Watchlist Investing Newsletter

Patiently finding and following great public companies to own at the right price.

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“One person said to me, 'I have a list of 300 potentially attractive stocks, and I constantly watch them, waiting for just one of them to become cheap enough to buy.' Well, that's a reasonable thing to do. But how many people have that kind of discipline? Not one in 100.” – Charlie Munger

In this issue:

Watchlist

The “Suspect” Suspect:

Credit Acceptance Corp.

(NASDAQ: CACC; Disclosure: None)

Price (3/29/21):	$373
Shares out (diluted):	18.98mm
Market cap:	$7.1bn
Return on Capital:	13%
Return on Equity:	30%
Insider ownership:	19%*

*Doesn’t include others including former CEO/founder.

Introduction:

How an investor handles disconfirming evidence plays a large role in their returns over time. As the theory goes, you should do what Darwin did and write down the evidence that goes against your thesis right away before your brain has a chance to play tricks. This all sounds well and good in theory but in practice it is harder to do. I came across such a situation with Credit Acceptance.

Credit Acceptance Corp. is a subprime auto lender. The company first came onto my radar when I screened for banks with high returns on assets and insider ownership. It stood as an outlier, but I chanced looking at the annual report.

What I found was a very well written letter to shareholders penned by its CEO. The letter detailed the business clearly and highlighted many key metrics which its management used to assess performance. To my delight I found CACC mentioned in a book about good companies and good management teams. What’s more, an investor I follow was on the board and had owned stock in the company for over twenty years.

Having seen enough to give me a general indication of a good opportunity I decided to highlight it in this month’s issue. I downloaded fifteen years’ worth of 10K’s and set to work getting a sense for the business and its history.

Then a W.I.N. reader alerted me to the short case against CACC. In fact, he had a small short position himself. Now, part of my research always includes looking at short interest, major respected shorts in the stock now or in the past, and any short reports available on the company. I’m grateful I had this information sooner as all indications were this was a very good company I might consider purchasing immediately.

My conclusion is that CACC *might* be a company worth putting on the Watchlist. I just don't know enough yet and I need to do more digging. What follows, hopefully, is a neutral assessment. At present CACC might be a viable long position *or* it could be a viable short position. There's too much gray area for me to conclude definitively, but I view it as my job to bring you the facts and not necessarily make a buy/sell/short decision for you.

Company Overview / Business Model

- Credit Acceptance Corp. is a subprime auto lender operating within the United States. The company's entire business model is built around lending to those individuals who other sources of financing have discarded. Almost 96% of its borrowers have FICO scores below 650 (or no score at all).

- CACC's history dates back to the 1970s when its founder, Donald Foss, needed a way to finance those with low credit scores at his auto dealerships. The business expanded to include financing customers of other dealerships and CACC ultimately went public in 1992. CACC "grew up" with the industry and in some ways helped lead the maturation of subprime auto finance.

- CACC's history includes forays into adjacent business areas, many of which were not profitable. Some of these plagued the company for years. Business dealings between Foss and others, and CACC, put a question mark on what might lurk beneath the surface today at CACC.

- The basic business model of CACC is simple. The majority of the company's revenue is earned by financing auto loans. These auto loans fall into two categories: program loans and purchased loans. Finance charges from these two represent 92% of revenues.

    - <u>Purchased loans (35% of loan dollar volume)</u> are the traditional way auto lending is done and consist of the auto lender making a loan to a consumer to buy a vehicle. In this case the dealer is only focused on selling the vehicle and retains no risk in the loan after the transaction.

    - <u>Program loans (65% of loan dollar volume)</u> differ from purchased loans in tying the dealer to the transaction after closing. The dealer receives an advance at closing (set by CACC) and the remainder is set aside as a holdback earned over time after CACC takes a 20% servicing fee. The idea is to incentivize the dealer to sell a good vehicle and make sure the borrower really can handle the loan payments. The customer wins, the dealer wins, and CACC wins.

- Other sources of revenue for CACC are premiums earned via reinsurance of vehicle service contracts (3.4% of revenues), and other income (4.6%).

- CACC funds its assets with a combination of equity and various sources of debt. Historically it has managed leverage to at or below 2.0 debt/equity, which is conservative compared to its peers.

Credit Acceptance Corp.
Capitalization Structure (in $ mil)

Total assets	$7,423	100%
Line of credit	$0	0%
Term ABS	$3,340	45%
Senior Notes	$1,188	16%
Equity	$2,355	32%

2019 data from company. Major sources shown.

CACC is based in Michigan but does business across the US. Here is the geographic breakdown by loan dollar volume for 2019:

(Dollars in millions)

	Consumer Loan Assignments	
	Dollar Volume (1)	% of Total
Michigan	$ 359.9	9.5%
Ohio	265.2	7.0%
New York	245.6	6.5%
Texas	201.5	5.3%
New Jersey	188.7	5.0%
All other states	2,511.3	66.7%
Total	$ 3,772.2	100.0%

History:

Credit Acceptance Corp. was founded in 1972 by Donald Foss. Foss owned a used car dealership and needed a way to finance customers with shaky credit. The financing business soon expanded to include outside dealerships and the subprime auto finance industry was born.

CACC has experienced several large cycles in its history:

Founding – 1994: Nascent industry/strong profits
1994-1997: Competition drives down profits
1997-2003: Lower competition/higher profits
2003-2007: Higher competition/abundant capital
2007-2011: Tighter capital/higher profits
2011-2019: Abundant capital/no end in sight

CACC went public in 1992. Its early history was one of strong profitability owing to very little competition in the new industry. From its IPO to 1996 earnings per share grew 45% per year.

Then came the first big wave of competition. As basic economics drove entrants to the market CACC experienced stiff competition. Coupled with an imperfect understanding of its loan book and customers, three years of subnormal profitability ensued.

In 1997 the company created a system to manage its data and forecast the cash flows necessary to underwrite profitably. In 1999, investor Tom Tryforos joined the CACC board. He instilled a discipline of focusing on return on capital.

Then in 2003 the second wave of competition arrived. An abundance of capital fueled by loose monetary policy after the post dot-com bust allowed easy competition and drove down pricing. CACC responded by increasing the number of active dealers in its network rather than rely on matching the actions of its worst competitors, which typically focused on pricing.

