Porter & Co.

THE BIG SECRET ON WALL STREET

AMERICAN VICE #4

THE GOLDMAN SACHS OF WHITE TRASH

FROM THE DESK OF PORTER STANSBERRY

SPECIAL REPORT

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The Goldman Sachs of White Trash

Making Loans Work For Everyone – and Profiting Along the Way

When Others Say No, This Company Finds a Way

In 2014 our friend Doug Casey visited Harare, the capital of Zimbabwe.

Doug, an experienced global investor, knew the country well. He'd become familiar with several of its largest estates, dating back to the 1970s when the country was called Rhodesia.

We should tell you, Doug is a romantic with a sense of humor. He would jokingly say, I'd like to be able to tell people, "Once I had a farm in Africa."

In the 1970s Rhodesia's farms were among the most productive in the world. Politically though, the country was deeply troubled.

Rhodesia was an international pariah because it resisted the "decolonization" trend of the 1960s and 1970s. Its white minority population, led by Ian Smith, refused to give up political control to the black majority. Painted as racist, Ian Smith and his Rhodesian patriots rightfully feared the consequences of majority rule in Rhodesia.

Not because the majority was black, but because they were led by violent Marxists and uneducated tribal leaders who had no concern for the rule of law or fair elections. But, Smith's patriots were fighting the tide. Rhodesia's white ruling class finally ceded political control in 1980.

Robert Mugabe, a Marxist rebel backed by North Korea, won the first general election. And just as Ian Smith feared, his ZANU party began a civil war to eliminate a rival tribe. They killed an estimated 10,000 people and ensured one-party rule, making Mugabe dictator for life.

One economic calamity after another ensued, with extreme poverty growing rapidly after 1985. Beginning in 1999, to mollify the growing criticism of his regime, Mugabe launched a policy of outright confiscation of white-owned farms. As a result, food production fell in half. Unemployment soared to over 80%. The economy completely collapsed.

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During the economic collapse, Zimbabwe's central bank, led by economist Gideon Gono, engineered the greatest hyperinflation in modern history, by printing vast sums to support government spending (and corruption) while making retail price increases illegal. Soon there was nothing in the stores. Wages were rendered worthless. Civil society was destroyed.

Inflation grew from around 50% in 1999 to over 500% annually by 2005. Then hyperinflation took off, reaching 1,200% in 2006 and then into numbers that simply have no meaning in 2007. At that point, there was essentially zero value to anything printed with the word *Zimbabwe* on it, no matter how many zeros they lopped off each new iteration of their dollar. But, officially, by 2008, one U.S. dollar was worth 2.6 trillion Zimbabwe dollars.

Finally, in 2009, the central bank gave up and stopped issuing any local currency. The country became "dollarized," which involved the government and the private sector using the U.S. dollar as the primary means of exchange, inflation was over, but the economy had been destroyed.

In the wreckage, our friend Doug smelled an opportunity.

He subsequently visited Gideon Gono at his home in Harare, looking for assurances that the ruling junta had learned its lesson and would maintain a more stable economic footing. During the meal, Gono insisted that Doug watch a 77-minute economic documentary on YouTube…

> *"This young economist from America is a genius, Doug. He is showing Americans what will happen next."*

Gono smiled broadly at Doug.

> *"Mugabe made me do these things to my country. We are poor. And our leaders are extremely corrupt. We believed we had no other choice. But why are your leaders doing this to your country? You are the richest and most powerful country in the world. If you destroy your economy, you will bankrupt the whole world."*

Gono turned his laptop toward Doug and a familiar voice began to narrate *The End of America…*

Written and recorded by Porter Stansberry in late 2010, *The End of America* is one of the most watched presentations on economics in history, with well over 100 million views. Millions of copies of Porter's *End of America* books (*The Battle for America, The American Jubilee)* were also printed and continue to circulate on Amazon and used bookstores.

The documentary described the inevitable economic, moral, and civic collapse

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that's underway in the United States. Because of out-of-control government spending financed via the monetization of debt by the Federal Reserve.

> *As early as 2010, Porter predicted America was approaching a crisis that would "change everything about your normal way of life," including, "where you vacation, where you send your kids to school, how and where you shop."*

The End of America predicted inflation in America would eventually soar, sending energy and food prices higher and robbing the middle class of their purchasing power and their savings. These problems would lead to tremendous political upheaval and a decline in civil society.

What Porter did not anticipate was that a global pandemic would trigger many of these events. Or as he likes to say, "I didn't even know they ate bats in China."

But perhaps the government's and the public's response to COVID says far more about the moral and cultural decline of our country than it does about science or medicine.

There's virtually zero evidence that any of the government-mandated shutdowns (and the accompanying $6 trillion money-printing spree) did anything, at all, to protect anyone from the virus. But it did open the flood gates to future government-control of the economy and still more inflation.

Plus, there's now a precedent for total government control of society – without any Congressional approval or judiciary oversight. Stay in your homes. Wear a mask (even on private property). No interstate travel without permission. Close the banks. No more First Amendment-protected freedom of assembly.

And that – greater and greater government power in the face of a decline in civil rights and the private sector – is all part of the *End of America* hypothesis.

Once government begins monetizing debt, it never stops voluntarily. The ongoing inflation requires increasingly more debt – or else the system collapses completely. More "emergencies" must be discovered, and more parts of the private sector must become politicized. The result is more power for the government over civil society.

Witness the latest industry to be "graced" with hundreds of billions in government spending – the already profitable semiconductor industry! Why? Because of China of course!

Meanwhile, there's zero evidence or rationale to believe that China has any desire to invade our country or to even fight a proxy war with us anywhere. Instead, it is our country that maintains ground troops in virtually every country in the world and continues to intervene in China's nearly 100-year civil war (Taiwan.)

What's the problem with inflation, with massive government deficits, and with the

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ongoing manipulation of our economy by the government?

There are two fatal flaws to government-led efforts to print prosperity and manage the economy.

First and foremost, ***the invisible hand of an economy works both ways.***

Where money is sound and private property rights are enforced, the invisible hand of the market directs scarce resources to where they are needed most and ensures a high price is paid for wasteful investment.

Sound money and the information it conveys through accurate prices are critical for this process. The invisible hand, when given the right data, ensures growth, supply, and increasing prosperity. But, when prices are manipulated, and money corrupted, the invisible hand is misled. Misdirected, it will take away prosperity with the same inevitability.

When governments attempt to regulate prices or profits, what happens? Supply disappears.

What do you think will happen to cheap and reliable transportation and cheap and reliable grid power as the government continues to manipulate the price of renewable power and electric cars via tax credits?

As sure as the sun rises, reliable supplies of on-demand energy (fossil fuels) will disappear and the price of reliable energy – both on-grid and at the pump – will soar.

Another example? Government regulations (like residential fire sprinkler requirements) make building new homes extremely expensive or economically impossible due to permitting uncertainties amid endless NIMBY (not in my backyard) lawsuits.

Then, to make those expensive homes “affordable,” the government creates a rigged market for mortgages, which permits far too much credit to be created against too little income. What could possibly go wrong? Asset bubbles form making housing all but unaffordable and creating a massive housing shortage.

