends. However, auction plus recovery rates, which include insurance proceeds and bankruptcy and deficiency sales, are only slightly down versus the first quarter of 2016. We continue to model lower recovery assumptions than current experience and believe we are adequately reserved. Additionally, non-prime industry securitization data, including delinquency and loss, show these trends are relatively stable to moderately higher. In either case, SC auto ABS remains structurally sound.

Turning to Page 7, in March we executed an inaugural transaction for approximately \$700 million prime retail loans with Banco Santander. We expect this strategy to support Chrysler Capital by providing a more stable framework for Chrysler Capital originations. This will in turn also be supportive to our Serviced for Others strategy through more prime asset sales. The two-year agreement will also provide SC with \$750 million in additional capacity to fund originations between transactions. This warehouse agreement closed in April, bringing our related party funding commitment to approximately \$7.7 billion, up from \$7 billion as of March 31, 2017.

Turning to Page 8, auto originations during the quarter totaled \$5.4 billion, down 21% from the prior year quarter. Originations with FICO scores below 640 in our core and Chrysler Capital channels decreased 16% and 33%, respectively, versus the prior year quarter. Core originations increased 9% quarter-over-quarter and Chrysler Capital loans above 640 decreased 42%, and leases were flat versus the prior year quarter.

Regarding our direct to consumer platform, volume through our Road Loans channel totaled \$53 million this quarter, up slightly versus the prior year quarter. This online portal has been additive to application volume and we expect Road Loans to be incremental to our originations as the market evolves.

We are committed to booking loans with attractive risk adjusted returns that will perform through cycles and create shareholder value. In our efforts to find pockets of value, we saw a moderate increase in non-prime originations in both our core and Chrysler channels quarter-over-quarter, which has continued into April.

Turning to Slide 9 and further drilling down into our originations mix, in the first quarter the mix of our originations was relatively constant on a percentage basis. Loans with FICO scores below 640 decreased approximately \$840 million to \$2.7 billion, from \$3.5 billion during the prior year quarter. In addition, the average loan balance has decreased due to a larger percentage of used vehicles and lower loan to values, reflecting credit discipline.

Now moving to Slide 10, the Chrysler Capital penetration rate as of March 31 was 19%, up from 17% in December. We remain the largest finance provider for FCA. Chrysler Capital is a focal point of our strategy and we continuously seek out ways to enhance and grow our relationship with FCA.

We remain focused on three key strategies, including, first, we've increased the number of Chrysler Capital dealers in our VIP program and we are still on track to roll this program out to all FCA dealers in 2017. This improves our ability to book standard rate transactions.

Second, our dealer floorplan strategy with Santander Bank NA continues to grow. We have increased our dealer receivables originations by 44% compared to the prior year quarter after a year of strong originations growth in 2016.

Finally, the Banco Santander flow agreement, as I mentioned previously. It's also important to note that our Chrysler Capital volume and penetration rates are influenced by strategies implemented by FCA including produce mix and incentives.

Turning to Slide 11, while still a differentiator for our business, our Serviced for Others balance continues to decrease due to lower prime originations and lower asset sales. Servicing fee income totaled \$32 million this quarter as we continue to deliver value through this capital efficient platform. Moving forward, we expect to drive the Serviced for Others platform by increasing our Chrysler Capital penetration through the execution of the flow agreement with Santander.

I would like to turn now to Izzy for a review of our financial results. Izzy?

Ismail “Izzy” Dawood:

Thank you, Jason, and good morning everyone. As Jason mentioned, there are some specific items I will discuss in more detail, which I also mentioned in our call last quarter.

As we continue to remediate our material weaknesses and address qualitative findings in CCART and our fed written (phon) agreement, we are also aligning several practices to reflect FFIEC guidelines and performance of certain vintages. One of these changes related to bankruptcy accounts increased our net credit loss by \$24 million which was offset by \$9 million lower allowance for credit loss, and decreased our pre tax income this quarter by approximately \$16 million. This impact is timing related, by which I mean it would have been incurred in future periods but was accelerated into this quarter.

Separately, we are taking a more conservative approach to the accrual of interest for certain TDR loans. This change does not impact the bottom line but reduced net interest income by \$26 million and was completely offset by lower TDR impairment, and is reflected in allowance for credit loss. I will cover these points again in their respective slides.

Let's turn to Slide 12 to review this quarter's results. Net income for the first quarter was \$143 million or \$0.40 per diluted common share. Net leased vehicle income increased 18% as we continue to see growth in our leasing portfolio with FCA. Total Other Income this quarter was \$55 million, which is net of approximately \$65 million of lower of cost or market adjustments related to personal lending, and \$12 million in other losses that I will detail on a subsequent slide.

Moving on to Slide 13 which highlights our performance excluding the impact of personal lending. Further details can also be found in the appendix of the presentation. Interest on finance receivables and loans decreased 6% year-over-year due to a mix shift in the portfolio towards higher credit quality assets with lower APRs and lower interest income accrual for specific categories of TDR loans. During the first quarter we shifted to a more conservative approach related to the accrual of interest for certain TDR loans, and the approximate impact to the top line was \$26 million. As I mentioned previously, this is completely offset in our allowance for credit loss. As it reduces the carrying value of the loans and therefore requires lower impairment, this is also reflected in a lower TDR allowance ratio this quarter.

