VANTOR INVESTMENT CLUB

Investment Report by Ashvin Moorjani

Date:	November 8, 2016
Investment:	Ally Financial Inc. (NYSE:ALLY)
Type of Investment:	Long Exposure / Low Business Strength / Undervalued
Recommendation:	Buy Now

Michael Burry, one of the investors profiled in "The Big Short", wrote the following in an October 2001 letter: *"Ick investing means taking a special analytical interest in stocks that inspire a first reaction of 'ick.' I tend to become interested in stocks that by their very names or circumstances inspire unwillingness – and an 'ick' accompanied by a wrinkle of the nose on the part of most investors to delve any further."* Ally brings about an "ick" reaction due to it being in the auto lending industry, which is becoming increasingly risky.

Ally was established in 1919 as the in-house financing arm of General Motors ("GM"). From 2009 until Ally's IPO in 2014 the US Treasury had significant influence on the firm, which was the result of the Treasury's 2009 $17B capital injection to help Ally with its mortgage losses (yes, GM was in the mortgage business). By the end of 2013, GM had divested of Ally and by the end of 2014, the Treasury did the same, and now Ally is an independent firm serving US car dealerships ("dealers") via its Dealer Financial Services ("DFS") business and serving bank clients via its online bank, Ally Bank.

Dealer Financial Services' Business Model

DFS provides financing that aids car manufacturers, known as Original Equipment Manufacturers ("OEMs"), and dealers sell vehicles. DFS basically does the following: 1) provides dealers with financing, insurance and support services; 2) finances the loans/leases of dealer customers; 3) holds or sells the loans/leases; 4) services the loans/leases by collecting payments and monitoring the collateral; and 5) sells vehicles after repossession or lease termination. DFS is the biggest player in the auto lending business with $109B of auto related loans/leases compared to $90B, $62B, $44B for JPMorgan ("JPM"), Wells Fargo ("WFC") and Capital One ("COF"), which are the next 3 biggest auto lenders.

OEMs rely on companies like DFS to provide dealers and end customers with enough financing to buy vehicles. To ensure a steady flow of financing, OEMs may start in-house finance companies, enter into agreements with third party lenders and/or incentivize lenders with risk sharing and subvention. Subventing involves OEMs paying lenders to offer lower than standard rates to customers, which makes vehicles more affordable. In addition to lowering costs for customers, subvention allows lenders to easily grow their loan book as they can offer low rates while receiving standard rates due to the OEM payment. DFS accesses subvention and other incentives by fostering OEM relationships.

OEM relationships also give lenders access to more dealer networks. DFS does business with 17K dealers (there are ~60K dealers in the US) and these dealers drive loan growth by their need for inventory financing, known as floorplan financing, and other forms of financing to fund operations (dealer loans were 23% of Ally's assets as of Q3 2016). In addition to dealer financing, DFS provides financing to the customers of dealers by making consumer auto loans and leases, which were 41% and 8% of Q3 2016 assets[1]. If the customer defaults or terminates the lease, DFS would sell the car to the dealer that sold the vehicle, through a physical auction or through its SmartAuction online auction platform, which DFS can use to attract dealers and gather market intelligence.

Financing adds value to dealers by making them capital light – they use little to no cash to buy inventory and they don't need to finance customer purchases. This in turn may contribute to dealers having great credit as DFS recorded losses on dealer-related loans within the range of 0.1-0.4% from 2006-2015. Ally's consumer loans are not as high quality with losses in the range of 0.5-5.8% over the same period. Because of these quality differences, DFS charged dealers an average rate of 3% during Q3 2016 vs. 5.6% for consumer auto loans. Where does DFS get the money to make its loans? Ally Bank is increasingly becoming its source.

Ally Bank's Business Model

Using US deposits as a yardstick, Ally Bank's $76B of deposits makes it the largest branchless bank (ING direct had $82B in 2011 when it was bought by COF, which has branches) and the 24th largest bank overall. By having no branches, Ally Bank can operate at low cost shown by it having an efficiency ratio (operating expenses to revenue) of 51% vs. 58%, 58%, and 55% for JPM, WFC and COF in 2015. Ally Bank's low cost gives it flexibility to offer higher interest rates and Ally Bank seems to be taking advantage of this, as it paid 1.15% on its deposits in 2015 vs. 0.09%, 0.06% and 0.52% for JPM, WFC, and COF.

1. As of Q3 2016, 72% of assets were related to auto finance, 5% to insurance, 5% to mortgages, 2% to corporate finance and 16% to corporate and other.