That cycle ended in 2007 because of the financial crisis. Thus a lack of capital and not simply an overabundance of competition stemmed the tide. CACC enjoyed a few years of higher profitability before competition re-entered the market in 2010.

Economic cycles also play a part in CACC's profitability. Specifically, the change in unemployment in the 24 months following loan origination play a big role in the ultimate collectability of loans for that cohort year.

Credit Issues: The very nature of CACC's business places it in a difficult position. While the company's mission to help consumers a) get into a vehicle regardless of credit history and b) give them a chance to establish or rebuild a credit history, by design CACC works with the most difficult borrowers.

It comes as no surprise that a significant portion of CACC's borrowers do not repay their loans in full. The company typically forecasts collections in the range of 65% to 75%, meaning 25% to 35% loss ratios.

With this level of losses comes some unpleasant tasks. Namely, the necessity of collection calls, wage garnishments, and repossessions (CACC takes vehicle title as collateral). Problems can arise when CACC steps over the bounds of the law in its collection practices. In 2006 the company agreed to a $12.5 million settlement in a class action lawsuit dating back a decade.

The question becomes, how much of this unpleasantness—the grumbling about collection practices, lawsuits, etc.—simply represent a part of doing business with a sub-650 credit score constituency, and how much represents the company earning strong returns for shareholders by taking advantage of a generally financially illiterate constituency?

Since going public in 1992 the company has increased diluted EPS by 26% and earned an average ROE of 28%, all the while repurchasing shares at intervals. It's done this with about 2.0 debt/equity, meaning an average return on invested capital in the low double-digits. All of this is evidence of a good economic engine for shareholders.

Ownership/Governance:

Insiders own a large portion of CACC. The largest shareholder is Prescott General Partners at 14.9%. Prescott is an investment firm managed by Tom Tryforos and Scott Vassalluzzo, two of CACC's board members. Tryforos owns another 2.5% and CEO and board member, Brett Roberts, owns 1.9%. The last of the four board members, Glenda Flannagan, owns an undisclosed number of shares (i.e., beneath the reporting threshold).

Founder and former CEO, Donald Foss owns 10.3% of the company while his wife, Jill Foss Watson, owns 13.9%. Alan Apple, a former CACC insider, owns 10.4%.

Interestingly, CACC does not have a formal Chairman of the Board. Instead, Tryforos, as the longest-serving independent member (1999) runs meetings.

Roberts is paid about $1 million per year. He's also entitled to performance-based RSUs and restricted shares based on performance above a cost of equity capital. His lieutenants are paid around $550,000 and occasionally receive stock awards (the most recent being $1.5 million in 2017).

Key drivers / How CACC makes money:

The majority of CACC's business is a function of lending directly (purchased loans) or through dealerships (portfolio loans) to consumers financing an automobile. CACC is not unlike a bank in that its business depends on the volume of loans it produces, the yield earned from those loans (although it doesn't state the portfolio yield explicitly), credit losses, cost of capital, and leverage.

Loan unit volume: The volume of loans CACC produces in any given year is a function of three variables: 1) Number of new dealer partners; 2) dealer attrition; and 3) average volume per dealer partner. Note that loan volume is separate from loan size/term and will be discussed below.

Until recently, to become a dealer on the CACC platform a dealership had to pay a one-time $9,850 enrollment fee and a separate $600/month fee to access CAPS, it's propriety credit scorecard/approval system. The structure of these fees have changed over time, with CACC realizing the explicit monthly fee was causing higher attrition. To counter this, the company began in 2007 taking the $600 fee from the holdback. The company also came up with a program to allow dealerships to not pay the enrollment fee and instead cede 50% of any holdback on its first 100 loans. Note that as of August 2019 the company eliminated the enrollment fee altogether and reduced the pool of loans necessary for a holdback payment from 100 to 50.

CACC reports its market potential at about 60,000 auto dealers across the US. In looking to verify that number I came across a figure of about 18,000 new vehicle dealerships and 38,000 "independent" dealerships or about 56,000 for 2020, which would appear to validate the company's figures. In 2001, CACC had 1,180 active dealers, a figure which declined to 950 in 2003 and then steadily rose to 13,399 at the end of 2019. By this measure CACC has a presence at between 22%-23% dealerships in the US. An important note: a dealership usually has more than one and sometimes up to 20 financing sources available. This means CACC is just one of many options available to dealerships. The better credit quality customers go to banks, credit unions, and other finance companies, with CACC and a few other subprime lenders taking up the rear financing anyone leftover.

The average CACC dealer today makes 27.6 loans per year. This figure is down from a high of 61.2 loans per dealer in 2004 and represents a trend of slowly decreasing loans/dealer.

Average loan size: Offsetting lower loans/dealer is the average loan amount, which has increased steadily over the years. In 2010 the average loan was $14,480 (note this also includes contractually owed interest) and the initial term was 41 months. Fast forward to 2019 and the average loan increased by 60% to $23,139 and the term by 39% to 57 months. This follows a general industry trend of higher loan amounts and longer terms, which in turn follow higher quality vehicles on the road today compared to the past. But there must be a limit to loan amount and term. And one must distinguish between underlying factors and the risk that both are a temptation for lax underwriters.

A combination of a larger number of dealers and lower unit volume per dealer resulted in total unit volume growing from 136,813 in 2010 to 369,805 in 2019, an increase of 170%. Thus, a combination of greater units and higher loan size drove growth in loans receivable higher than either metric on its own.

Key accounting considerations:

As a quasi-bank, the accounting for a company like CACC is all-important. The disclosure about management's discretion in accounting rings loud and clear here, but we can take some comfort in the fact that long-term trends reveal truth.

Loan balances vs. contractual cash flow: CACC does not book loans at principal value like a bank. The key here is the difference between contractual net cash flows from repayments and expected net cash flows from repayments. This difference is called the nonaccretable difference and, importantly, is not booked as income or recorded on the balance sheet as an asset. In this way it serves as a sort of margin of safety. Considering CACC generally expects to receive in the area of 70% of contractual payments (see appendix), this is a big number to simply disappear. From here the difference between the expected cash flows and the underlying loan balance is taken into income on a level-yield basis.