Interest expense increased 25% versus the prior year quarter, driven by the increase in benchmark rates. One month LIBOR increased more than 50 basis points from March 2016 to March 2017. Cost of funds of third party amortizers and warehouses increased approximately 60 basis points versus the first quarter 2016. Cost of funds in newly issued term ABS improved approximately 30 basis points due to spread tightening partially offset by benchmark rate increases. Similar to last quarter, these increases were partially offset by interest rate derivatives.

Servicing fee income decreased 29% year-over-year due to lower balances and a change in the credit mix of the Serviced for Others portfolio. Average gross retail installment contract balances were flat year-over-year. Leased assets were up 20% year-over-year and are expected to remain flat for the foreseeable future as our new originations are in line with lease terminations.

Turning now to Slide 14, we will further drill down into Total Other Income. Reported Total Other Income was \$55 million in the first quarter 2017. The impact of lower of cost or market adjustments for personal lending of \$65 million include \$111 million in customer defaults offset by a net reduction of market discounts of \$47 million as balances decreased versus the prior quarter, in line with seasonal patterns. Normalized investment losses for the quarter were \$12 million, primarily driven by losses on asset sales and customer defaults associated with auto assets held for sale. After including servicing fee income and fees, commissions and other, normalized Total Other Income was approximately \$120 million.

Turning out attention to provisions and reserves on Page 15, at the end of the first quarter 2017 the allowance figure totaled \$3.5 billion, up \$31 million from the end of the prior period. Drivers of the increase include \$171 million associated with new originations, \$128 million due to troubled debt restructuring or TDR migration, meaning the additional allowance coverage required for loans that now qualify for TDR treatment per our definition which we are not classified as TDRs during the prior period, and \$10 million due to performance adjustments. These are partially offset by \$278 million in liquidations which includes paydowns and charge-offs. As we discussed at our Investor Day, TDRs are an accounting classification for assets that meet certain loan modifications or extension criteria. Our Loans Servicing team uses loan modifications and extensions on a case by case basis to offer assistance to some customers experiencing temporary financial hardship. Under GAAP, the allowance requirement on an asset classified as a TDR takes into consideration lifetime losses and even if the loan performs it will continue to be classified as a TDR for the remainder of its life.

The allowance to loans ratio was 12.7% as of the end of this quarter, up from 12.6% at the end of the prior period. The primary drivers were increases in TDR balances and a denominator effect of slower portfolio growth. As I mentioned earlier the allowance of credit loss includes the reduction of approximately \$26 million related to TDR interest accrual and \$9 million related to accelerated charge-offs.

Continuing to Slide 16, delinquency rates, delinquency rates including the 31 to 60 and 61-plus buckets increased 40 and 80 basis points, respectively, from the prior year quarter. Retail installment gross charge-off increased 180 basis points and net charge-offs increased 120 basis points. The net charge-off ratio increased to 8.8% this quarter, up from 7.6% during the same period last year. The increases in both of these ratios were driven by the aging of the more non-prime 2015 vintage and overall portfolio ageing. As an example, in the current quarter, the 2015 vintage was approximately 30% of our loans outstanding, but contributed 35% of our losses. Additionally, portfolio ageing driven by lower originations decreases the denominator of this ratio and decreases the balances of loans in the numerator that are newer and have not yet experienced delinquency or charge-offs. Losses were also impacted this quarter due to writedowns of loans in bankruptcy which I will cover further on the following slide.

Recovery rates, as expected, increased from the prior quarter but decreased year-over-year. We continue to see a bifurcation in performance between sedans and larger vehicles such as SUVs and trucks, which have performed better but still continue to face declines in value.

Turning to Page 17 to review the loss figures in dollars. Net charge-offs in our auto loan portfolio for individually acquired retail installment contracts increased \$59 million to \$599 million. This quarter we accelerated approximately \$24 million in losses attributable to assets which are written down upon receipt of a bankruptcy notice. The majority of these losses would have been otherwise occurred later in the year and do not alter our overall view of losses for the year but rather represent a timing impact for Q1. Another \$19 million of the overall increase is due to portfolio growth, ageing and mix shift. The primary driver was portfolio ageing as the average unpaid principal balance was relatively flat versus prior year quarter. Recoveries were also lower this quarter by approximately \$19 million and bankruptcy deficiency sales increased versus the prior year quarter by approximately \$15 million.

Turning to Slide 18, operating expenses this quarter totaled \$305 million, an increase of 5% versus same period last year. This increase was driven by continued investment in Compliance and Control functions and severance expense related to efficiency efforts. The expense ratio for the quarter totaled 2.4%, up from 2.2% in the prior year quarter.

Turning to Slide 19, total committed liquidity increased 5% to \$41.4 billion at the end of the quarter versus prior quarter end. During the quarter we executed two DRIVE and one SDART securitization totaling approximately \$3.1 billion. As with our other DRIVE and SDART non-prime securitizations, these typically remain on our balance sheet and we retain the first plus position. Also during the quarter, 49 ABS tranches were upgraded, positively impacting more than \$4.2 billion in securities. Also, this quarter we increased unused capacity in our revolving facilities by approximately \$1.9 billion and remain confident in our overall liquidity position.