Given these economic realities, it’s inevitable that homebuilders with access to land will make a killing – which is why we recommend investing in them. It is just as inevitable that homes will become increasingly unaffordable, leading to big problems for our society.

The Bigger Problem With Inflation: Middle Class Misery

The more obvious problem with debt monetization and massive government deficit spending is outright inflation.

Printing money to finance government spending has an extraordinarily negative

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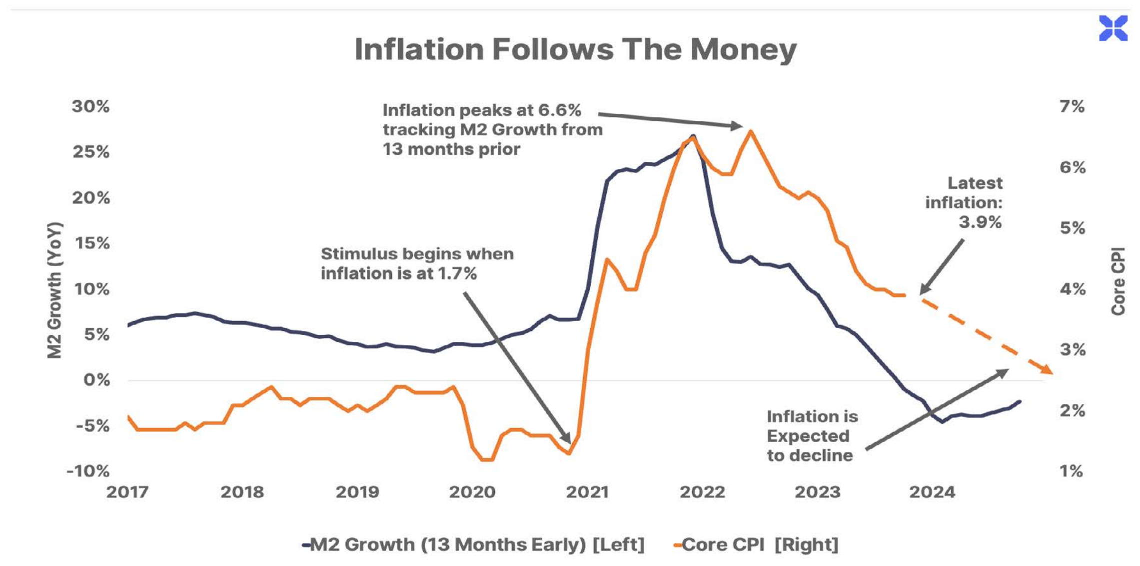
impact on real wages over time. Printing money destroys the middle class. It steals their wages and their savings. It makes a mockery of American family values – like hard work and diligent saving. And it is that middle-class work ethic that is the ultimate source of our society's stability.

The $6 trillion that was given out, for free, during the COVID lockdown resulted in a huge increase in money supply. The chart below shows how this massive increase in money supply, led directly (13 months later) to a matching increase in inflation – the largest amount of inflation we've seen since the late 1970s, early 1980s.



Whether it's war, a banking crisis, or the flu, democracies with fiat currencies have never failed to find reasons to expand their banking systems until they collapse in an inflationary spiral. The record of fiat currencies is unblemished by success: *there's not a single paper (fiat) currency in history that survived.*

The U.S. dollar will not be an exception.

Societies suffering from fiat-currency collapse and rising inflation all have the same societal trends – from Roman coin shaving to today's digital receipts – when government plays an ever-increasing role in the private sector, there's a vast increase in war and war-like activities to gain access to more resources (take, for instance, the Iraq war)...

Then people abandon traditional values... there's a huge increase in gambling and other forms of speculation. Violent crime increases substantially. And alternative monetary schemes flourish (crypto anyone?).

There's no question all of those things are happening in our society.

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More worrisome for us is that the rate of the decline of our currency (and thus, the growing instability of our society) will continue to accelerate as past excesses contribute in a collective way to the problems. Debts mount. Interest payments grow.

And, inevitably, more printing is the only politically viable answer. So, it must continue.

Tracking The Demise Of America

How long can the current system last?

As long as people don't understand the underlying economic reality, we promise no one else will explain this to you. ***If this was widely understood by the public, there would be a revolution tomorrow.***

In an honest marketplace with real private property and a legitimate currency, the value of wages *always* rises to meet growth in productivity. This is a key feature of the invisible hand of the free market.

Why would anyone voluntarily pay higher wages? To maximize earnings. That might be confusing at first. Often, it's easier to see the invisible hand at work when you "invert" the question.

So, what happens when governments mandate minimum wages that are in excess of prevailing productivity? Unemployment soars of course: *entrepreneurs can't afford to pay wages that are not economically viable.*

The opposite is also true: when productivity increases, entrepreneurs increase employment and wages. They do so because of the invisible hand: to maximize their own profits.

Think Henry Ford. He famously doubled the wages of his huge workforce from $2.50 per day to $5 per day in 1914. It was a pay raise that cost him $10 million. Why did he do it?

Because gains in productivity made producing more cars vastly more profitable. But to increase production he needed a reliable labor force. The year before the pay raise, Ford made 170,000 cars. In 1914 he was able to increase production to 202,000.

The details matter when it comes to pay and incentives. Most historians leave out that Ford's pay raise came in the form of a bonus paid at the end of the year. And only paid to those workers who lived their lives in an "American" way. They had to speak English. Their wives couldn't work outside the home. And they had to avoid drinking and gambling. Sound money and a free market promote a stable and orderly society.

[Interesting historical footnote: The cotton gin was patented in 1793. It, along with innovations to industrial scale weaving, greatly increased productivity in cotton farming and the garment industry. As a result of the increase in labor

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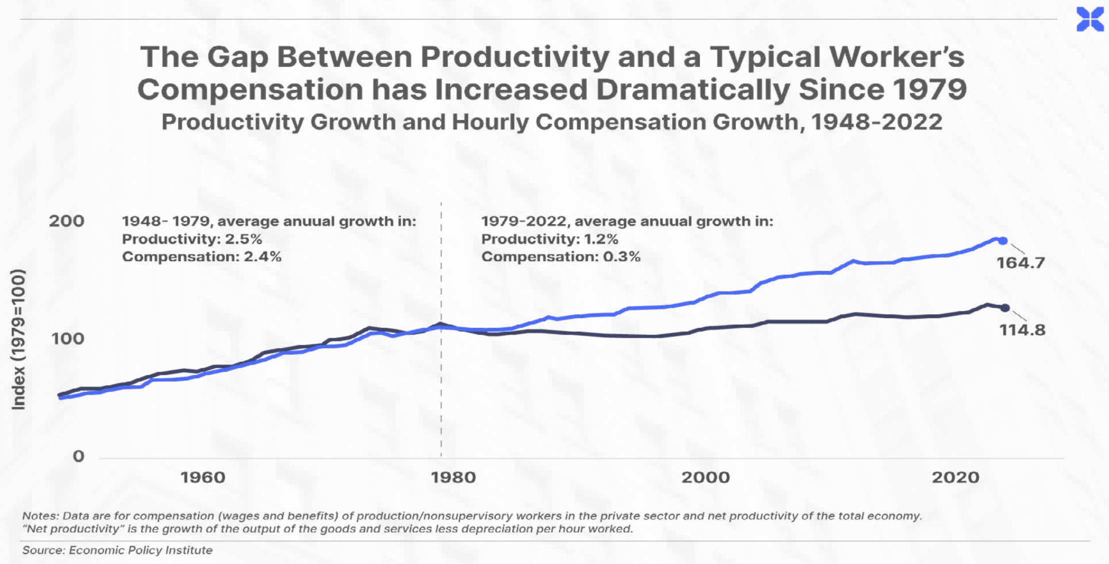
productivity, slavery as an institution no longer made economic sense in most of the British Empire. Shortly thereafter, in 1807, the British banned slave trading and, a generation later, in 1833, made slavery itself illegal. Today it's fashionable to see the abolition movement as a moral crusade. But the reality is that slavery only became illegal when it no longer served society. And that change was based on economics, not morality.]