Level-yield non-GAAP adjustment: It is this level-yield basis that causes the need for an adjustment to GAAP earnings, which appears logical and rational. The way the accounting works is such that positive changes to expected cash flows are made via adjustment to the yield and taken over time, where negative adjustments are expensed immediately. The company has in the past reported years where adjusted earnings are lower than GAAP, so this isn't a case of just trying to make earnings look better.

Other adjustments: CACC presents a few other adjustments to its GAAP earnings, which appear reasonable and defensible to bring them closer to economic reality. These include a program fee adjustment (largely in the past), a debt adjustment (to correct for refinancing) and a tax adjustment for when tax rates changed. In most cases these are both positive and negative adjustments over the years.

CECL changes: I've not dug into the full ramifications of the 2020 Current Expected Credit Loss framework. This accounting change, which will apply to banks and companies like CACC, will have the effect of depressing earnings. In its 2019 annual report, CACC estimated earnings would be between 30% and

60% lower under the CECL framework. Cash flows, however, will not change.

Capital allocation:

CACC today has a focused business which operates in one niche and has relied on share repurchases to return capital to shareholders. But that was not always the case.

Earlier in its history CACC was tempted into expanding beyond auto finance into areas such as reinsurance of non-related products, providing lines of credit to dealerships, auto leasing, and operating overseas.

Here are some of the major capital allocation decisions and changes in business strategy:

1996: Acquired a credit reporting business. This business was sold in 1999.

2001: Stopped providing lines of credit to dealers.

2002: Exited its auto leasing business.

2003: Discontinued operations in the UK and Canada.

2003: Discontinued operations reinsuring credit life and disability insurance.

2005: Implemented option for dealers to skip the upfront $9,850 enrollment fee in exchange for 50% of holdback on first 100 loans.

2007: Implemented pilot program for purchased loans.

2009: Formed VSC Re to reinsure vehicle service contracts.

2012: Increased its sales force rapidly to counteract lower volumes and maintain underwriting discipline.

2016: Recognized that the current cycle could be the "new normal".

Share repurchase history: Since beginning to repurchase shares in 1999, CACC has repurchased 35.1 million shares for $2.3 billion. Between 2011 and 2019 the company returned $1.5 billion of the $3.2 billion reported as earnings, or about 47%. About 3% went to expanding PP&E, and the other half remained in the business to fund growth.

Competition:

CACC competes against traditional subprime auto lenders (the purchase program-type of lending) such as **Consumer Portfolio Services (Ticker: CPSS)** and others such as **Santander Consumer USA Holdings (Ticker: SC)** and **Capital One (Ticker: COF).** CACC is one of the largest players in the subprime auto finance industry (but smaller compared to the whole) with its total loan book of $5bn. CPSS is a pure-play competitor with a $2.3bn loan book. CPSS, however, is levered more like a bank at over 12x assets/equity, where CACC manages at about 3x.

COF has a $63bn auto portfolio but also operates in a broader FICO-score range. Subprime auto (scores less than 620) makes up just 34% of its book and another 20% fall within the 621-660 range. Its auto portfolio dominates its consumer banking line (retail banking makes up $3.1bn), so most of the book is auto. COF had net charge offs of 0.87% in 2019 and its allowance was just 4%.

SC has a $30.8bn book of retail installment contracts with $12.3bn in the car category ($17.2bn in truck and utility and $1.3bn in van and other). Of its $30.8bn loan book all but $6.1bn have a score below 640. While not a perfect comparison (SC has a leasing business), its assets/equity ratio comes in at 6.7x.

Ally Financial (Ticker: ALLY) is also a major player. It has a $74bn consumer auto book. It's charge-off rate of 1% speaks to the fact that they play mostly in prime auto finance. Of their loan book $8.6 bn was classified as nonprime auto, which is a score below 620. A closer look reveals a big chunk is in the 540-619 category and very little to the deep subprime categories.

Another big player in the market is Toyota Financial, which has a book of $74bn. Like SC, Toyota has a leasing business, but its assets/equity ratio is 8.7x.

Short Thesis:

According to Morningstar, CACC has about 2m shares short. This is about a quarter of float but about an eighth of total shares out (because of the high insider ownership).

The short thesis for CACC rests on the assertion that the company is unfairly making money off its customers. The PlainSite reports (below) refer to CACC as a debt collector disguised as a lender.

The PlainSite reports point to a striking statistic: about one in eight (at the time of the 2017/18 report) court cases in Detroit involved CACC. The report makes CACC out to be a predatory lender that knowingly incentivizes dealers to sell cheap used cars for more than their worth and include a vehicle service contract (VSC) in the purchase.

The VSCs are a big source of profit for the dealer and CACC. CACC participates in these via its reinsurance arm. In this way CACC does appear to have an incentive for the borrower not to repay, as repossessions mean CACC instantly earns the premiums taken in for that vehicle/borrower.

From my study of the industry, it appears almost all subprime (and a lot of prime) auto lending relies on the securitization market to finance deals. Loans are packaged into bundles, insured, and marketed to investors as safer securities. The shorts also point to allegations that CACC "tops off" its securitizations with more loans, which infer that the initial assets were not sufficient. The report also points to the Office of the Comptroller of the Currency, which has stated that overreliance on securitizations is a red flag. This appears to be a somewhat inflated statement since it's a part of the industry (all of the companies I looked at use them).

In contrast to the PlainSite reports, which focus on wrongdoings, the Citron report (see below) focuses more on regulation. The thesis is that lawsuits/regulation will severely impact CACC's profitability going forward.

It seems to me that at best CACC operates in a very tough industry. By the very nature of its business, it is dealing with individuals with shaky credit histories (or no history), which make high losses part of doing business. The question becomes, how much of the negativity surrounding the business is part of doing business and how much is bad acting caused from incentives not aligned with customers?

PlainSite CACC Report #1

PlainSite CACC Report #2

PlainSite CACC Report #3

Citron Report

Risks/Concerns/Questions:

Regulatory Risk: As noted above, the industry appears at the beginning of new regulatory troubles. CACC and some competitors have lawsuits pending with various state attorneys general. It also seems likely additional security at the federal level wouldn't be far off.