Asset sales in the quarter totaled \$931 million driven by our new agreement with Banco Santander.

Briefly turning to Page 20, our CET1 ratio for this quarter is 13.8% which is 170 basis points higher than first quarter 2016.

Looking ahead to Q2, my comments will be relative to Q1 unless otherwise noted, relative to Q1 2017 unless otherwise noted, and will include the impact of personal lending, unlike prior quarters when we excluded personal lending. The personal lending assets remain on the balance sheet and are still classified as held for sale. We will update our comments, if necessary, based on any developments in our sale process.

We expect net interest income to be down 5% to 7% in the second quarter due to credit mix, lower interest accrual on TDR loans and a smaller balance sheet. Also, lease assets are expected to be flat next quarter relative to first quarter 2017. We expect our allowance for credit losses to be down \$20 million to \$40 million. Net charge-offs are expected to be \$130 million to \$150 million lower as the second quarter is seasonally our best performing quarter. Therefore, incorporating the outlook on net charge-offs and allowance for loan loss, overall provision expense is expected to be \$180 million to \$220 million lower than Q1 2017.

Other Income is expected to be \$30 million to \$40 million lower, primarily due to customer defaults in Bluestem, held for sale assets, lower servicing fees driven by lower managed assets, and changes in consumer practice.

Operating expenses are expected to be down \$5 million to \$10 million.

Before we begin Q&A, I would like to turn the call back over to Jason. Jason?

Jason Kulas:

Thanks, Izzy. During the quarter we continued to make progress on strengthening our culture of compliance and enhancing our consumer practices with several notable changes which Izzy briefly referenced regarding fees. In order to be more simple, personal and fair with our customers, SC now provides more free ways to pay or methods for our customers to make payments without payment fees. In addition, beginning on April 1, and in order to align with industry best practices, SC will no longer accept credit cards, which in the past carried higher fees. We have also reduced the fee to pay with debit cards.

We are also focused on continuing to improve our customer experience with a pipeline of other consumer initiatives including a look at our customer statements and more financial education for our customers so

they can have more insight into the status of their loan and how late payments impact their status. We look forward to sharing updates on these topics in future discussions.

Finally, during the quarter we launched a new complaints management strategy which we expect to enhance our ability to identify and address root causes of complaints, and put us in a position to better serve our customers.

Finally, in response to several investor inquiries regarding dealer management and monitoring following the recent settlement with Massachusetts and Delaware, we have included two slides in the appendix of our presentation this quarter. These slides provide additional color on our Dealer Services team and the evolution and enhancements to our dealer performance management program over the past several years. This slides (inaudible) of our dealer oversight and monitoring efforts. As the industry continues to focus on this area, we are committed to be leaders in dealer management, moving beyond the traditional methods of monitoring credit performance.

We believe there's a direct connection between strong consumer practices, a culture of compliance and the creation of shareholder value. Simply stated, the companies that embrace and execute on these concepts will be more successful than those who do not. In 2017, SC will drive value through enhancing compliance controls and consumer practices, continued credit discipline, diverse and stable sources of liquidity, industry leading efficiency and technology, a focus on recognizing upside in Chrysler Capital through dealer VIP, floorplan and the Santander flow program, and finally, being simple, personal and fair with our customers, employees in all constituencies.

With that, I'd like to open the call for questions. Operator?

Operator:

Hello. We will open the call for questions. Please limit yourself to one question and one follow-up question. Thank you.

Our first question comes from John Hecht with Jefferies. Please proceed with your question.

John Hecht:

Hey guys, thanks very much. A real quick question. Just there's a lot of moving parts with respect to the trajectory of your allowance. You've got TDR migration with the '15 vintage that should be alleviating over the year, you've got a tightening credit book with newer originations. How should we think about the trajectory to ALL over the year given those factors.

Ismail "Izzy" Dawood:

Sure. John, I'll take that and then Jason will chime in. First of all, I think we're seeing what we expected, the growth in TDRs, even though it's occurring it's growing at a slower pace. We remain comfortable saying TDRs will peak late 2017, early 2018 based on everything we're seeing. That's the first item.

The second item, if the credit mix of our origination holds true in what we see, overall timing of provisions by math and intuition, provisions should come down. It's just a timing of that decrease in provisions can't be exactly pinpointed, but I think, as I said, if everything continues the way we've been seeing and what we're experiencing, we should see that allowance level get lower.

John Hecht:

Okay. Is that sort of linear downtick or is there some seasonality we should think about there?

Ismail “Izzy” Dawood:

Like I said, John, from a quarterly basis it's tough to pinpoint. It's really not seasonality; it's more about the overall—two things: one, the overall change in credit mix of our portfolio as 2015, more non-prime vintage runs off; and second, just over the last several quarters the overall portfolio growth has slowed. That's the other driver of the overall allowance level.

John Hecht:

Okay. That's helpful. Thanks. Then second question is we've heard some banks talk about pulling back. You guys have alluded to some improvements in certain components to the competitive market. I wonder if you can give us a little bit more deep dive there. What are you seeing? At what point do you think you'll be able to both tighten and take back share? You know, where are we in the overall cycle? Thanks.