Historically in the U.S., "real" wages (after tax, after inflation) continuously rose to match the rising productivity of the U.S. economy. This is exactly as economic theory would predict – in a free market, with sound money.

As the productivity of our economy grew, thanks, at first, to the industrial revolution, then to the electrification of our country, and finally to the information revolution, real wages rose at virtually the exact same rate. No need for unions or strikes. Just the invisible hand.

But all of that changed, suddenly in the early 1970s. As the chart below shows clearly, wages and productivity "decoupled" about 50 years ago.



That's when the U.S. abandoned the gold standard. By untethering our currency and banking system from a foundation in gold, credit was able to expand far beyond savings – setting the stage for a massive inflation and ever-increasing government borrowing.

Ever since then, most of the gains we've experienced in productivity have, sooner or later, been erased from real wages by periods of inflation.

The spike in inflation we saw in 2022 that is just leveling off now will probably

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reduce real wages by 10% to 20% over the next five years, even as productivity continues to grow.

That's why, for more Americans, no matter how hard they work, they will not be able to avoid slipping into poverty. That's why, for more Americans, our government, our economy, and our "system" seem completely illegitimate.

They are not wrong: they have been defrauded.

The root of this problem isn't the private sector or "greedy" corporations. It is simply the ongoing rising (and massive) government deficits, which are financed, increasingly, by inflation. Ironically, it is typically poor Americans who continue to vote for yet more government spending and intervention in the economy. And, sadly, it seems virtually certain that their gullibility will only increase, thanks to the growing influence of the government over the media.

Sooner or later, a massive – and possibly violent – crisis will strike.

Jamie's Warning – Like Merrill's?

JPMorgan CEO Jamie Dimon is *so far* the only major Wall Street figure who has offered any substantial warning about what's happening.

He said in June 2022, *"You'd better brace yourselves… a hurricane is coming."* And he's so concerned he's having his bank stockpile reserves in the hundreds of millions. This isn't business as usual.

Right before the Great Depression, in the spring of 1928, a young stockbroker advised his clients to get out of debt – completely. Back then, virtually all investors in the stock market used margin loans to finance their holdings. Telling his customers to get completely out of debt was tantamount to telling them to sell virtually all their investments.

This young broker also warned his clients to strictly avoid owning any corporation that was financed, in any way, with debt. He repeated this advice month after month for more than a year until the market crashed in the fall of 1929.

His advice saved the fortunes of his clients. And it made him, and his firm, Merrill Lynch, the most famous and successful stock brokerage in the country for nearly 70 years.

Dimon's warning is essentially the same. And for the exact same reason.

What's happening right now is the big "unravel." Since the Great Financial Crisis of 2008-2009, the U.S. economy has been completely dependent on the creation of massive amounts of additional debt.

Most of the debt that's been created (in the U.S.) is federal government debt,

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which now totals $34.5 trillion, up more than 200% since before the 2008 Great Financial Crisis.

Lots of other forms of private debt have grown too, like student debt. Today 44 million Americans owe a total of $1.7 trillion in student debt, overall up 183% since before the financial crisis. These debts are virtually all held by the U.S. government, which has suspended repayment of some loans since the onset of COVID and now seems determined to forgive most, if not all of this debt – another massive form of inflation and a severe blow to the kind of middle-class work ethic that sustains our society.

Going back to the huge stock market bubble of the late 1990s and early 2000s, over roughly the last 20 years, total debt in the U.S. economy has grown from 2.6x GDP to 4x GDP. Today that total debt is an incredible $92 trillion.

That's a number that's impossible to conceptualize. But it's basically $1 million per household. Meanwhile, the average U.S. family has under $10,000 in savings.

This level of debt is, as should be obvious, completely unsustainable. And the only way it can be financed is by continued increases to the money supply, via the Federal Reserve.

Our central bank has been printing new dollars, by the trillions, and buying government bonds and mortgage bonds to keep interest rates low, and fixed income (bond) prices high. This is, on a much, much bigger scale, "third world finance"— just as Gideon Gono recognized.

And this kind of manipulation will produce a booming economy… until… eventually… inflation soars. Once people begin to realize that the entire economy is built on a house of cards, everything changes. People began to horde resources and shun financial assets. Everything collapses. That's what's happening. It's happening right now. And you have to get ahead of it… or you risk losing everything.

That's why Jamie Dimon is so worried. And I know, in time, Dimon's warning will be remembered as virtually identical to Merrill's nearly 100 years ago.

He warned us: A hurricane is coming.

That storm will see rising interest rates, rising debt defaults, and, most importantly, declining real wages, because the inflation that's begun will prove very difficult to reign in. This recession will probably be "mild" for most affluent Americans, whose relatively high incomes, investments, and real estate will shield them from the worst impact of inflation. But for the middle class, the coming recession will be the worst since the 1970s.

The working poor and lower middle class in America largely vote Democratic. They vote for more government spending, imagining they won't have to pay for the benefits. And they are about to get what they deserve, good and hard.

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What should we do about the poor? We suggest taking a cue from philosopher Ayn Rand, who famously advised her followers: *"Don't be one of them."*

That is why in this Special Report of *The Big Secret on Wall Street* we recommend investing in a business that's found a nearly foolproof way to profit on the growth of poverty in America.

It's a trend that's inevitable: more of the middle class will slip into the working poor over the next five years...

And when they do, we will make a lot of money.

Isn't profiting off the poor immoral? Mmn, well. *It's economics*.

So let's dig into it...

The Goldman Sachs Of Poor White Trash

There's nothing more *End of America* than a buy-here, pay-here used-car lot.

Don Foss is the greatest used-car salesman of all time. He knew his customers: they were poor and had bad credit. When Don Foss started selling used cars in the 1970s, he found there was one major factor holding back sales: financing.

To grow, he had to find a way to give poor people, who probably didn't deserve a loan, the money they needed for a car. Then they could drive to work and earn the money to pay for the car they'd bought. Foss built a business model for making good money on bad loans.

His core innovation was surprisingly simple: Foss made sure his finance company virtually couldn't lose money on a loan by making sure his finance company was paid all of its fees and all of its principle back, in full, *before* sharing the upside of each loan with the dealerships who underwrote them. In this way, dealers had a big incentive to underwrite conservatively – they bore virtually all of the risk in each loan.