The question for me becomes, how basic/important an industry is this? What I mean is, CACC earns about 12% on total capital. Its ROE is much higher due to leverage. But CACC is the best-run company in the industry (from a purely financial standpoint anyway, in my view). If regulations tamp down on returns, will industry volume decline because it's just not feasible to do business? Then where do consumers turn to finance their vehicles?

Fintech: In my view the risk of fintech disruption is lower, or at least mitigated, by the fact that dealers can get approvals in 60-seconds. So, it probably won't be the speed of approvals where innovation happens. Could it happen in overhead cost? Maybe, but CACC already spends just 6% of capital. This is 25% of revenues, so maybe. CACC also already competes with Ally, a bank, so cost of capital probably isn't an immediate threat.

Securitization: Even though it is industry practice to rely on securitization to fund the balance sheet, it remains a risk. What happens in the event of another 2008-style credit crunch? CACC has issued senior debt, but this appears as a result of growth, not to bring down the reliance on securitization. ABS financing has actually *increased* over the last ten years to 45% of total assets.

Dealership consolidation: What does the competitive environment look like with fewer dealers? Does CACC have to continue to give up ground on terms? Such as lowering the number of loans in a pool, or increasing advance rates?

Market saturation: What is the upper limit for CACC dealerships? Is the business transferable to adjacent markets like Canada, Mexico? What about Europe? Will management be tempted to go into unrelated markets again if/when dealership growth matures?

Management: Current CEO, Brett Roberts, has been in his post for a long time. Who's the strong #2 if/when her retires? Does a company like CACC need more than a four-person board?

Economy: CACC has done well through difficult periods in the past. But those have usually been a result of a lack of capital for competitors. What happens if the Fed continues to pump cheap capital into the economy while consumers suffer significant losses to income? One cannot bank on endless fiscal and/or monetary stimulus.

Valuation:

It's tough enough to place a valuation on something in which I have high confidence. At this point you can probably tell I'm a bit unconfident as to CACC.

CACC has traded in a range of between 2.6x and 4.6x book, with an average of 3.9x. The 2.6x is its 2020 multiple and it currently trades at 2.7x. Does that mean it's undervalued? Not necessarily. The key here is to remember that the price/book ratio magnifies any changes to return on equity. Keeping things simple, if CACC can earn a 30% ROE and it's priced at 3.0x book, then the going-in return is 10%. But if ROE falls to 20%, now you're down to a 7% return until growth can overtake some of the difference.

Let's consider 2019 as a "normal" year given the pandemic. If we assume a normalized net income of $650m, that results in a going-in return of about 9% on the market cap of $7.1bn (fully diluted).

It's at this point I've reached a somewhat strange conclusion that CACC could be either a long or short play, with the difference being one's outlook on future regulation/returns. If you think the industry is necessary and will survive largely intact, current prices might give a reasonable margin of safety considering CACC's historical metrics. On the other hand, if you think regulation will take returns way down (or perhaps wish to speculate on short-term reactions to sentiment), CACC could be a short candidate.

Conclusion:

I've concluded I don't know enough to have a strong conclusion on either side of the trade.

There are a lot of things I like about CACC. These include its long history of great returns, a relatively simple business model, and what appears to be great communications with shareholders.

What I don't particularly like is the tobacco-like nature of the business. If CACC does in fact "rely" on its customers doing poorly, that doesn't speak well for the company's image. Then again, tobacco isn't at all necessary, while basic transportation is.

To conclude my conclusion, I don't feel I have enough confidence to put CACC on the Watchlist as a company I'd buy on a dip. But if more information comes to light that helps clarify my thinking, or a significant-enough price decline occurs, I'd like to know. I'll keep it on the Suspect List for future study.

Perhaps you, the reader, have done work on CACC? What am I missing? How should I think about this differently? (As a side note, how do you feel about a write-up like this where I do a lot of work but either don't have enough information to make a judgement or conclude it's not worthy of the Watchlist?)

Credit Acceptance Corp. Financial Statements

Balance Sheet FY 12/31/xx $ millions, rounded	**2019**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**
Cash	$187	$26	$8	$15	$6	$6	$4	$9	$5
Restricted cash + securities	390	362	302	270	216	211	165	139	915
Loans receivable, gross	7,221	6,225	5,049	4,207	3,345	2,720	2,408	2,110	1,753
Credit allowance	*(536)*	*(462)*	*(429)*	*(320)*	*(244)*	*(207)*	*(195)*	*(176)*	*(154)*
Loans receivable, net	6,685	5,763	4,620	3,887	3,102	2,513	2,213	1,934	1,599
PP&E	60	40	21	18	19	21	22	22	18
Other	101	46	36	29	47	34	29	30	31
Total Assets	**7,423**	**6,237**	**4,986**	**4,218**	**3,389**	**2,785**	**2,433**	**2,133**	**1,759**
Accounts payable/accruals	206	186	152	144	128	114	114	106	96
Revolving LOC	0	172	14	0	58	120	103	44	44
Secured financing (ABS)	3,340	3,093	2,514	2,062	1,479	1,333	936	853	599
Senior Notes	1,188	544	543	541	548	300	350	350	350
Deferred income tax	323	237	187	273	249	213	157	148	123
Other	12	14	40	24	0	3	24	10	6
Shareholders' equity	2,355	1,991	1,536	1,174	928	702	750	622	540
Total Liab. + SH equity	**$7,423**	**$6,237**	**$4,986**	**$4,218**	**$3,389**	**$2,785**	**$2,433**	**$2,133**	**$1,759**
Diluted SH outstanding (avg.)	*18,976,560*	*19,532,312*	*19,558,936*	*20,410,116*	*20,980,753*	*22,331,401*	*24,009,593*	*25,598,956*	*26,600,855*