Jason Kulas:

What we typically talk about is kind of the top 20 or so lenders versus the rest of this fragmented market that we operate in, and a couple of observations there. If you look at the all-in retail market, what we're seeing is the top 20 lenders are still incrementally losing share to everyone else, but if you drill down into prime versus non-prime, that story is still true for prime. The prime and near-prime parts of the business remain extremely competitive and the top lenders are continuing to incrementally lose share to everyone else. But it's not true in non-prime where we've seen—again, these are incremental shifts but an incremental pick up in the top 20's overall share of non-prime versus everyone else, and I think you see that reflected in our originations where we're factoring in what we see to what we originate, and we're getting incrementally more of it relative to the past couple of quarters. Relative to this time last year, we're still getting significantly less, so we're still in a very competitive market, and that's the reason we keep stressing this word incremental. But, we are seeing that competition has declined maybe slightly in non-prime, allowing some of the larger lenders to get a little bit more of that share on terms that a larger, more sophisticated lender would think make sense.

So, you know, I'd say again, these shifts are very minor shifts. What we see is what we've been seeing, which is it's a very competitive market. Cost of funds is still very low. Availability of liquidity is still very high and we're factoring in everything we see into new originations and I think you see that reflected in the quality of what we're putting on the books right now.

John Hecht:

Great, guys. Appreciate the color, thanks.

Jason Kulas:

Sure.

Operator:

Our next question is from Jack Micenko with SIG.

Jack Micenko:

Hey, good morning guys. First question, a follow-up on that first one. We've seen certainly in the prime world and then maybe a few on the non-prime, some modest uptick in pricing in the last couple of quarter. I think, Jason, it's consistent with what you're saying but I guess my question would be are you seeing less competition through more rational pricing of the loans or are you just seeing less providers out there?

Jason Kulas:

We haven't seen rationalization in numbers of competitors. We do talk from time to time about how longer term we actually expect that to happen. This is more about how people are pricing and structuring loans, different ways to put in prices, not just APR. You can advance more or less and those kinds of things.

I can speak obviously the most about what we do and what we're seeing is that we're being more conservative on payment to income ratios. We're being more conservative on loan to values. Our terms, our contractual terms are relatively flat and with that approach we're getting volume that we think makes sense; significantly down year-over-year but a little bit more sequentially.

In terms of pricing going up in the market, that's not a big surprise given the fact that benchmark rates have migrated the way that they have. For us, what you see is more than that, right? We've migrated our APRs more than what would be needed to make up for increases in cost of funds because we're still focused on this trade-off between losses and risk adjusted yield. We're not looking for lower losses, we're just looking for the relationship between losses and risk adjusted yield to be at the right level, and we're pretty pleased with what we're seeing. We showed a slide in the Investor Day where we looked at '16 versus '15 and talked about those concepts of yield versus loss. What we're looking at now is Q1 versus Q1 versus Q1. We're kind of looking at '17, '16 and '15, and we really like that relationship between risk adjusted yield and loss and what we've put on the books in '17, even more than what we did in '16.

We feel good about where we are in this competitive environment. Yes, price is going up but people are doing that to different degrees and not everyone is holding the line as much on PTI and LTV as maybe some others are.

Jack Micenko:

All right, that's helpful. Then, Izzy, I know expenses were up this quarter. You had guided I think down 5 to 10 sequential. I think you talked about some investment in Compliance offset with some severance. Is there an investment cycle that we're in perhaps falls off, or is that sort of down 10 from here sort of the new run rate?

Ismail "Izzy" Dawood:

Hey Jack, good question. The investment is basically in our run rate. I think we're getting to a point where it's pretty mature. The reason I guided down for a lower expense for next quarter is there's just several non-recurring or one-time items that hit this quarter, not really a compensation. One of them was severance, obviously in compensation, but we had some higher legal and professional fees in this quarter that were offset by other efficiencies elsewhere.

You would think about our guidance for next quarter as kind of the run rate and kind of where we'd feel comfortable, and then we'll update that going forward.

Jason Kulas:

Just a little bit of additional color on the expense side. We are making—we're continuing to make investments in our risk and control and financial areas, and some of that's headcount but some of it's also just cost per person. We've made some really key additions to the Company and these are people who understand—the way we talk about it internally is they understand what good looks like in a highly regulated bank type environment, and we think that's going to continue to serve us really well as we work on improving a lot of those control areas of the business.

Even with those additions though, we're proud of our relative efficiency. We're always focused on it. The severance expense was related to that. We had an opportunity to outsource some functions in a very specific area of the Company, but we want to be efficient even while we're making those very key investments that we think will differentiate us going forward, if that makes sense.

Jack Micenko

Yes, it does. Thank you.

Operator:

Our next question is from Mark DeVries from Barclays.

Mark DeVries:

Thanks. So, intraquarter you got another written agreement from the Fed, and while it seems to address a lot of issues that you're already remediating, it also seems to reflect growing impatience on their part. Was just interested, Jason, on getting your comments on what this may reflect in terms of their willingness to approve any kind of capital returns for the upcoming CCART year.