The rest, as they say, is history. Foss took his company, **Credit Acceptance (Nasdaq: CACC)**, public in 1992, and the share price performance since then tells the story in one chart:

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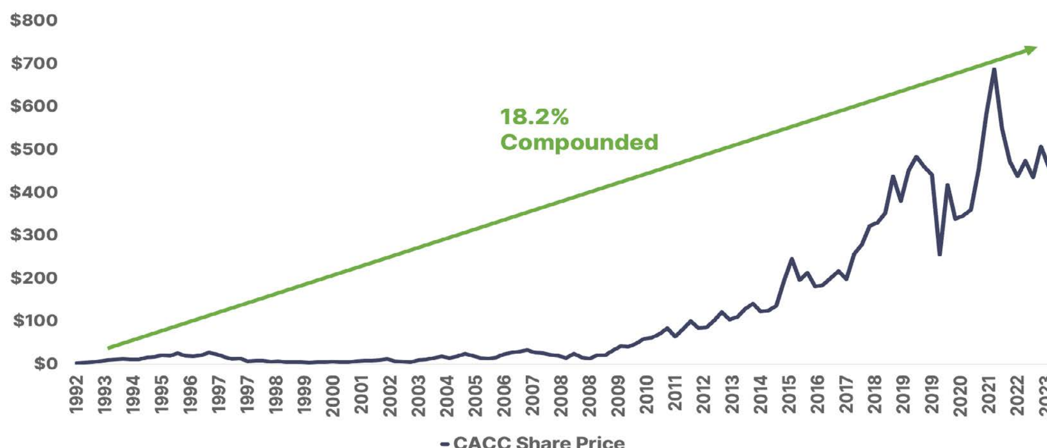

As shown above, CACC sits among the rarefied air of companies that have compounded shareholder wealth at 18% for three decades running.

It's one of the most capital efficient businesses in the market, ***converting an astounding 42% of earnings into free cash flow*** ("FCF")and earning a 28.7% return on equity over the last two decades.

With such a profitable business model and long track record of success, you might expect shares to command a rich premium. But today, you can buy into this world-class wealth compounder at less than 14x earnings.

Why is the stock so cheap? Well, obviously it is a business with a dreadful reputation. Nobody wants to be associated with subprime lending at used car lots. It's kind of like how trailer parks have historically been extremely high-yielding real estate investments.

But the more significant reason is because very few investors understand how Credit Acceptance's lending is vastly different (and far safer) than that of virtually any other kind of subprime lender.

Over 90% of the loans Credit Acceptance makes come from subprime consumers. The company knows many of these loans will default. On average, Credit Acceptance will only recover about 65% to 70% of the loans it makes.

So, therein lies the billion-dollar question: How do you profitably lend money to poor people, many of which you know aren't going to repay you?

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Here's How It Works

Let's say Sam's Hot Car Lot buys a wholesale Honda Civic from around 2011 for $13,000 with the aim of reselling it on the lot for $15,000. A potential customer shows up with $2,000 cash and a 620 FICO score (i.e., a low-credit quality, subprime borrower). The customer wants the Civic, and the dealer wants the sale.

With your normal financing institution, this deal doesn't get done. When you factor in the elevated likelihood of default, the costs of repossessing the car, and collecting on the bad debt – likely for pennies on the dollar – the risk/reward just doesn't pencil out.

But Credit Acceptance found a way to make this work.

First, Credit Acceptance offers an upfront cash advance to the dealer in exchange for rights to service the loan. As part of the deal, Credit Acceptance becomes the lienholder on the vehicle title. The structure also establishes an 80/20 risk-reward split between both parties. *The dealer receives 80% of the net loan repayments, while Credit Acceptance earns the remaining 20%... but Credit Acceptance gets paid first and takes virtually no risk.*

The dealer only gets his cut after satisfying three criteria.

1. Credit Acceptance earns a one-time, upfront collection fee
2. After netting out this collection fee, Credit Acceptance earns a service fee equal to 20% of the net loan payment
3. Credit Acceptance earns an amortized repayment of the dealer advance

Only after Credit Acceptance recoups the full dealer advance, along with its collection and service fees, the dealership receives its 80% share of the net loan repayments, referred to as the "Dealer Holdback."

The reason for the term "Holdback" is because the 80% dealer payment must first work down the repayment of the advance to Credit Acceptance. That's where the term "Holdback" comes from – the dealer is entitled to the payments, but they're first held back to satisfy the outstanding obligations to Credit Acceptance.

So, in the case of the $15,000 Honda Civic sale, the buyer made a $2,000 down payment and took out a $13,000 loan to satisfy the remaining balance. He agrees to a 20% annual interest rate over 60 months. There's a lot of profit in this loan – if it's repaid. Total amortized cash flows will amount to $20,665. The high interest rate is necessary because Credit Acceptance knows that a lot of these loans will not be paid in full. Even so, assuming a 70% collection rate, it's still worth $14,500 in amortized cash flows.

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And to make sure Credit Acceptance can't lose money, the company will price the cash advance for this loan at approximately 45% of the full recovery rate (i.e., 45% of $20,665), or about $9,300.

In the worst-case scenario, the borrower never makes a single payment and defaults on the vehicle immediately. In this case, Credit Acceptance re-possesses the vehicle. Let's assume $2,000 in repossession costs and maybe another $1,000 in vehicle depreciation. That leaves net proceeds of $10,000 from the vehicle repossession.

Since Credit Acceptance holds the senior position in the loan (it holds the note) it gets $9,300 of the $10,000 as repayment of its cash advance. The remaining $700 balance gets split 80/20 between the dealer and Credit Acceptance. So, the dealer ends up with a check for $560 in proceeds from the repossession auction and Credit Acceptance gets $140.

Even in this worst-case scenario, Credit Acceptance breaks even, or even a little better. It gets its advance back, plus fees, and a modest $140 in proceeds from the repossession.

Now, consider the other perspective of the dealer – who keeps the $2,000 down payment and the $9,300 cash advance, for a total of $11,300 in upfront cash. Add in $560 from the repossession sale, and that's just $11,860 in final payments. But remember, the dealer paid $13,000 for the vehicle to begin with.

So, the dealer loses $1,120 in this situation, compared with a net profit (albeit small) for Credit Acceptance. In other words: The deal structure creates a situation where the dealer starts off at risk of losing money, whereas Credit Acceptance is protected from day one, thanks to its claim on the vehicle title.

Now, the flipside here is a successful loan. In that case, the dealer gets the bulk of the future cash flows on a 20% annual loan. Plus, the dealer also gets a very nice upfront cash infusion – in this case $11,300 on an asset worth $13,000. Thus, in the success case scenario, the dealer gets the majority cash flows from the high-yield loan, and also gets a cash infusion that allows him to finance more inventory, and do this over again.

The model works in the aggregate because of these protections and the incentive the dealer has to make good loans. And to make sure that one or two really bad deals don't spoil the math, Credit Acceptance typically requires dealers to aggregate 50 to 100 loans per pool before they are funded.

The wide margin of safety in these deals means Credit Acceptance can use a modest amount of leverage to safely push more capital into the model – targeting a maximum debt/equity ratio of roughly 2.5.

If the average loan comes with a nominal interest rate of 20% and a 70% recovery rate, this translates into an effective yield of roughly 14% across the loan book.