Income Statement FY 12/31/xx $ millions, rounded	2019	2018	2017	2016	2015	2014	2013	2012	2011
Finance charges	$1,369	$1,177	$1,012	$874	$731	$630	$590	$538	$461
Premiums earned	51	47	41	43	48	52	52	47	40
Other income	69	62	57	52	47	41	40	24	25
Total revenue	1,489	1,286	1,110	969	825	724	682	609	525
Salaries & wages	193	168	140	127	116	100	87	82	63
General & administrative	65	56	56	48	38	34	34	31	26
Sales and marketing	70	68	58	49	46	37	35	31	24
Loss on debt extinguishment	2	0	0	0	0	22	0	0	0
Total overhead costs	330	291	254	224	200	193	156	144	112
Loan loss provision	76	57	129	90	42	13	22	24	29
Provision for claims	30	26	23	26	33	40	41	35	30
Interest	196	157	120	98	76	57	65	63	57
Pre-tax income	856	755	584	531	475	421	398	343	296
Taxes	200	181	114	198	175	155	145	123	108
Net income	**$656**	**$574**	**$470**	**$333**	**$300**	**$266**	**$253**	**$220**	**$188**
Diluted EPS	$34.57	$29.39	$24.04	$16.31	$14.28	$11.92	$10.54	$8.58	$7.07

Ratios & Key Figures	2019	2018	2017	2016	2015	2014	2013	2012	2011
Invested capital	6,883	5,800	4,607	3,777	3,013	2,455	2,139	1,869	1,534
Average invested capital	6,341	5,203	4,192	3,395	2,734	2,297	2,004	1,701	1,345
Revenue/avg. capital	23.5%	24.7%	26.5%	28.5%	30.2%	31.5%	34.0%	35.8%	39.1%
Overhead/avg. capital	5.2%	5.6%	6.1%	6.6%	7.3%	8.4%	7.8%	8.5%	8.3%
Interest/avg. capital	3.1%	3.0%	2.9%	2.9%	2.8%	2.5%	3.2%	3.7%	4.3%
Total provisions/avg. capital	1.7%	1.6%	3.6%	3.4%	2.7%	2.3%	3.1%	3.5%	4.4%
Return on assets (NI/avg. assets)	9.6%	10.2%	10.2%	8.7%	9.7%	10.2%	11.1%	11.3%	12.1%
Adjusted return on capital	12.7%	12.5%	11.2%	11.9%	12.7%	13.2%	14.1%	14.7%	16.8%
GAAP return on equity	29.8%	31.7%	36.9%	31.1%	35.4%	37.0%	38.0%	37.8%	40.0%
Leverage - debt/equity (FYE)	1.9	1.9	2.0	2.2	2.2	2.5	1.9	2.0	1.8
Leverage - assets/equity (FYE)	3.2	3.1	3.2	3.6	3.7	4.0	3.2	3.4	3.3
Overhead/reveneus	22%	23%	23%	23%	24%	27%	23%	24%	21%
Secured financing/total assets	45%	50%	50%	49%	44%	48%	38%	40%	34%

Capital Allocation	2019	2018	2017	2016	2015	2014	2013	2012	2011
Net income	656	574	470	333	300	266	253	220	188
Purchase of PP&E	(27)	(25)	(8)	(6)	(4)	(4)	(6)	(9)	(6)
Share repurchases	(300)	(129)	(124)	(122)	(87)	(344)	(135)	(135)	(153)

	Active dealers	Year-to-year change	Unit volume per dealer	Year-to-year change
2001	1,180		52.5	
2002	843	−28.6%	59.1	12.6%
2003	950	12.7%	64.7	9.5%
2004	1,212	27.6%	61.2	−5.4%
2005	1,759	45.1%	46.2	−24.5%
2006	2,214	25.9%	41.3	−10.6%
2007	2,827	27.7%	37.7	−8.7%
2008	3,264	15.5%	37.2	−1.3%
2009	3,168	−2.9%	35.0	−5.9%
2010	3,206	1.2%	42.7	22.0%
2011	3,998	24.7%	44.5	4.2%
2012	5,319	33.0%	35.7	−19.8%
2013	6,394	20.2%	31.6	−11.5%
2014	7,247	13.3%	30.9	−2.2%
2015	9,064	25.1%	32.9	6.5%
2016	10,536	16.2%	31.4	−4.6%
2017	11,551	9.6%	28.4	−9.6%
2018	12,528	8.5%	29.8	4.9%
2019	13,399	7.0%	27.6	−7.4%

($ in millions)	Adjusted average capital invested	Adjusted return on capital
2001	$ 469.9	7.7%
2002	$ 462.0	7.9%
2003	$ 437.5	9.7%
2004	$ 483.7	12.3%
2005	$ 523.4	13.7%
2006	$ 548.5	13.9%
2007	$ 710.1	11.9%
2008	$ 975.0	11.3%
2009	$ 998.7	14.6%
2010	$ 1,074.2	17.7%
2011	$ 1,371.1	16.8%
2012	$ 1,742.8	14.7%
2013	$ 2,049.2	14.1%
2014	$ 2,338.1	13.2%
2015	$ 2,831.9	12.7%
2016	$ 3,572.0	11.9%
2017	$ 4,276.4	11.2%
2018	$ 5,420.9	12.5%
2019	$ 6,372.2	12.7%
Compound annual growth rate 2001 – 2019	*15.6%*	

