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Subprime Lenders Expecting Credit Quality to Stay Stable

■ BY ERICK BERGQUIST

Despite widespread worries that the American consumer's budget is strained, several subprime lenders, both secured and unsecured, sound bullish on near-term credit quality.

There is a strong argument for the notion that credit performance is worsening. The American consumer faces a number of challenges, such as high energy costs, rising interest rates, and a heavy debt burden. And to make matters worse for mortgage holders, the bulk of the adjustable-rate loans made in 2003 and 2004 will reprice in 2006 and 2007.

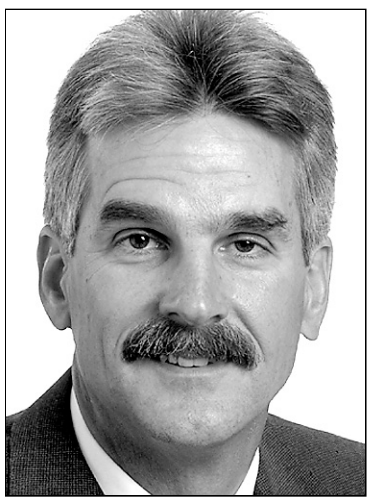
But the optimistic lenders cite employment trends, a drop in gas prices from their September peak, and home values that have kept rising despite signs the real estate market is cooling.

Dan Berce, the chief executive of the Fort Worth subprime auto lender AmeriCredit Corp., said in an interview this week that it expects credit quality to be stable.

"Our guidance regarding credit over the next nine months calls for delinquencies and losses to be similar to what they were" in AmeriCredit's last fiscal year, which ended June 30, Mr. Berce said.

AmeriCredit predicts net credit losses of between 5% and 6% in its $11 billion loan portfolio for its current fiscal year. The rate for its last fiscal year was 5.7%.

For Mr. Berce, there is one overarching reason credit quality will be stable: employment.


Berce: Employment is the most important factor in consumer credit.

"The most important economic factor relative to credit for the American consumer is job creation, or the level of employment," he said. "Our models show that if the consumer has a job, he pays … [his loan]. And the American economy continues to create jobs, albeit at a moderate pace. And unemployment levels are reasonably low compared to" historical trends.

What's more, Mr. Berce said, a job has such a powerful effect on consumers that, according to AmeriCredit's model, its customers can weather a storm with crosscurrents such as the high energy prices they face today.

AmeriCredit boosted its fiscal first-quarter allowance for loan losses by 30 basis points from the previous quarter, to 6.4%, partly because of Hurricane Katrina, increasing heating and gas prices, and rising inflation. The company said the allowance would drop this quarter and then return to the first-quarter level.

Don Gayhardt, the president of the Berwyn, Pa., payday lender and check casher Dollar Financial Corp., said employment figures drive his company's loan collection rates.

"What we see is employment strong … particularly for low-wage service-sector workers," who are Dollar's bread and butter, he said. If "we're cashing checks, our customer is still in pretty good shape."

Mr. Gayhardt said he thinks small-loan borrowers can moderate their spending when they face issues, such as rising energy prices, and Dollar's borrowers tend to go to special lengths to make ends meet.

"In various cycles in the past, they have shown the willingness and the ability to work more. They will take a second job, work overtime," he said. The average Dollar customer attaches three W-2 forms to an annual tax return. "At many points in the year they have more than one job."

For the next year or so, Dollar "is not forecasting much of an improvement," he said, but by the same token, "we're not forecasting a big decline" in credit quality "absent some big shock" to the economy, like a spike in oil prices.

After rising in the immediate aftermath of the Gulf Coast hurricanes, energy prices have "come down a fair degree over the past couple months," and that drop helps Dollar customers, Mr. Gayhardt said.

Also, "by and large our customers are not homeowners," so they do not have to worry about rising mortgage rates.

And Dollar may get a volume boost from the rise in minimum payments that credit card issuers will have to adopt by January of next year, he said. "People use payday loans because they are a better, cheaper alternative to having a late payment or bouncing checks."

Jim Konrath, the chief executive of Accredited Home Lenders Inc. in San Diego, agreed with the others about credit quality. "There are still jobs, inflation is under control. … We're pretty optimistic for '06, given the credit we're seeing."

He would not label the current moment in the credit cycle and said it is "very hard to predict a top or a bottom."

Nonetheless, he said the growth in home prices has definitely helped credit performance for the past couple of years and should continue to do so in many places.

"Even [if they face] a bad loan or a bad situation — a loss of job, a divorce — in many of the housing markets people can still bail out very easily and make a profit selling the home," Mr. Konrath said.

Robert Cole, the chief executive of New Century Financial Corp., an Irvine, Calif., company that competes with Accredited, also cited "tame" inflation and the drop in oil prices as factors in his assessment that, unless some major problem develops, "consumers won't be too stressed."

Credit quality "should be attractive over the next two years," he said.

Robert Napoli, an analyst at Piper Jaffray Cos., hosted Mr. Berce, Mr. Gayhardt, and Mr. Konrath at a luncheon conference last week in Boston. After the conference, Mr. Napoli issued a report saying he too expects "credit trends in the first half of 2006 could be better than the market currently expects."

Metrics could get a lift from "seasonal strength in the first half of '06" and "the pull-forward of credit losses due to the bankruptcy legislation," he wrote.

In an interview, Mr. Napoli said that he has known the management teams of AmeriCredit, Dollar, and Accredited "for a long time," and that he was impressed with the "confidence" the executives showed during the conference. ■

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