GM Financial

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Jon Rau: Good afternoon. Thanks for joining us on the first day of the J.P. Morgan Auto Conference, virtual this year of course. My name is Jon Rau. I cover the high-grade automotive credit sector at J.P. Morgan.

We're happy to once again host GM Financial at our conference. It is my pleasure today to introduce Dan Berce, Chief Executive Officer. Dan has been CEO of GM Financial and its predecessor entity since 2005. He has 30-plus years of experience in the auto finance industry.

Just a reminder as we begin, that folks joining us for the webcast should be able to access the slides and submit questions virtually through the digital conference book site. With that, let me turn it over to Dan.

Dan Berce: Thank you, Jon. For most of you, good afternoon, I guess some of you, good morning. With me today in the room, socially distanced, is Susan Sheffield our CFO, and Steve Jones, our head of Investor Relations.

You all should have the presentation, I'm going to skip around a bit and not go through it from front to back. In fact, my remarks today are going to revolve around five different topics. Number one, originations and asset growth. Number two, credit. Number three, residual value. Number four, leverage and liquidity. Number five, profitability.

With that, I'm going to start out. Again, originations and asset growth. I'm going to start out on slide eight if you'd like to follow along. In terms of asset growth, GMF now has $94 billion of assets. That's down a bit both sequentially from the March quarter and from June a year ago.

A couple of things going on here. Number one on the retail loan side, we had a very strong quarter. In fact -- I'm going to refer to slide nine -- we originated a record $8.7 billion of loans in the quarter. Most of that was financing a new GM vehicle.

Our penetration of GM retail sales in the US was 53 percent, higher than our target of 50 percent, which really then despite the fact that industry sales were down, that high penetration level is what led our record originations.

A couple of factors behind it. Number one, General Motors had a very strong retail incentive program earlier in the quarter, April and May. They had a zero percent for 84 month offer with payment deferrals up to 120 days. That drove a lot of application volume to GM Financial since that offer is done exclusively through us.

It was meant for very high qualified consumers. Even though it only resulted in less than 20 percent of our originations, it drove a lot of application activity. If the customer didn't qualify, dealers quickly pivoted the customer from the zero percent offer to another GMF program, resulting in really good originations for us.

Our used car originations were also quite strong in the quarter. Latin American originations and our so-called AmeriCredit originations were down.

Offsetting our strong loan originations were weakness in lease. If you want to refer to a slide, it's number 11.

Our lease volumes were off considerably in the quarter. $3.2 billion less than a year ago, less than the sequential March quarter, primarily because some of the major lease markets in the country, those being Michigan and New York, were really part of the major lockdowns during the quarter. As of today, month of July into August, lease volumes have now recovered to about normal levels.

Finally, the other aspect of our assets is our commercial book, which is mainly floorplan finance. You can see on slide 13 that our commercial book has now shrunk to about $7.9 billion, about $5 billion down from a year ago when it was $13 billion.

The commercial book inventory floorplan finance has shrunk for two reasons. Number one, the work stoppage for General Motors in the fall, and then the shutdown of the plants because of the pandemic in the spring.

Inventory levels at the dealerships are down quite a bit. That's reflected in our commercial asset balances.

Moving now to my second topic, which is credit. I'm going to go to slide 10. The story here is that entering the pandemic back in March and April, we as well as other auto lenders were quite concerned how credit would develop. In fact, early in the quarter, we offered quite a bit of payment relief to our consumer base in the form of deferrals.

We approached it a little bit different than other auto lenders. We actually had a discussion with each of our consumers who wanted to deferment instead of doing a blanket policy. We also offered just a two-month deferral in most cases rather than some lenders did as long as 120 days.

During the pandemic period from the middle of March through roughly the end of June, we deferred roughly 127,000 accounts, which was about 6.7 percent of our total portfolio. Our payment performance on those accounts since deferment has actually been quite good.

In fact, as of July 26th, which is when we reported earnings, 80 percent of those customers that were deferred had made their payment in full. 14 percent were one or more days past due, one percent only had redeferred or re-extended, and five percent had not yet had a due date at that point in time.

Those stats are a lot better than what we would normally see from our deferment program. I want to add that our deferment levels for the month of July, for instance, are back to normal, about one percent per month, so good performance coming off the deferment. Just about all those accounts have been resolved at this point.