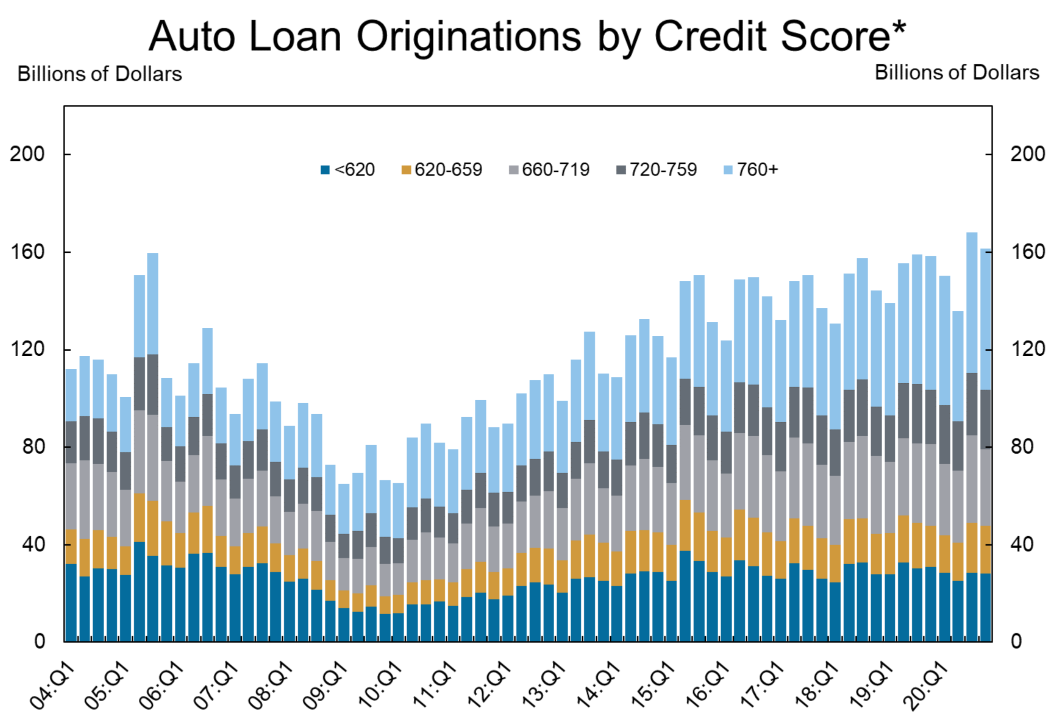
Consumer loan assignment year	Total		Portfolio program		Purchase program	
	Unit volume	Year-to-year change	Unit volume	Year-to-year change	Unit volume	Year-to-year change
2005	81,184		73,708		7,476	
2006	91,344	12.5%	87,519	18.7%	3,825	−48.8%
2007	106,693	16.8%	87,872	0.4%	18,821	392.1%
2008	121,282	13.7%	85,092	−3.2%	36,190	92.3%
2009	111,029	−8.5%	96,076	12.9%	14,953	−58.7%
2010	136,813	23.2%	124,388	29.5%	12,425	−16.9%
2011	178,074	30.2%	164,653	32.4%	13,421	8.0%
2012	190,023	6.7%	177,985	8.1%	12,038	−10.3%
2013	202,250	6.4%	189,101	6.2%	13,149	9.2%
2014	223,998	10.8%	203,155	7.4%	20,843	58.5%
2015	298,288	33.2%	260,604	28.3%	37,684	80.8%
2016	330,710	10.9%	260,026	−0.2%	70,684	87.6%
2017	328,507	−0.7%	238,313	−8.4%	90,194	27.6%
2018	373,329	13.6%	260,302	9.2%	113,027	25.3%
2019	369,805	−0.9%	248,455	−4.6%	121,350	7.4%
Compound annual growth rate 2005 – 2019		*11.4%*		*9.1%*		*22.0%*

($ in millions)	GAAP net income	Floating yield adjustment	Senior notes adjustment	Income tax adjustment	Other adjustments	Adjusted net income	Year-to-year change
2001	$ 24.7	$ 1.2	$ —	$ 2.0	$ (1.1)	$ 26.8	
2002	$ 29.8	$ 2.8	$ —	$ 2.9	$ (4.5)	$ 31.0	15.7%
2003	$ 24.7	$ 1.4	$ —	$ 5.7	$ 5.6	$ 37.4	20.6%
2004	$ 57.3	$ (0.1)	$ —	$ (1.8)	$ (3.2)	$ 52.2	39.6%
2005	$ 72.6	$ (2.2)	$ —	$ 0.1	$ (7.3)	$ 63.2	21.1%
2006	$ 58.6	$ 0.4	$ —	$ (1.7)	$ 4.4	$ 61.7	-2.4%
2007	$ 54.9	$ 3.6	$ —	$ (1.2)	$ 4.4	$ 61.7	0.0%
2008	$ 67.2	$ 13.1	$ —	$ 0.4	$ 2.1	$ 82.8	34.2%
2009	$ 146.3	$ (19.6)	$ —	$ (1.8)	$ 0.1	$ 125.0	51.0%
2010	$ 170.1	$ 0.5	$ —	$ (10.4)	$ 0.3	$ 160.5	28.4%
2011	$ 188.0	$ 7.1	$ —	$ (1.3)	$ 0.3	$ 194.1	20.9%
2012	$ 219.7	$ —	$ —	$ (3.5)	$ —	$ 216.2	11.4%
2013	$ 253.1	$ (2.5)	$ —	$ (2.3)	$ —	$ 248.3	14.8%
2014	$ 266.2	$ (6.0)	$ 12.5	$ (1.0)	$ —	$ 271.7	9.4%
2015	$ 299.7	$ 12.9	$ (2.0)	$ (0.8)	$ —	$ 309.8	14.0%
2016	$ 332.8	$ 28.1	$ (2.1)	$ 1.8	$ —	$ 360.6	16.4%
2017	$ 470.2	$ 34.1	$ (2.1)	$ (102.4)	$ —	$ 399.8	10.9%
2018	$ 574.0	$ (24.4)	$ (2.5)	$ 7.4	$ —	$ 554.5	38.7%
2019	$ 656.1	$ 0.2	$ (0.8)	$ 2.9	$ —	$ 658.4	18.7%
Compound annual growth rate 2001 – 2019							*19.5%*

Consumer loan assignment year	Portfolio program: Forecasted collection percentage as of[1] December 31, 2019	Portfolio program: Forecasted collection percentage as of[1] Initial forecast	Portfolio program: Variance	Purchase program: Forecasted collection percentage as of[1] December 31, 2019	Purchase program: Forecasted collection percentage as of[1] Initial forecast	Purchase program: Variance
2005	73.6%	74.0%	−0.4%	75.7%	74.7%	1.0%
2006	69.9%	71.3%	−1.4%	75.6%	74.0%	1.6%
2007	68.0%	70.2%	−2.2%	68.6%	72.7%	−4.1%
2008	70.8%	70.2%	0.6%	69.7%	68.8%	0.9%
2009	79.3%	72.1%	7.2%	80.8%	70.5%	10.3%
2010	77.6%	73.6%	4.0%	78.7%	73.1%	5.6%
2011	74.6%	72.4%	2.2%	76.4%	72.7%	3.7%
2012	73.7%	71.3%	2.4%	75.9%	71.4%	4.5%
2013	73.4%	72.1%	1.3%	74.4%	71.6%	2.8%
2014	71.6%	71.9%	−0.3%	72.5%	70.9%	1.6%
2015	64.8%	67.5%	−2.7%	69.3%	68.5%	0.8%
2016	63.2%	65.1%	−1.9%	66.6%	66.5%	0.1%
2017	64.2%	63.8%	0.4%	66.3%	64.6%	1.7%
2018	64.7%	63.6%	1.1%	66.0%	63.5%	2.5%
2019	64.4%	63.9%	0.5%	65.1%	64.2%	0.9%
Average[2]	*68.1%*	*67.7%*	*0.4%*	*68.3%*	*66.6%*	*1.7%*