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As a basic assumption, we can assume that the other fees charged cover the corporate overhead.

So, assuming a cost of capital of roughly 3% to 4% (weighted-average interest rate was 3.6% last year), that's about a 10% return on assets, which is what the company targets in its financial modeling. Then, management leverages that return on assets by 2.5x and you get a 25% return on equity.

As one anecdotal example of how valuable Credit Acceptance can be for independent car dealers, consider the case of Keith McCluskey, owner of McCluskey Chevrolet Mission Automotive in Cincinnati, Ohio.

When starting out in the 1980s, his dealership was only selling about 10 to 15 cars a month. He was running into the very same issues that prevented Don Foss from selling cars early on – many potential customers were routinely refused financing by the big banks.

Everything changed after he came across a mail advertisement from Credit Acceptance that promised "Financing for Everyone." After calling the company, McCluskey was shocked to discover it was true. Credit Acceptance was willing to provide financing for any borrowers, regardless of how poor their credit quality might be.

A skeptical McCluskey called around other dealerships that Credit Acceptance was partnered with to verify the claims. He learned that one dealer in Detroit had just pulled in $125,000 in profits in a single month – and McCluskey was sold. After all, that was more money than his dealership had earned throughout the entire decade of the 1980s… but this would soon change.

By partnering up with Credit Acceptance, McCluskey removed the single biggest obstacle preventing his customers from getting a car. Sales went through the roof, and McCluskey went on to become Ohio's number-one Chevy dealer in new and used vehicle sales.

Success cases like this explain how Credit Acceptance grew its dealership partners more than 15-fold from 2002 to 2019.

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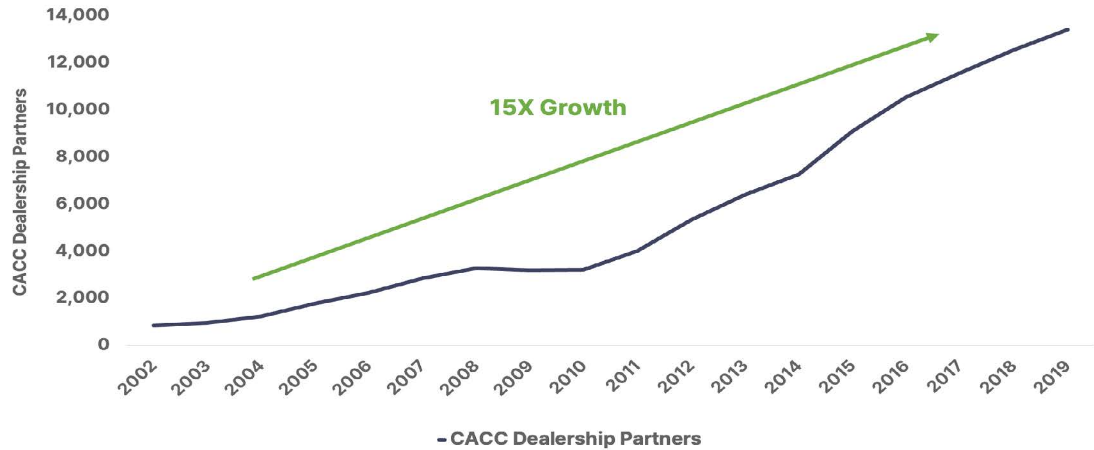
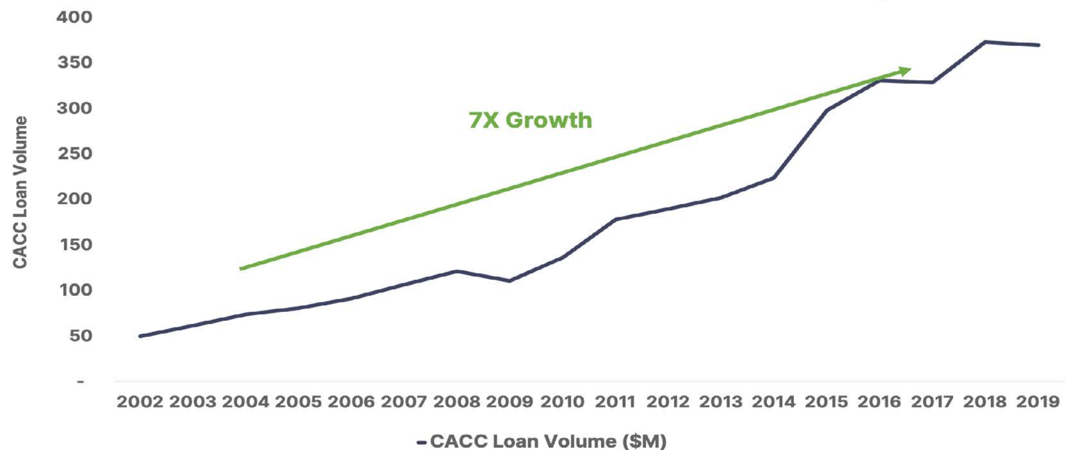


More dealerships meant more loan volumes for Credit Acceptance, which also enjoyed dramatic growth over the same time period:



Now, you might be thinking – sure, it's a great business model... but what about the competition? After all, if the secret sauce simply distills down to the deal structure, why can't competitors enter the market and do the same thing?

To answer this question, we must rewind back to the early 1990s.

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Surviving the First Subprime Boom/Bust Cycle

After enjoying two decades of success as a privately run company, Credit Acceptance went public in 1992. As Wall Street discovered the success of the model, it attracted a horde of imitators, as Foss explained in an interview...

> *"The thing I didn't realize about going public is that you tell everybody how your business works."*

Over 20 new IPOs hit the public markets by 1994, unleashing a new class of subprime auto lenders. This influx of competition created a scramble for market share, pushing down credit standards and loan quality across the industry.

Credit Acceptance refused to join the race to the bottom in underwriting standards, and instead began to seek out new markets for growth opportunities. This included expansion outside of the U.S. into international markets like Canada, Ireland, and the UK.

Credit Acceptance also opened a new business line by entering the leasing market in 1999. In the leasing segment, the company purchased vehicle leases from dealers, and assumed ownership of the vehicle and payment stream from the customer.

Straying outside of its core competency delivered the predictable result – lower profitability, and ultimately, a multimillion-dollar asset impairment on the leasing business. After taking its lumps with the poorly executed expansion, Credit Acceptance reversed course and shut down the leasing segment in early 2002, as explained in that year's annual report:

> *"In early 2002, the decision was made to exit the leasing business. This decision was based upon the conclusion that the leasing business was unlikely to produce a higher return than the Company's automobile lending business over the long-term."*

The year 2002 marked a critical turning point for Credit Acceptance. Following its struggles with competition and expansion into less-profitable segments, the company got back to basics. A new CEO took over the reins – Brett Roberts – and he helped re-focus on the core business model that made Credit Acceptance great in the first place.

Roberts brought a Warren Buffett-like approach to capital allocation (he was known for widely citing Buffett in the company's earnings calls and annual reports in the early 2000s), including his landmark achievement – introducing the key metric of Economic Profit for guiding the company's capital deployment.

Economic Profit is a measure of profitability that factors in the cost of funding – both debt and equity – and measures how efficiently the company deploys capital.