Ally Bank's deposits have grown from funding 4.1% of Ally's total assets as of 31/12/2006, to 48%[2] as of 30/9/2016. Growth in deposits lowers interest expense as they cost Ally 1.14% vs. 1.89 for total liabilities in Q3 2016 (to put this in context, if the deposits cost the same as total liabilities it would have reduced 2015 pre-tax income by ~25%). To expand Ally Bank's offerings, Ally acquired an online discount brokerage, TradeKing and recently launched its first credit card. With more offerings, Ally Bank is looking to attract more deposits, which would lower Ally's interest cost as a whole.

Profit Generation and Other Lines of Business

Since Ally Bank sources funds for DFS, it may not be useful to look at the profit of DFS and Ally Bank on a separate basis. Rather, Ally breaks down profit by the following: a) auto finance, which generated 96% of Ally's pre-tax profit in 2015; b) insurance, which generated 15%; c) mortgage operations, 6%; and, d) corporate and other, -17%.

Ally's insurance products insure dealer inventory against weather related and other damage, and protect consumers against unforeseen vehicle servicing requirements. Ally's insurance business remained profitable even during superstorm Sandy and it seems quite stable. Ally's mortgage operations involves buying mortgages from other institutions that make them. Ally Bank is looking to make mortgages directly to customers towards the end of this year as an additional product offering. Corporate and other makes loans to mid-sized US companies and allocates resources to the other businesses.

Overall, Ally's profitability is heavily tied to auto finance and this reliance makes it susceptible to the increasingly unfavourable auto lending environment.

Ick Factor: Riskier Loans

By the end of Q2 2016, there was a record $1 trillion of consumer auto loans outstanding, up ~30% from when household debt peaked in mid-2008. Since then, auto loans have grown from 6% of household debt to 9%. Another record was also reached in Q2 2016 as the percentage of used vehicles with financing hit 55.9%. All this is great, but have lower credit standards been a driver for growth? The simple answer is yes, nonprime (FICO scores under 660) auto loan originations from 2009 to 2015 have grown at 15.4%/year vs. 10% for prime or higher. More delinquencies and longer loan terms also indicate more industry-wide risk.

DFS surpassed the industry's origination growth rate since 2009 by 0.6%/year and its risk appetite also seems to have grown shown by a) its originations having increasingly lower FICOs and longer terms, b) its past due loans and charge-offs increasing, and c) it slightly shifting away from safer dealer loans to more risky consumer loans. DFS has increased the rates it charges, but they have increased less than loan loss rates and the bigger concern is that Ally may simply continue to take more risk so it can keep growing its market share in an industry that as a whole is loosening credit standards.

DFS's risk appetite may be driven by its quest to diversify away from GM and Chrysler, whose vehicles accounted for 77% of dealer loans and 69% of customer originations in 2015. DFS has been gradually moving away from GM and Chrysler, but the concern is that in order to win new business from different brands, DFS may have to take on more risk, thereby increasing the chances of loan losses.

Is the Ick Factor Priced In?

The simple answer is that I believe so. The primary reason being that if Ally were to experience a financial crisis like scenario again (prior to which the auto lending industry was making even more nonprime loans at 42% of total new consumer loans in 2007 compared to 36% in 2015), I estimate that the stock would take a ~5% hit, which is based on the result of the Federal Reserve Board's CCAR stress test (touched upon in the Citigroup investment report) compared to an upside of at least 20%, which is based on a 10x multiple on the last 12 months of earnings.

The reason for the limited downside is Ally's low valuation, which is 8x the last 12 months earnings and 34% below its tangible book value. In addition to protecting against loan loss risk, this valuation means that if Ally let its loans be repaid, paid back its creditors and wound down operations, we should still make money.

Recommendation and Other Risks

By looking at the numbers, Ally does seem to offer a very favourable risk/return trade-off. However, Ally's lack of a diversified risk profile and management's short track record (Ally's CEO was appointed in early 2015 and the CFO was appointed in late 2013) lead me to believe that we should allocate only an initial 5% in Ally with the possibility of an additional 5% if shares present a more compelling bargain in the future.

I believe we should exit this investment if it reaches a price of ~$21.5 unless fundamentals at that time warrant a longer holding period.

I, Ashvin Moorjani, will initiate a long position in Ally within the next 5 days.

2. Other than deposits, Ally's assets were funded by borrowings (40%), stock (9%) and other liabilities (3%)