[1] The forecasted collection rates presented for Portfolio loans and Purchase loans reflect the loan classification at the time of assignment. Under our Portfolio program, certain events may result in dealers' forfeiting their rights to dealer holdback. We transfer the dealers' loans from the Portfolio loan portfolio to the Purchase loan portfolio in the period this forfeiture occurs.
[2] Calculated using a weighted average based on loan origination dollars.

Data by the NY Fed puts the subprime auto market at about $182 billion.



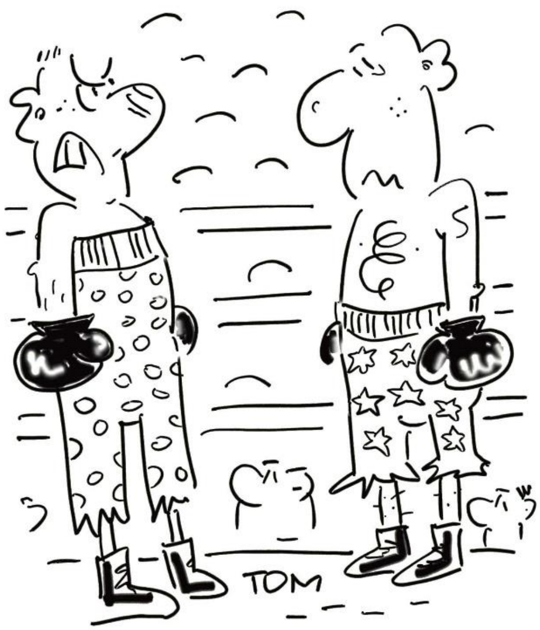
Source: New York Fed Consumer Credit Panel/Equifax
* Credit Score is Equifax Riskscore 3.0

Watchlist Investing Newsletter

Patiently finding and following great public companies to own at the right price.

Issue #2 | April 2021

QUICK LOOKS:



"Well, my shorts are longer than your shorts!"

In the March issue I called this segment Shallow Dives. Somehow that sounded oxymoronic (not to mention risky if you're a swimmer). Anyway, I decided Quick Looks would be better after initially calling it Long Shorts (which would only invite confusion with short sellers). Anyway, enough of this sidebar/tangent…

Like last month there's just one Quick Look. Some months might be more. (Still other months might feature many if I can't complete a full deep dive for the Watchlist—it's all evolving, and I appreciate your support and feedback/ suggestions!)

Monarch Cement Co.

(Pink Sheets: MCEM; Disclosure: N/A)

Price (4/7/21):	$102
Shares out (diluted):	3.8m
Market cap:	$388m
Revenues (FYE '20):	$189m
Net income:	$34m
Equity:	$213m
Net debt:	Nil
Insider ownership:	14%

I found this company through a simple screen of small <$500m market cap US companies with less than 10% debt. It was intriguing to me for having apparently good returns and a simple business. The more I dug in the more I liked. That included 14% insider ownership, a balance sheet with excess cash and surplus investments, and a pretty good shareholder letter. The company also acts as its own transfer agent, which I took as a good sign. There's more work to be done, including assessing the cyclical nature of the business, but it seemed interesting enough to share with you and add to the Suspect List.

Overview/Industry:

Monarch's business is super simple: concrete. Technically portland cement, which goes into making a host of concrete-like and related products. The company is based in Humboldt Kansas and does business in that state, Iowa, Nebraska, and some parts of Missouri, Arkansas, and Oklahoma.

What's great about a business like Monarch is it can capture a geographic area because of the high cost of transport of its products. (That also protects it from overseas competition.) I don't yet know if that's the case, but the potential exists. The downside to a basic business like this is cyclicality, but that isn't a reason not to invest if a reasonable multiple to normalized earnings can be determined.

Balance Sheet (FYE '20)	$ millions
Cash	31
Receivables	19
Inventories	41
PP&E, net	96
Investments	49
Invest. in affiliates	11
Other	11
Total assets	**258**
Accounts payable	7
Accruals	8
CMLTD	1
LTD	0
Pension/Health Liab.	29
Equity	213
Total liab + equity	**258**

P&L (FYE '20)	$ millions
Revenues	189
COGS	130
Gross profit	59
GPM	*31%*
Operating income	40
OPM	*21%*
Net income	34
EPS	$8.78

Using some round and conservative numbers, if we assume the business needs 2.5% sales as cash ($5m) and add in A/R, Inventories, subtract A/P and accruals, we get net assets of $146m to run the business. On that basis the profit figures look highly appealing. But the business is cyclical, remember. According to Morningstar revenues were $154m and dipped to $121m in 2010. Operating margins likewise went from 11% to slightly negative.

Digging just a bit deeper (I couldn't help myself), the investments on the BS are concentrated in the building/construction industry, which presumably management knows well. It also owns stock in a privately-owned brick company (valued at 8x earnings).

On the other side of the ledger, the company has pension and postretirement health/life insurance benefit liabilities. MCEM's assumptions appear conservative. It used an expected return of 6.50% and 6.75%, respectively, rates it decreased each year since 2018. Investments are ~60% equities / 35% bonds. The net underfunded status of these liabilities shows up on the BS but appears more than compensated for with the investments and extra cash on the books.

Other:

Skimming through the 10k/annual I came across what appear to be two acquisitions of ready-mix concrete companies. It appears MCEM is getting into this business line which, at first glance appears unprofitable. Perhaps there's a scale component is working toward that I don't understand.

The company also is a repurchaser of its own shares. It completed a modified Dutch tender auction in late 2020 that retired 1.6% of shares at $70/share.