The other thing to mention on credit is that our delinquencies, especially 5 to 30 day and 30 to 60 day are at levels that we have never seen before. They're really quite low, driven by, of course, the stimulus money, both one time and supplemental unemployment checks, but probably more so by the fact that consumer spending is way down.

Consumers aren't going out to eat, going to movies, taking vacations, buying clothes. That's left them a lot of discretionary income to make their auto payment. To a great extent, just like the Great Recession 10 years ago, the auto is a very important asset to the consumer. With ride sharing down, mass transit not being utilized, customers really need their car and they're paying for it.

Our guidance for the year in terms of credit losses was for a range of 2 to 2.5 percent. For the first half of the year, we ran 1.6, so losses would have to elevate quite a bit in the second half to reach our 2 to 2.5 percent target. Again, we've seen very strong payment performance amongst our consumer base. At this point, it's not likely that we'll hit that 2 to 2.5 percent range, so we believe we have some upside here.

What might be happening though is that with unemployment still high and weakness in the economy, some of the losses we might have expected in the second half of 2020 may be pushed out into 2021, but I want to remind everybody that because of the CECL Accounting Standard, we allow for losses on a lifetime basis.

In fact, our allowance is 4.4 percent of the portfolio at June 30th, which would give us two plus years of loss coverage. Our average life of a loan is two to two and a half years, so we believe we're provided for quite well at this point and perhaps some upside if credit develops better than we think.

Next topic, which many people I'm sure consider the most important topic and that's residual values. I'm referring to slide 12. GMF has a fairly sizable lease book, roughly $29 billion of residual exposure.

Early in the pandemic, April, the used car values declined 10 to 15 percent very quickly. Fortunately, used car values troughed in early April and they've been up on a week-over-week basis ever since then, to the point that here in beginning of August, used car prices are actually higher than they were pre-pandemic.

From a strategic standpoint, GMF played this dynamic quite well. We get about 40,000 or 50,000 cars coming off lease a month. Back in April and May when prices were weaker, we held inventory. In other words, we didn't sell into a weak market.

In June, as prices began to increase, and certainly through July and through August to date, we have been very aggressive sellers in the market, realizing pretty robust gains on this inventory sale.

Remind you that going into the year, we had expected used car values to be down 3 to 4 percent, we modified that early in the pandemic to 7 to 10, more recently, our guidance was 6 to 8 percent down.

We're depreciating our leased assets to that six to eight percent assumption. Again, based on actual proceeds in July and August, we're well ahead of that six to eight percent assumption. We'll likely look at things again at the end of September, but again, just like credit, we believe there's a little upside here in terms of GMF exposure.

Next topic, I'm going to go to is leverage, liquidity and capital. If we go to slide number six, this is a look at our liquidity and leverage. GMF ended the June quarter with quite strong liquidity, in fact, $25 billion, which was at or above our target of having six times our expected cash outflow per month without raising new capital, that that's our liquidity buffer.

Unleveraged ratio on the bottom of this slide rose a little bit to 9.38 times, less than our managerial target of 10.

The reason the leverage increased was three-fold. Number one, the adoption of CECL was one-time hit to tangible equity on January 1st. Number two, we had a fairly sizeable FX hit related to our Latin American operations, and then number three, our earnings in the first half were less than our expectation going into the year.

Nevertheless, again, below the managerial target of 10, and we expect to remain below that target, going forward.

I'm going to pivot now, staying on the capital and liquidity theme, pivot to slide 15, talking about our global funding platform.

We were very successful during the quarter raising money. We issued $3.5 billion of senior notes during the quarter. We also executed various securitization transactions on our platform, and we renewed, it was $13 billion of credit facilities during the quarter, so funding is actually quite good at this point.

Spreads are wider, but with base rates being as low as they are, we're executing some pretty good cost to funds at this point.

My final topic is related to profitability, and I'm going to go to slide seven. For the first half of the year, we've earned $456 million before taxes, down close to $400 million to $500 million year-over-year, but the quarter earnings were $226 million.

Steady state earnings for GMF should be about $2.5 billion, so we're below that on a run rate basis, but we believe that with upside in credit as well as residual values, that our second half earnings should exceed our first half by a meaningful amount.

Finally, we did pay another $400 million dividend to General Motors in the second quarter, raising our year-to-date dividend to $800 million. At this point, we do not expect further dividend payments to GM, but that could change depending on earnings and where leverage actually ends up at the end of the year.

Finally, our return on tangible equity, although down because of lower earnings, remains in the low double-digit area.