Jason Kulas:

Okay. Mark, thank you first of all for the acknowledgement that these are items that we've been working on for some time and talking about for some time, and we're very optimistic about our ability to meet regulatory expectations. We think the level of dialogue and the level of progress we're making is very encouraging. At the same time, you know, we do have this written agreement and I think an important distinction we need to make is that when we talk about distributions, in the past we've talked about CCART but then we've also expanded that to include the written agreements that were in place from 2014 and 2015 that do restrict capital actions and cover a lot of the qualitative aspects that you also see in CCART.

We're still very cautiously optimistic that we're on the right path on all of those items. Obviously we don't want to get ahead of the process and say exactly when we'll be able to resume distributions but we're focused on all of the actions that will get us there. We don't feel like this new written agreement in any way is a step back for us in that regard. Our ability to pay a dividend at some point in the future is not changed by the presence of this new written agreement.

Maybe I'll come full circle back to the initial comment, which is, as you've said, these are topics we've been discussing for some time, and we feel really good about our ability to get where we need to be.

Mark DeVries:

Okay, great. Appreciate that.

Jason Kulas:

Sure.

Operator:

Our next question is from Betsy Graseck with Morgan Stanley.

Jeff Adelson:

Hi. This is actually Jeff Adelson speaking for Betsy. I just wanted to follow up on the guidance you gave for the next quarter. It sounded like NI was down 5% to 7%. Just wondering what the bigger driver was there. Is it more just the loan growth? Is it more the credit mix or the accrual on TDRs you mentioned?

Ismail “Izzy” Dawood:

Actually it's primarily the change in the credit mix that we see. Just the portfolio that we have generated over the last year is of lower APR but higher credit quality and even though this last quarter we do have higher APRs it will take a while for that to run through the income statement. That's a partial driver. I won't say primary but a big part of it. The other one is the non-interest accrual on the TDR loans.

Jeff Adelson:

Okay. Thank you. Then just one more question. With regards to the new flow agreement with Banco Santander, you've obviously done the \$700 million already. Just wondering if you could help us think about the benefit that you may have already had at your originations. Is that \$700 million you wouldn't have done otherwise? Then maybe the second part of the question, how big could that flow agreement eventually get?

Jason Kulas:

That's a difficult question to answer because as we mentioned before, we still think the upper parts of the credit spectrum are the most competitive parts of the market. What we know for sure is that what we're doing, what we're originating for this flow agreement with Banco Santander is we're better off with that agreement than without it, and so it will produce incrementally more volume. In terms of how much of the \$700 million would or would not have been originated without it, it's again kind of difficult to say. It's even more difficult to say going forward how much we'll get. What we do know is that we'll be competitive and depending on what the rest of the market is doing and how they're pricing and structuring loans, we're going to try to get as many of them as we can.

The reason this is so encouraging for us is we want to focus on the things for Chrysler and that relationship that we can control, and that's the reason we continually mention those three items because we can control those, right? We can control this relationship we have with our ultimate parent and becoming more competitive in prime originations. We can control how much dealer floorplan we put in place, to a certain extent. Obviously we're active in that market and we're seeing big increases year-over-year in our originations which is where we want to be, and we're also actively rolling out this dealer VIP program with the goal, a continued goal—and we on track for this—of rolling it out to the entire Chrysler dealer network by the end of the year. All of those efforts will bring us incrementality on volume, we think, all else equal. Unfortunately, of course, all else is not equal and we don't know what the migration of the competitive market will be. Perfect world for us is that we do those things and at the same time the market continues to get maybe incrementally more rational and we get a multiplier effect, but we can't count on it.

Jeff Adelson:

Okay, great. Thank you.

Jason Kulas:

Sure.

Operator:

Our next question is from Steven Kwok from KBW.

Steven Kwok:

Hi. Thanks for taking my questions. I was wondering if you could talk about the lease portfolio and what are your assumptions around the used car prices and any sensitivities on changes to that.

Ismail “Izzy” Dawood:

Hey Steven, it's Izzy. Let me address that. As we talked about at Investor Day, on an economic basis we're still seeing, and we saw it in Q1, our lease terminations came in slightly above our CRLIT or the residual less incentive and taxes, and we continue to see that in Q1. We do expect obviously residual prices to adjust as expectations for prices come down, but at the same time we do benefit from the residual risk agreement that we have with FCA. So, if there's a significant drop in residual prices there's a loss share agreement that protects us.

Furthermore, we are also—you'll see it through our depreciation—we are also adjusting any meaningful changes in residual prices through depreciating that lower value over the remaining life of the asset. But net-net, even as the prices are coming down, residual values are coming down, we are not seeing a significant dislocation in the marketplace that would portend to anything really meaningful from an impact perspective.

Steven Kwok:

Got it. Just around your practice around no longer accepting credit cards, do we know what percentage of your customers were using either credit cards and debit cards to pay?

Jason Kulas:

We haven't disclosed the percentages but we feel like—I mean we're doing this because we think it's the right thing to do. As we sort of look out in the market at the benchmark competitors and large banks who are actively competing up and down the credit spectrum in consumer finance, we tended to be a little bit of an outlier in that regard. So what we've done with our customers is we've, as we mentioned, given more ways to pay without a fee, which we think is a good practice. We've also had a ramp on this where there's a notice period and anyone relying on making payments by credit cards had time to pay with a different means. But, in terms of disclosing the actual percentage, we've not given that breakdown.