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This renewed focus on economic value helped the company right the ship, and enjoyed two decades of stellar profit growth – 22% per year on average, including sailing right through the Great Financial Crisis without so much as a hiccup:

But what about those imitators who flooded the market in the mid-1990s? Like every classic credit boom, aggressive loan creation and lax underwriting standards set the stage for spectacular collapse.

The first domino fell in January 1997, when Mercury Finance – the industry's largest independent lender at the time – announced that it had overstated earnings four years in a row. The revelation forced Mercury into default on $61 million in debt repayments and sparked a chain reaction that sent the industry reeling.

One week later, the Jayhawk Acceptance Company announced a surprise bankruptcy. We use the term "surprise" because Jayhawk's Chapter 11 filing came no less than a week after company management assured analysts of its financial situation. One securities analyst explained the situation in a *New York Times* interview:

> *"The events at Jayhawk reflect a classic case of management who thought they knew what they were doing and obviously did not."*

On the day of the Jayhawk's Chapter 11 news, subprime-auto-lending stocks like Jayhawk, Mercury, and others plunged by 20% to 30% across the board. This marked the start of a wave of share-price destruction and bankruptcies that washed over the industry during the next 18 months.

The American Bankruptcy Institute published a post-mortem that explained the fundamental problem:

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> *"New (subprime auto) lenders had liberal credit standards that did not implement credit scoring and inadequately provisioned for credit losses... In the highly competitive subprime auto finance sector, risk management tools are very important to success. The most important tool is the ability to reliably track the performance of loans purchased from each dealer."*

So, returning to the question of what makes Credit Acceptance stand out, and what prevented the army of imitators in the 1990s from encroaching upon its business model in the subsequent decades?

The secret to its success goes beyond just deal structuring. The first part is the company culture.

Credit Acceptance enjoyed the benefits of a seasoned management team, who – in contrast with the fly-by-night operators like Jayhawk – knew what it was doing. Sure, management ventured off into unprofitable business lines in response to the increased competition... but it never lost sight of what it takes to succeed in the business. That's how it avoided going bust in the late 1990s, and it's how it set the stage for tremendous success in the decades that followed.

We can distill the competitive advantage into two categories – a seasoned management team with a culture for disciplined risk management, combined with a robust process for deal-making and serving customers that beats the competition.

Risk Management as a Competitive Advantage

Starting on the risk-management side of the business, we can see the evidence of Credit Acceptance's culture of conservative loan underwriting with one simple metric: a comparison of loan recovery values versus the company's initial forecast when underwriting each loan.

The chart below shows the spread between actual versus initial forecast on loan recoveries – referred to as "variance" – for each year since 2002:

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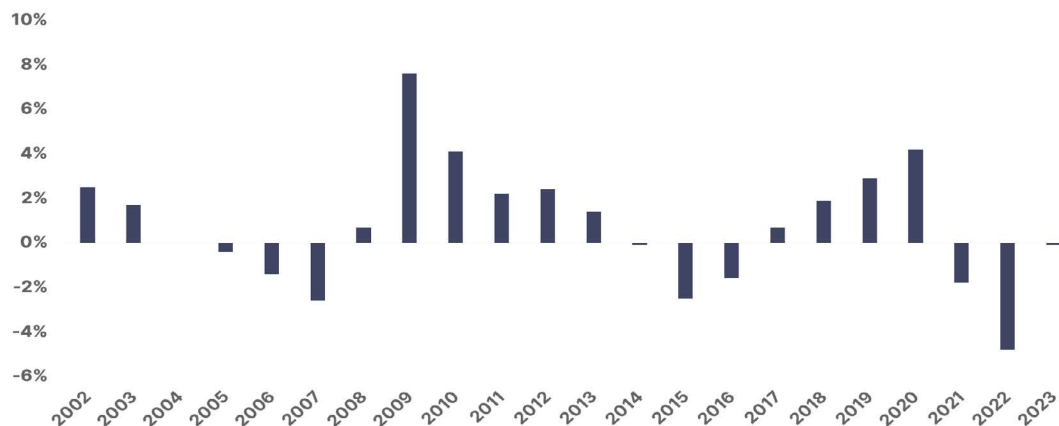

This shows Credit Acceptance's superior risk management, in what is an otherwise risky business. Recall from the earlier discussion that Credit Acceptance only recovers, on average, about 65% to 70% of the face value of loans across its book.

Based on this forecast of the recovery value, the company adjusts the price it pays to acquire loans. That's why it doesn't matter what the recovery value for any given loan is on an absolute basis. All that matters is whether Credit Acceptance prices the risk accordingly.

The chart above shows that Credit Acceptance is a conservative underwriter, with the average loan recovery exceeding their initial estimate (i.e. the estimate used when pricing the loan acquisition) by an average of +0.8%.

We also know that Credit Acceptance bakes in a high margin of safety against situations where the recovery value is less than expected. How? Well, recall the chart above showing the earnings-per-share history. Even in the eight years where loan recoveries were less than expected during the last two decades, the company never suffered a hiccup in earnings – posting consistent earnings growth even in the years of less-than-expected loan recoveries.

So, we know that management is conservative when forecasting loan performance, and it also builds in a wide margin of safety in case they're wrong. That's part of the reason why the company grew earnings at 26% per year for two decades and including through the Great Financial Crisis.

But how can we know that management won't lose its focus...?

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Credit Acceptance's Secret Weapon – the CAPS System

Every loan that dealers submit for acquisition to Credit Acceptance must pass through the company's proprietary credit screening software – the Credit Approval Processing System ("CAPS").

CAPS uses a unique credit scoring algorithm designed to estimate the following key variables:

The future cash flows from a given loan, the risk associated with those cash flows, and the appropriate cash advance Credit Acceptance should issue to achieve its target return on capital. This is the mathematical approach the company uses to price its acquisition of loans from dealers.

Here again, we revisit the key idea: Just because a loan carries high default risk, doesn't mean that loan can't be priced in a way that makes it a low-risk investment. That's the entire premise of the business model, and CAPS turns this underwriting process into a system.

Critically, the CAPS system isn't just based on formulas born in the mind of a computer programmer or loan underwriter. It draws upon the company's 50-year history of successful subprime auto lending, data that no other company has access to.

In the game of statistical analysis, data is king. The more historical case studies you can draw upon, the more accurate your predictions will be. CAPS will take input data, like a consumer's credit history and income, and compare it against consumers with similar profiles in the database, to estimate the likelihood and degree of default.

CAPS also takes input data on the vehicle itself to determine a valuation estimate for the underlying asset. This also helps in pricing the loan, by providing the estimate of the recovery value in the event of default and repossession.

The system is continuously updated and monitored. Each month, CAPS updates the loan status across the company's entire portfolio. This allows Credit Acceptance to continuously monitor its loan exposures and adjust underwriting as market conditions evolve.

Credit Acceptance also uses CAPS data to monitor the performance of their dealership partners. This includes ranking the dealers based on a variety of loan performance criteria, which can impact the acquisition values the company uses for loans.

So when you dig into the nuances, *you see that this is not a commodified business*.