With that, I am going to stop and open it up for Q&A.

Jon: Great, thank you Dan for those comments and what was, I thought, a very helpful overview. First, I wanted to turn to your comments on the charge-off trends.

I think that your point about charge-offs potentially being lower than the two to two and a half percent range with the stronger trends you've seen in July, is there any kind of color you can give us around what the assumptions are, like bigger picture?

I suppose this is a bit of a crystal ball question, but to get to two to two and a half percent range, what are you thinking in terms of the broader US economy and the US consumer?

Dan: First of all, unemployment is still in double-digit area, and we expect that type of unemployment to be sustained for much of the calendar year 2020 before moderating a bit in 2021, but still being quite a bit higher than what we saw pre-pandemic.

With that type of unemployment backdrop, we would be seeing considerably higher delinquencies and defaults than we're seeing now. Again, stimulus payments have been a help. Consumer spending has been a tailwind.

Our expectation is that there might be some type of extension of the stimulus, but nowhere near what we saw in the first half, and so you have uncertain economic backdrop. That's what gives us pause in terms of where we see credit today, where we think it will develop.

Jon: Thank you. That's really helpful. In a little bit different direction, if you look across the lease and loan portfolio and where you're doing dealer financing business as well, is there anything to glean from your underwriting that rising COVID cases had any impact on vehicle sales or underwriting trends?

For a while, I think the cases were rising in Texas, in California, in Florida, which are large auto markets. Is there any noticeable impact to your business from that?

Dan: Yeah. First of all, from a new car sales standpoint, the market has recovered quite well. July, the SAAR was 14 and a half million, which on a retail basis, is reasonably close to where it was year-over-year.

Of course the fleet activity is still down quite a bit, but in any particular market, whether it's Texas, Florida, or Arizona, we saw pretty much market trends despite the June and July spikes in COVID. Nothing remarkable that stands out because of the virus spread. Of course, Texas, Florida now are recovering somewhat, California. It's moving to different hot spots.

Another maybe slightly off-topic underwriting comment is as it relates to our new car sales originations, our credit appetite remained unchanged during the quarter despite unemployment being where it's at and economic uncertainty. We tighten up our used car and AmeriCredit subprime finance though during the quarter.

In terms of consumer credit impact of COVID, nothing notable there. Again, delinquencies are really quite low. Part of that is because of the lack of spending because of the lockdown [inaudible] restaurants and bars and such.

[pause]

Jon: Dan, can you hear me?

Dan: Yes.

Jon: My screen froze. I think that might be just on my end. Apologies. I guess maybe shifting gears again, I wanted to ask maybe if we could get a little bit more color on used vehicle prices specifically.

Very much appreciate your comments earlier talking about maybe there's some potential upside to that six to eight percent that I suppose that you're underwriting the lease contracts toward. We've seen this really big rebound in used vehicle prices if you follow the Manheim index as somewhat of a proxy.

To expect things to get to down six to eight percent for the year or maybe even if there's some upside there, what are we missing? What's been driving such positive trends in used vehicle prices since April? How much of this is going to reverse by the end of the year?

Dan: Good comment, Jon. A couple things going on. Number one, there has been a lack of used car inventory in the market, which has really driven the increase in prices. The lack of inventory is for a few reasons.

Number one, a lot of leases that would otherwise have been grounded and returned to the lessor weren't. The leases might have been extended, or the lessor might have taken the vehicle back and not sold it right away because the market was weak.

I'd say number two, there's been a shortage of trade-ins. With new car sales down, that means there's less trade-in activity. There's also been minimal repo activity. All the normal supply factors have been disrupted, creating a shortage of used cars. That's caused prices to increase.

I'd say the other factor is when consumers are uncertain about their economics, they tend to trade to a used car rather than buy a new car. I think that's going on. It happened in the Great Recession 10 years ago. It's happening today. That's helping the demand side.

What a lot of the pundits are talking about for the second half of the year is a reversal of those dynamics. In other words, more off-lease supply, some repo activity, more trade-ins, and then rent car companies defleeting.

That could flip the supply side from a positive to a negative. Demand, new car inventories, is starting to recover with production resuming and ramping up. That could flip the demand side from a positive to a negative.

Then you've always got the seasonality of used car pricing. If you look at where prices go month to month to month throughout a calendar year, September, October, November, December are always weaker than the first half of the year.

In fact, I remember sitting here a year ago, in August, and remarking about how strong the used car market was through August. It fell off the last part of the year, which it usually does and very well could do this year.