Ismail “Izzy” Dawood:

Steven, I'll chime in from a economics perspective. Obviously we have introduced multiple options where it doesn't cost the customer anything, in the past where they would have paid a fee. We believe we currently get about \$3 million to \$4 million a month in fees with those practices, and that's been incorporated into the Other Income guidance I provided. Assuming there's a full pick up of that we would see a lower amount in our Piece Commission Other line item.

Steven Kwok:

Got it. I was just wondering if there's any thoughts around the credit quality as a result of maybe customers that can no longer use their cards to pay.

Jason Kulas:

No, we don't expect that. We don't expect to see that.

Steven Kwok:

Great. Thanks for taking my questions.

Jason Kulas:

Sure.

Operator:

Our next question is from Eric Wasserstrom from Guggenheim Securities.

Eric Wasserstrom:

Thanks. I have a question but just one quick point of clarification, Izzy. On the Other Income guidance, the sequential delta, that's relative to the \$55.5 million reported figure, is that right?

Ismail "Izzy" Dawood:

That is correct, exactly.

Eric Wasserstrom:

Okay, thanks. Then my question also goes back to the allowance. Given all of the dynamics that are moving through it currently, is there any significant change to the historical pattern of seasonality?

Ismail "Izzy" Dawood:

To some degree seasonality is almost gone away from an allowance perspective. The reason I say that is the allowance is now broken into two meaningful buckets. One is TDRs and the impairment of TDRs is completely dependent on the cash flows expected from that asset, and so there's no real seasonality there. The non-TDR, effectively performing loans, there is a loss emergence period that we look at, and again, that is just 12 months or so of losses that we have put in non-TDR.

We probably had seasonality in the past before we changed the allowance methodology; that's really gone away.

Eric Wasserstrom:

Got it. So from that perspective you've given guidance on the TDR trend and therefore anything—the other effects will really be a function of credit experience in the non-TDR portfolio and growth, right?

Ismail "Izzy" Dawood:

Exactly right. That's really a good way to think about it. I think that change has made our allowance much more reflective of the portfolio we have as opposed to any seasonal elements associated with it.

Eric Wasserstrom:

Great. Thanks very much.

Operator:

Our next question is from David Ho with Deutsche Bank.

David Ho:

Good morning. I just want to talk about how aggressively and kind of gauge your tone in terms of how aggressively you would pursue incremental opportunities if the market presented itself to you in the non-prime space. Just trying to gauge your confidence in terms of how much you believe the mix is mostly stabilized from here, just given the competitive outlook.

Jason Kulas:

David, thanks for the question. I think the first part of the answer to that question is that right now we're focused on the other elements that we've discussed: making sure we're fully realizing the upside potential of the Chrysler relationship, looking at the control areas of our business, compliance, consumer practices, those kinds of things, to make sure we're playing for 20 years from now as much as we are the near-term financial performance of the Company.

Having said that, I think the reason you asked the question is that we've done more of these kinds of acquisitions than anyone else, so we've got a team who's very experienced in acquiring and converting assets and taking them from other people's systems and consolidating into our very scalable system. We would certainly hope that in the future we'd see more of those types of opportunities.

We don't see a lot of activity on that front. You'll see something from time to time, and when it's out there it tends to get shown to us, but I think that's the order we'll take it in. We'll focus on our business first and the upside opportunities we already have, and then over time as those things happen, they're likely to happen in conjunction with a shift in the economy, the sort of state of the economy. As those opportunities happen, we would certainly hope to be in the mix and get involved.

David Ho:

Thanks. Then separately, in terms of the mix of originations, and kind of your incremental shift a little bit towards sub-prime again, is that a function of what the competitive environment has given you? How do we have confidence that you won't pursue deeper sub-prime, kind of what you saw in 2015, those vintages, in any meaningful way, depending on the competitive environment?

Jason Kulas:

That's exactly what it is. It's taking what the market gives us. We always want to maximize our capture with all applications that we get. The issue we always have is that many times at different parts of the credit spectrum at different times what we think is the right pricing structure, the market may have a different view so we get less.

Our cash rate to non-prime, even though they're up sequentially, are still in the high single digits, which historically is the range we've been and that's the range that has served us well through several cycles. So, for us, we track competitive factors, we track market share, we look at volume, but what we really want is the right risk adjusted return for every single asset we book, and that's where we're going to be focused; not on doing more or less of any certain part of the credit spectrum.

I will say, being specific about comparing 2015 to what we've originated so far in 2017, there are some very key differences. We feel like our—going back to the other comments about the trade-off in risk

adjusted yield versus loss, we feel like there's a much better trade-off in our early 2017 vintages on those two factors than what we had in 2015. There are certain pockets of what we originated in 2015 that we are no longer originating. So, just by definition in terms of our approach to the market, it'd be different.

We saw that same thing, by the way, when we went through 2006 and 2007. When you go through those types of situations, you learn from them. You leverage your data, you make decisions based on what you're seeing and some things you never do again and some things you just make sure you price for. For us, it's a little bit of both.