RUSSELL 3000 BANK PROJECT:

This project came about after I learned that about 80 banks would be removed from the Russell index when it's reconstituted in June. Here's an update on that project.

1. I found data on the Russell 2000 at suredividend.com. That list included 1,956 companies.
2. The list was sorted by market cap and all companies at or below a $300 million market cap were segmented. You can see the results of that sort below.

	Total List		=<$300mm	
Row Labels	#	%	#	%
Basic Materials	62	3%	5	1%
Communication Services	67	3%	9	3%
Consumer Cyclical	192	10%	10	3%
Consumer Defensive	65	3%	10	3%
Energy	79	4%	14	4%
Financial Services	386	20%	110	32%
Healthcare	453	23%	108	31%
Industrials	260	13%	25	7%
N/A	10	1%	1	0%
Real Estate	135	7%	15	4%
Technology	213	11%	32	9%
Utilities	34	2%	6	2%
Grand Total	**1956**	**100%**	**345**	**100%**

Finally, here is the list of financial companies in the Russell with a 1% or greater return on assets. I like to see banks with high levels of insider ownership and was surprised to see so many with significant ownership levels.

I took a quick pass through this list and nothing stood out as matching **Hingham Institution for Savings (HIFS; Disclosure: Long; See Issue #1).** Although interestingly, SNFCA is a cross between a life insurance company, mortgage company and a cemetery business. PKBK engages in cannabis lending. ATLO stood out for having an okay shareholder letter and for what appears to be preparation of their own 10K. Value Line showed up as a financial but is really a data company.

Financials in Russell 2000 =>1% ROA

Ticker	Name	Market Cap		Insider Ownership
FDBC	Fidelity D&D Bancorp, Inc.	$	301	23%
VALU	Value Line, Inc.	$	291	0%
NRIM	Northrim Bancorp, Inc.	$	283	4%
FCBP	First Choice Bancorp	$	278	16%
NBN	Northeast Bank	$	264	8%
PKBK	Parke Bancorp Inc	$	250	13%
ATLO	Ames National Corp.	$	248	1%
NKSH	National Bankshares Inc.	$	247	4%
TSBK	Timberland Bancorp, Inc.	$	245	13%
LCNB	LCNB Corp	$	243	7%
PCB	PCB Bancorp.	$	240	16%
NWFL	Norwood Financial Corp.	$	237	9%
GCBC	Greene County Bancorp Inc	$	233	7%
ESQ	Esquire Financial Holdings Inc	$	199	14%
LEVL	Level One Bancorp Inc	$	188	23%
FCAP	First Capital Inc.	$	185	4%
BSVN	Bank7 Corp	$	170	0%
SNFCA	Security National Financial Corp.	$	166	27%
OPBK	OP Bancorp	$	166	0%
ICBK	County Bancorp Inc	$	163	24%
FSFG	First Savings Financial Group Inc	$	161	0%
PLBC	Plumas Bancorp.	$	155	19%
WHG	Westwood Holdings Group Inc	$	149	10%
SBFG	SB Financial Group Inc	$	142	9%

WHAT'S COMING NEXT MONTH:

I don't have a specific company in the waiting right now. I might do a few more Quick Looks, perhaps at the expense of a Deep Dive. Or I might take a look at a company already on the Suspect List. What do you think? Would you rather see one Deep Dive as the main focus or see more of a breadth of possible good companies via the Quick Looks section?

In addition to the ongoing search for good companies in general, I'd expect to have a progress report on the Russell Project.

NOTES FROM READERS:

Better intros / clearer writing: I'm grateful to Tim for providing me with some excellent feedback. That included a suggestion for more of an introduction to each segment/company. Tim also suggested I give you a list of the companies that *didn't* make the cut. Great idea! (A related idea would be to study business failures to learn from them, but I wonder if that's mission creep for this newsletter.)

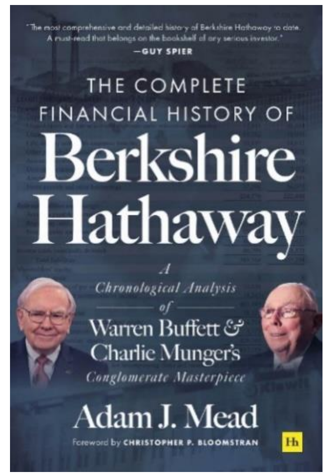
More clarity on valuation: John wrote suggesting I take a stand (my words, not his) on valuation. He thought it jarring to get to the end of the HIFS writeup and not have a specific value I'd pointed to. That's fair criticism. My approach is to think in ranges and probabilities, and that sometimes means being imprecise. I'm also wary of saying "here's the value" because everyone has their own opportunity costs and discount rates. All of that said, his feedback is fair and a welcome reminder that if I'm going to buy a company (which I purportedly would if it's on the main Watchlist) then I need to take a figurative position to back my sometimes literal position in a company. Humility in investing is all well and good but a purchase/sale is almost by definition an act of arrogance since you're saying you know more than the market.

To see the latest Watchlist and Suspect List on Google Sheets, head to www.watchlistinvesting.com or click here.

About

After nearly two decades as an individual investor, a decade in commercial credit at various banks, and a few years managing money for friends/family in the background, I decided to go full-time managing money for clients in 2020. Watchlist Investing is an extension—albeit separate and distinct—of what I do day-to-day as a practicing capital allocator. Inverting the margin of safety principle, I hope to add value to readers above and beyond the nominal cost of the newsletter.

My investing style is influenced by my background growing up in a family of business owners. I followed suit selling firewood through high school and founding a welding business in college. Looking at stocks as businesses is natural to me. My investing approach rests on fundamental value investing tenets, but it's adapted to suit my style. I'm 100% certain I'm not the best investor or analyst, but I hope to improve over time.



Between 2016 and 2021, I wrote a book on Berkshire Hathaway. *The Complete Financial History of Berkshire Hathaway* was and is my passion project. I hope it brings new shareholders up to speed on the company and provide a fresh look to longtime shareholders, in addition to serving as a resource/reference book. The publication date is April 13, 2021 and can be purchased here. I also created www.theoraclesclassroom.com as an extension of the book, which includes an archive of a lot of BRK material.

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