That's the backdrop of why we think we'll beat that six to eight, but we're not out of the woods by any means in terms of used car pricing.

Jon: Thank you. That's great. Maybe a question on the financing side of the business. You spoke to unsecured funding costs have come down, a consequence of a lot of tightening in your credit spreads and then also lower Treasury yields. I noticed your guidance for unsecured funding was taken up a little bit, maybe a billion at the upper end.

As of second quarter earnings, I think it's $7-9 billion, but correct me if I'm wrong. As you think about funding on an unsecured basis versus funding on a secured basis, where's a more attractive place for you to finance your business in the current environment? Have those dynamics really changed at all over the last couple months?

Dan: As you know, Jon, our articulated target for secured/unsecured portion of funding is 50/50. We're slightly above that now, unsecured being...Is it 54 percent, Susan?

Susan: 56, right?

Dan: 56 percent. We're ahead of that. If we were sitting here in the environment two or three months ago, we would have said unsecured is quite unattractive compared to the ABS market. Things have normalized now, where cost of funds of unsecured is really quite good from a historical perspective. We're back to 50/50 and maintaining that.

We want to make sure that we have a large amount of unencumbered assets on our balance sheet, giving us financial flexibility. I'd say the factor in bumping up our unsecured range is that our loan originations have been quite strong, as I've mentioned. Our need for funding might be a little bit more.

The other factor is we have a decent amount of maturities in 2021. With the market being attractive now, we may move some of that refinancing, if you will, into 2020 with the market being attractive now.

Jon: Thank you. We have one question from the audience, which is "Could you please delineate the macro assumptions under CECL, specifically unemployment, for 2020 and 2021? One competitor noted Moody's severely adverse scenario for the first year and unemployment of six and a half percent for the future. Is there any color you can offer on GM Financial's approach to this?"

Dan: Our approach would be quite similar to those remarks. We would expect to sustain double-digit unemployment for the bulk of 2020, moderating to the high single-digits in 2021.

Jon: Thanks. I've got one more on my end. We're getting close to the half-hour mark here. This maybe comes back, Dan, to some of your prepared remarks about the balance sheet and in the direction of auto sales. If we think about General Motors' sales, they're down pretty meaningfully in the first half of the year.

Maybe you could provide some color here on your loan and lease and commercial portfolios. I know you mentioned some of the programs in place. Is it a little odd that your loan portfolio is actually up while lease and commercial are down compared to year-end?

Dan: Some color on that. As you pointed out, the loan book is up $3-4 billion sequentially from March. A lot of that's because of the attractive zero for 84-month offer that GM had in the market.

That not only propelled the loan business forward but also maybe took away some of the lease business. Zero percent for 84 months is a really low payment point, very competitive with a lease.

On the lease side, the lockdowns were really pointed in the markets like Michigan and New York that are high-lease markets. The zero for 84 took away some of the volume. Leasing, as I said, today is back to about normal, 20-some percent of GM sales mix.

On the commercial side, I referred to the $5 billion run-off of that portfolio primarily because inventory declining on the dealer lots. We really haven't seen that budge much at this point. Even though production is ramping up pretty nicely, what they're producing, they're selling.

We do expect, as we go throughout the course of 2020, for that commercial book to recover somewhat, but unlikely the entire $5 billion this calendar year.

Jon: I have one last one, if I can sneak it in here. That is on electric vehicles. We saw last week Cadillac, they debuted the LYRIQ. There are some more electric vehicles, a large number of them, coming down the pipeline from General Motors.

In this context, how does the growth of electric vehicles influence your depreciation assumptions around internal combustion engine technology, or are we too early at this point for it to make a difference?

Dan: We're too early at this point. Our lease book is typically a three-year lease. I would say for the next three years, depreciation of ICE vehicles won't be affected by EV penetration. That's a pretty safe assumption. At some point, we'll have to start thinking that through a little bit more.

On the EV side itself, EVs are very lease-conducive product. We'll be right in the middle of all of GM's efforts in terms of rolling out EVs.

Jon: I'd love to go on and on, but I think we're running up on the time here.

Dan, Susan, and Steve, really appreciate you taking the time, and to all of our audience on the line as well. Thank you for joining us this afternoon. I hope we can do this again next year, but in person.

Dan: Yeah. Our pleasure, thank you.

Susan: Nice.

Steve: Sounds good.

[music]