That's what we're doing. We're learning from what we see. We're factoring it into the new originations and we would expect that, for example, if we were sitting here on our second quarter call talking about incremental growth in non-prime originations, that we would be getting more than paid for those originations and we'd feel very good about them, or we won't do them.

David Ho:

Okay. That's helpful, thank you.

Jason Kulas:

Sure.

Operator:

Our next question is from Moshe Orenbuch from Credit Suisse.

Moshe Orenbuch:

Great, thanks. At the risk of asking a version of the originations question again, can you just talk a little bit—you'd alluded to, Jason, in the fact that there are still some things that need to be done from a process standpoint. As those get done will that in fact improve your ability to originate loans? Any way to kind of think about that?

Jason Kulas:

I guess let's talk in general about credit trends because that's really what is the driver for what we're getting relative to the market. We're not in control of how competitors react to it but obviously we can put discipline in place ourselves. As we talked about, 2016 vintages are performing better than 2015. We're expecting in terms of the overall migration of TDRs in the Company that that will peak, as we've said, sometime in 2017. As you look at the consumer, the consumer is still strong and that's a fairly consistent story where unemployment is low and gas prices are still relatively low. One aspect of the consumer we're watching is consumer debt and we've talked about this in the past. That continues to sort of inch up, so non-mortgage consumer debt is still increasing. That's something we watch because over time that does continue to higher delinquency and you've got to factor that in to your underwriting. But in general, the consumer is strong, the economy is strong.

We're pricing the trends that we're seeing in delinquency and loss in the new originations. We feel good about that and that's reflected, as I mentioned earlier, in what we're seeing in some of the credit trends, PTI, LTV, those types of things.

As you look at recoveries at auction, we are seeing a gradual decline. If you look at that all-in recovery rate, it is gradual. It's 53% down to 51% if you look at Q1 versus Q1. We would expect that to continue. We don't see the bottom falling out of recoveries. We expect it to continue to be gradual.

The reason I go through all of those items is those are the items that really influence our originations more than anything else because we react to them. When we see them I'd add cost of funds to it. When we see those things happening we react to them and we factor them in and different companies do that at different rates in this kind of normal ebb and flow of people taking share, giving share. For example, in Q1, domestic OEMs picked up some share based on some incentive strategies that were being put in place, but as we look at what happened post Q1, they're giving some of that share back. There's the natural ebb and flow and what we're trying to do is maintain a consistent approach, factoring in what we see to what we originate and just making sure that what we get is good no matter how much of it we get.

In terms of the question about these other areas of the business we're focused on, I think that's more about long-term success. We know that whether you're a highly regulated banking institution or you're a non-bank finance company licensed in all 50 states, the regulatory environment, our operating expectation is that it's not going to change. We actually believe that a highly regulated environment benefits players like us who are making real investments in those areas, but, you know, we have to continue to focus on those areas. Those areas, they weave themselves through the written agreement we have with the Fed. They're very key front and center items for us that I think are more about long-term opportunity costs for the business than they are about short-term ability to originate assets.

Moshe Orenbuch:

Okay. Just as a follow-up, the \$700 million that you did with your Parent for Chrysler, is that something that they will do that how often, I guess? Maybe just to put that in context, if that agreement had been in place as of the beginning of the quarter, what do you think your penetration for Chrysler would have been versus that 19%?

Ismail "Izzy" Dawood:

Hey Moshe, it's Izzy. Let me answer that, the two questions. One, we expect right now based on what we see to at least execute a transaction quarterly. It just is a matter of how quickly we can 'fill up the bucket', but at least quarterly to get you sized at efficient and cost effective to execute on.

Second, we've been talking to the Parent obviously since the middle of last year, so we had incorporated many of these elements before we finalized the agreement. So, we've been working the last couple of months to fill up the bucket so we can execute in Q1. The penetration, I think what we have is what we can offer to the marketplace, keep our profitability, take advantage of strategies that FCA has in place. So, no meaningful difference in terms of the timing of when that agreement was executed.

Moshe Orenbuch:

Got it, thanks.

Operator:

The next question is from Chris Donat with Sandler O'Neill.

Chris Donat:

Good morning. Thanks for taking my question. Jason, wanted to revisit something that came up at the Investor Day in February. There's the issue of the delay in federal tax refund and you said there was kind of a timing issue with originations. I was just wondering if you could give us a sense of the pace of originations by month in the quarter. Was January below normal? February above? March above? Can

you give us a sense of what's going on in April? Just give us—I'm looking for what's going on, if that was just a blip or something more lasting.

Jason Kulas:

What's really interesting about tax returns is as more information comes out on that, it appears that a lot of the delay was based on filings with earned income tax credits. Those earned income tax credits are more kind of lower income type returns which would fall more squarely in non-prime originations and trends.

What we've been tracking more closely than volume, because I do think it did impact volume somewhat—what we've been tracking more closely than volume is performance. We actually think that as these returns have come in, maybe a little bit later, April versus March, in that timeframe, we've seen maybe some incremental benefit, or at least not incremental detriment given the fact that those returns are coming in. We're talking about billions of dollars of refunds that were held up, that fell into that earned income tax credit category.