This is an information-based business. It requires no real physical capital – just the intangible capital of experience and wisdom, which the company has distilled

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down into a data-driven process. That leads us to the best part of all about this enterprise – it's incredible capital efficiency, which is a key factor behind the historical earnings per share growth, and thus share price outperformance.

Profiting Off Poor People – Efficiently

You can see the capital efficiency in this business in a number of ways.

One measure is the profit generated per employee. During up-cycles, the business only requires about 2,000 employees to earn roughly $1 billion in annual operating income. That's half a million dollars per employee.

Even better, capital expenditures over the last five years have averaged a minuscule $10 million per year.

That's a big reason why the company can grow its earnings per share at such a rapid pace. Most companies that earn $1 billion in operating income will send hundreds of millions back into capital expenditures to keep the business going. Not Credit Acceptance, which doesn't require any incremental capital to grow production and net income – the company just needs more dealers to purchase loans from.

The cash that doesn't go back into the business can instead go to shareholders, via share repurchases. And best of all? The stock has a habit of trading cheap – for reasons we'll discuss in the final section. Some investors complain when the stock they own trades at a discounted valuation. If your goal is to flip the shares to someone else at a higher price, of course you want multiple expansion.

But for investors looking to compound wealth by owning world-class businesses for the long run, the best thing you could possibly hope for is a permanently cheap stock. Why? Because that lets the company return more capital to investors through share purchases. The cheaper that shares trade, the more shares the company can purchase through buybacks, and the higher your compounded returns.

This is a process that's happening as we speak, and has been quietly happening for years, as Credit Acceptance outperforms the market without anyone noticing. Since the year 2000, Credit Acceptance has grown its earnings 40-fold from $24 million to $958 million in 2021. Because of the capital efficient nature of its business model, those earnings went back to investors through share repurchases, allowing the company to slash its share count from 42 million to 14 million:

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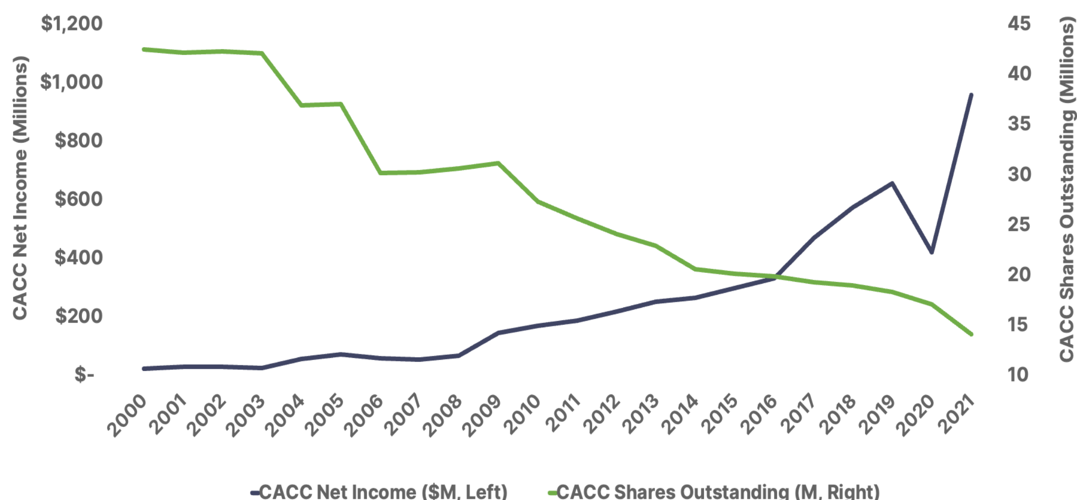

If you were a long-term investor who bought into the company in 2000, your share of the company grew 300% just from repurchases alone. *Combine this growing percent ownership with the 40-fold earnings increase, and it's easy to see how investors earned a return exceeding 18,000% over the time period.*

Now, let's end by addressing some of the naysayer points, which also explains why the stock trades cheap today as well as historically.

Recent Macro Obstacles and Bear Case

In a recent issue, we made the case for an auto-lending bubble – with a particular emphasis on subprime auto loans – that we believe will implode in spectacular fashion.

The current auto market shares many similarities with both the 1990s subprime auto-lending boom as well as the 2000s real estate boom. The aggressive loan creation, the shoddy underwriting, and widespread lack of income verification to name a few. And the big risk we see coming: a painful recession and default cycle in the broader economy.

For a normal subprime auto lender, you might expect disaster. But that's why we spent so much time highlighting Credit Acceptance's unique business model and risk-management process. They've been through this twice before – both in the late 1990s and 2007-2009, both of which saw spectacular auto lending blow ups.

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This company is not built to blow up during a down cycle in the market. It's built to withstand risk from defaults – that's the entire business model. A recession doesn't change that. In fact, a recession is the bull case for this business. If anything, the unique bull market environment of the past two years has been the equivalent of a recession for Credit Acceptance.

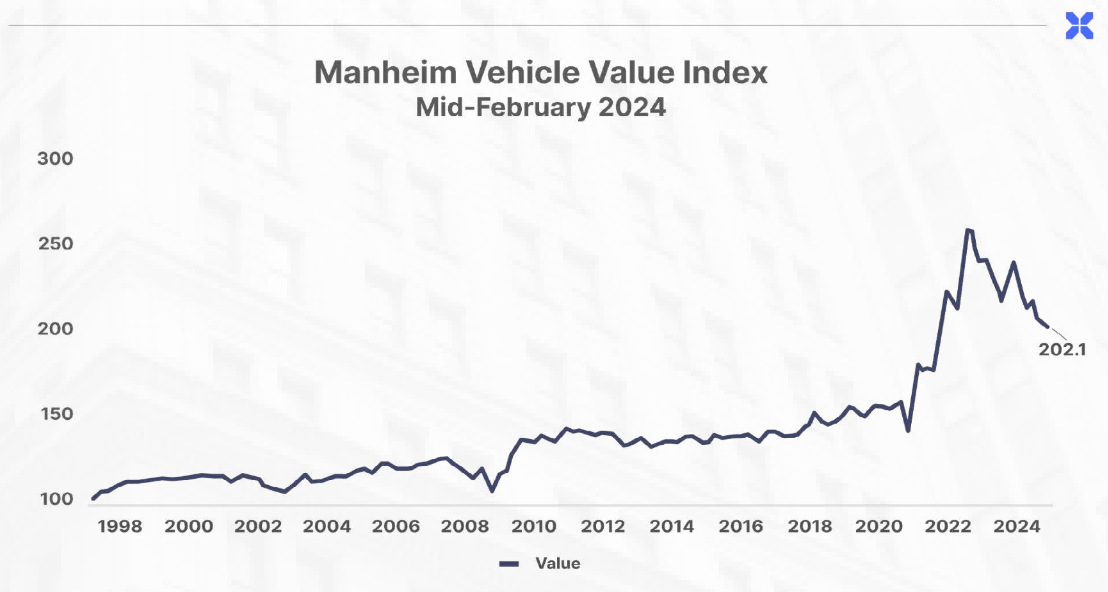
Let me explain…

You see, Credit Acceptance thrives in markets where capital is expensive, and when there's a lot of subprime borrowers who can't get financing from alternative sources. The last 10 years has produced the exact opposite conditions.