I don't know that we have a definitive answer to the question. It's something we watch very closely, to look for trends and performance and how that factors in to new originations. For us, the origination story is really about our own credit discipline and about what competitors are doing. We have to be careful about how we talk about what it's related to, right? Because while it's certainly true that we've done more non-prime originations in the last couple of months than we did in the couple of quarters that preceded it, we also are doing substantially less than this time last year. So, it's—we're constantly looking for ways to do more up and down the credit spectrum. The impact of tax refunds, the impact of gas prices, performance in different areas of the country, those kinds of things are one of, or I guess a few of many things we look at and trying to figure out that very complicated answer.

Chris Donat:

Okay, thanks. Thanks for that; I appreciate the complexity of what you're working with on it. Then at the risk of maybe taking a comment you made a few moments ago out of context, on recoveries you said you expected to see a gradual decline. There's been a lot of focus on used car prices and what's going on there. Just any comment so far on April trends?

Jason Kulas:

You know, we're seeing more of what we've been seeing. We're not seeing anything that's concerning as we look at really performance year-to-date. It's all very gradual, and all, we think, still driven by supply/demand factors.

What I would say, I guess the short answer to that question is we're not seeing anything that really sticks out and causes any great concern.

Ismail "Izzy" Dawood:

I'll just add, Chris, is that as we mentioned we expect recovery rates will come down. Used car prices are coming down. We continue to see that, again, but not away from the curve that we expected.

Chris Donat:

Okay. Thanks, Izzy and thanks, Jason.

Jason Kulas:

Thank you.

Operator:

Our last question comes from Charles Nabhan with Wells Fargo.

Charles Nabhan:

Good morning guys and thanks for taking my question. I understand a lot of factors go into the pricing and structure of loans but could you talk about how your ability to pass on rate increases changes over time as the tightening cycle proceeds? For example, does it become incrementally more difficult to pass on a pricing increase when the Fed funds goes from 150 to 175, for example, versus 75 to 100 bps.

Jason Kulas:

The answer to that question is different for the different parts of the credit spectrum. At the lower end of the credit spectrum it's really about affordability. You have the ultimate ability to pass it on; it's just ultimately at some point your capture gets more impacted by affordability and people just sort of falling out of the system and buying an older car at a cheaper price point that's really not our market, than it is about a competitor taking a loan from you.

As you move up in the credit spectrum, there's a lot more elasticity there where the affordability is not as much of a factor, and then it just comes down to what you're doing versus what competitors are. I'll say for us, because we are looking at things from a markets perspective and looking at benchmark rates versus deposit basis, what we see is in a situation where there's a rising rate environment for prime originations, we'll tend to react more quickly to that than the rest of the market, but over time those lines converge again. Over time in a rising rate environment deposit costs go up, inevitably, and that gets passed on when it goes up. For us, we'll sort of in a rising rate environment, as you move up the credit spectrum, we'll see detriment before things catch up.

Ismail "Izzy" Dawood:

Chuck, I'll add on top of that. Especially in the non-prime segment where it's back to affordability, that's the key item. We do pass on the rates pretty quick, but most of our competition there is also from marketplace funded lenders and we believe we truly have an advantage there where we will see our rates go up but probably not as fast as some of the others. So that would be kind of the offset as well.

Charles Nabhan:

Got it. Thank you. As a follow-up, I was hoping to get your comments on the demand environment in the non-prime space, and specifically whether you're seeing any softening in the used vehicle market. Any drop-off in application volumes. There's been some press about softening in demand in new vehicle sales so I was wondering what you're seeing in the used vehicle market as well.

Jason Kulas:

We've definitely seen some of that; not to any great degree overall, but we've seen some of that. The good news for us is we are operating in both markets. You've seen that in our trends. The mix of new versus used for us has shifted a little bit the other direction where we're doing more used than new, and so you'll see that reflected in the average financed and those types of metrics.

You know, another influencing factor also is the mix of the vehicles available. Certain manufacturers are going to have lineups that are maybe more conducive than others at price points that are more conducive to non-prime originations than others, and so that's another factor to watch.

For us, we've definitely seen it. We've seen that some of the demand has shifted from new to used, and you've also seen it in SAR. You've seen people in general maybe shifting slightly away, only slightly but slightly away from new car purchases. Still at very high levels relative to where we've been historically but down from the recent peaks.

Again, for us, we operate in both markets. I do think it's very interesting, if you look at there was a sort of belief for some time that because the average age of cars on the road is at an all-time high, at some point that would cause this windfall of demand, and while I think generally at some point that does maybe fall incrementally, what we're really seeing is that cars last longer. They're made better, they last longer, and so the idea of trading off new for used, depending on where the prices are, is not necessarily a negative thing for performance. That's the reason why you're seeing some extended term business being done, and if it's structured the right way it makes sense because the asset will have value and will run for a good period of time.

Charles Nabhan:

Got it. Thanks, guys.

Jason Kulas:

Sure.

Operator:

Thank you. There are no further questions at this time. I'll now turn the call over to Jason Kulas for final comment.

Jason Kulas:

Thank you everyone for joining the call today and for your interest in SC. Our Investor Relations team will be available for follow-up questions and we look forward to speaking with you again next quarter. Thank you.

Operator:

Thank you. This concludes today's conference. You may disconnect your lines at this time.