First, credit became extremely cheap starting in 2011 when both benchmark interest rates, and credit spreads dropped into record low territory. This produced a search for yield among financial institutions, and attracted a lot of capital from larger, established banks including Santander, Capital One, and Wells Fargo.

This growing competition presented mild headwinds, but still allowed the company to grow its overall loan volumes and profitability through 2019. However, the last few years have presented a unique confluence of factors that have created very poor macro conditions, causing the company's loan growth to drop by nearly 30% from the prior peak in 2019.

First, there was the consumer stimulus programs that boosted incomes across the board. Then, there was the overall inflation and shortage of vehicles, which combined push up used car prices by more than 50% since 2020:



Source: Cox Automotive

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In the short run, this created a substantial uplift in the recovery values of 2020-2021 vintage loans. That's because consumers first had more money to service their loans, and then the higher vehicle prices created an incentive for consumers to pay off their vehicles – as equity values exceed their loans in many cases. In these cases, even if a consumer could no longer make monthly payments, he had an incentive to avoid default by simply selling the car on the market to repay the loan and pocket the positive equity.

In the longer-term, the vehicle shortage meant that there were simply fewer loans to execute in general – and even fewer subprime loans. In addition to the factors described above, a severe lack of dealer inventory caused a natural "high-grading" in credit standards. After all, if you only have five cars to sell instead of the usual 10, you're naturally going to sell to the higher credit borrower… because why take the risk with the lower quality credits if you don't have to?

Of course, this is not to say that subprime lending isn't happening. It's the opposite – the dearth of deals has pushed the industry into a scramble for yield, extending loans on progressively less competitive terms with looser underwriting standards.

Meanwhile, if a recession hits, many consumers will suddenly find themselves underwater on their loans as car prices plunge… and if they lose their jobs and no longer need their vehicles for work, many could simply walk away from their obligations – just like in 2008, when millions of homeowners with negative equity walked away from their mortgages.

In any case, this kind of lending environment means the prices Credit Acceptance is offering for its loans are increasingly uncompetitive. Why? Because Credit Acceptance follows a strict risk control process, and their process is – for now – causing their loan acquisition program to be uncompetitive with alternative financing sources.

That's to be expected during a credit bubble, just as we saw in the late 1990s. Given this backdrop, we view it as a great thing that Credit Acceptance has pulled away from the market and experienced a nearly 30% drop in loan volumes since 2019:

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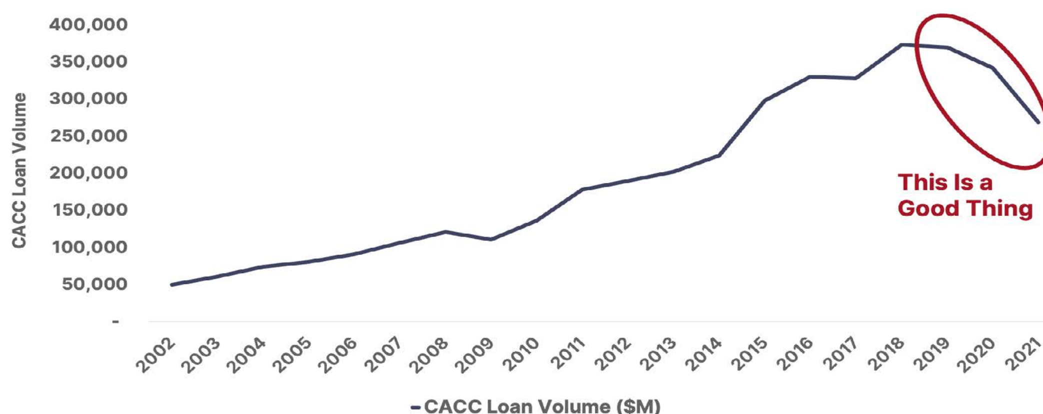

As the saying goes: "Anyone can lend, not everyone can collect."

We believe anyone aggressively lending into today's market – particularly on the subprime end – will have a lot of trouble collecting, just as they did in the 1990s.

Credit Acceptance knows to avoid that trap. Instead, it is deploying its still-healthy cash flows into shareholder returns through an aggressive buyback program – including $2.5 billion in repurchases, which retired 28.5% of the company's outstanding shares since 2021.

That's a big reason why earnings per share continue marching toward new all-time highs, and which we expect to continue even through the coming recession. A recession will transform the headwinds of the last two years into tailwinds, by introducing lower vehicle values and tightening lending standards, creating a lender's market in the subprime auto space once again.

Indeed, in 2023 the competition left the market and Credit Acceptance increased market share. Its loan volume grew 18.6% in 2023. The company's strong loan-volume growth suggests it is now capitalizing on favorable market conditions.

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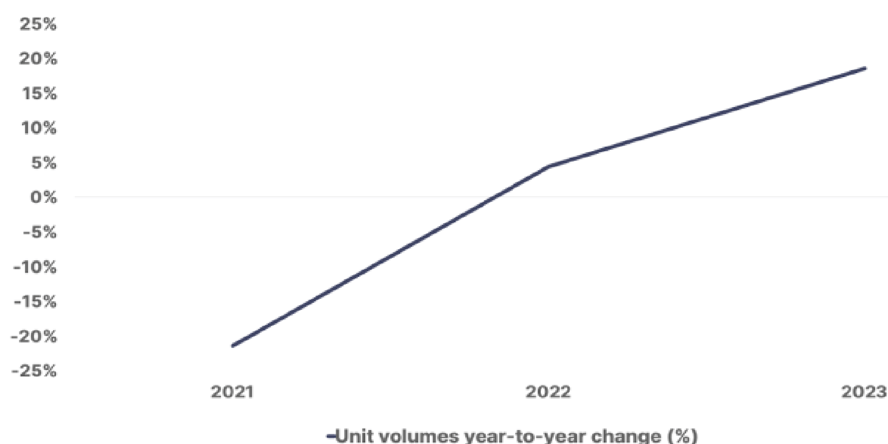

Not only is Credit Acceptance increasing loan volumes, but it's also making more money on each loan. We can see this in the spread (or difference) between the value recovered from each loan compared to the projected recovery at the time of issuing the loan. Credit Acceptance's spread increased to 21.7% in Q4 2023 compared to 19.4% in Q4 2021, meaning that it received a higher percentage of net cash flows for loans issued in Q4 2023 compared to two years before. Lower spreads during 2021 and 2022 influenced the company's conservative nature in extending fewer loans. Now, with fewer competitors in the subprime lending market, Credit Acceptance is more selective in approving loans while expecting to earn a higher percentage of net cash flows compared to two years ago.

Credit Acceptance's differentiated lending model factors in a significant margin of safety into each loan so that even if a loan's performance is worse than expected, the company is still likely to earn significant profits.

We believe when the tide goes out, we'll see who was swimming naked in the subprime lending pool, and it won't be Credit Acceptance.

As the *End of America* economic fiasco continues to evolve, there could be tremendous growth in the subprime credit industry – simply because more and more Americans will slip into poverty. And Credit Acceptance Corp. is one of the very few safe – and highly capital efficient – ways to profit from this inevitable trend.

Action to Take: For the latest updates on our open positions, please visit our live portfolio **here**.

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