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JANUARY 2021

Specialty Finance Sector Review and Outlook

Defining Strategy and Executing in a Post-Pandemic World

Financial Services Investment Banking

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Table of Contents

2020 Year in Review 10
- Introduction 11
- Specialty Finance Review 12
- Strategic Trends Impacting Financial Services Broadly 19

Consumer Finance Review 30
- Introduction 31
- Subsector: Credit Cards 34
- Subsector: Student Lending 39
- Subsector: Auto Finance 43
- Subsector: Installment Lending 53
- Subsector: Pawn Lending 58
- Subsector: Debt Collection 62

Mortgage Finance Review 66
- Introduction 67
- Subsector: Nonbank Mortgage Companies 68
- Subsector: Residential Mortgage REITs 75
- Subsector: Investor Loan Providers 80

Commercial Finance Review 84
- Introduction 85
- Equipment Leasing and Finance 86
- Asset-Based Lending 88
- Year-End Review 89

List of Figures

Figure 1: 2020 Stock Market Performance....................11
Figure 2: Considering Relative Risk and Opportunity Across Specialty Finance....................13
Figure 3: Capital Requirements and Declining Rates Pressure Bank ROEs Post-Crisis....................21
Figure 4: Notable Partnerships Between Asset Management and Insurance Companies....................25
Figure 5: Athene Portfolio Composition and Characteristics....................26
Figure 6: 2020 Total Return Performance Across Financial Services Sectors....................29
Figure 7: U.S. Credit Card Landscape....................34
Figure 8: Credit Card Risk-Reward Profile....................35
Figure 9: Historical Credit Card Charge-Off Trends and Near-Term Projections....................37
Figure 10: U.S. Student Lending / Servicing Landscape....................39
Figure 11: Total U.S. Student Loan Debt ($B)....................40
Figure 12: Federal Direct Loan Servicing ($B)....................40
Figure 13: Total U.S. Auto Loans Outstanding ($B)....................43
Figure 14: U.S. Auto Finance Landscape....................44
Figure 15: Net Percentage of U.S. Banks Tightening Standards for Auto Loans....................45
Figure 16: Overall U.S. Auto Finance Market Share by Lender Type (New and Used)....................45
Figure 17: U.S. Light Vehicle SAAR (Monthly)....................46
Figure 18: U.S. Light Vehicle SAAR (Annual)....................46
Figure 19: Light Vehicle Production (#000)....................47
Figure 20: Automobile Inventory Levels (#000)....................47
Figure 21: Manheim Used Vehicle Index....................47
Figure 22: Car Gurus Used Car Price Index....................47
Figure 23: Second Quarter 2020 Y/Y Change in Auto Loan Volume by Borrower Credit Score....................48
Figure 24: Third Quarter 2020 Y/Y Change in Auto Loan Volume by Borrower Credit Score....................48
Figure 25: Risk Distribution of Total (Loan and Lease) Auto Originations....................48
Figure 26: Average Credit Scores on Total Used Vehicle Originations....................49
Figure 27: Average Credit Scores on Total (Loan and Lease) New Vehicle Originations....................49
Figure 28: Average Credit Scores on Total (Loan and Lease) Used Vehicle Originations....................49
Figure 29: Y/Y Change in Rates on Used Vehicle Loans Across Credit Scores....................50
Figure 30: Delinquencies (30+ DPD) on Prime Auto Loan Securitizations....................51
Figure 31: Annualized Net Losses on Prime Auto Loan Securitizations....................51
Figure 32: Delinquencies (30+ DPD) on Nonprime Auto Loan Securitizations....................51

Figure 33: Annualized Net Losses on Nonprime Auto Loan Securitizations 51
Figure 34: Extensions on Prime Loans 52
Figure 35: Extensions on Subprime Loans 52
Figure 36: U.S. Installment Lending Landscape 53
Figure 37: Marketplace vs. Balance Sheet 56
Figure 38: U.S. Pawn Landscape 59
Figure 39: Y/Y Decline in Pawn Loan Balances 60
Figure 40: Y/Y Decline in Pawn Inventories 60
Figure 41: Debt Collection Landscape 62
Figure 42: ERC Compositions by Geography 63
Figure 43: LTM Purchase Volumes 63
Figure 43: U.S. Unemployment Level and Nonbusiness Bankruptcy Filings 63
Figure 44: 2020 Global Corporate Debt Issuances Across Debt Collection Industry 64
Figure 45: U.S. Residential Mortgage Landscape 67
Figure 46: Top 20 U.S. Mortgage Originators 69
Figure 47: Record Mortgage Volumes in 2020 70
Figure 48: Market Backdrop Continues to Support Strong Performance in Near Term 71
Figure 49: Timeline of Mortgage Sector in Public Markets 72
Figure 50: Residential Mortgage REIT Landscape 75
Figure 51: Top 10 mREIT BVPS Reductions from YE 2019 Through Q1 2020 and Q3 2020 76
Figure 52: Investor Real Estate Loan Landscape 81
Figure 53: Historical U.S. Fix-and-Flip Volume 82
Figure 54: Historical U.S. Rentership Rate 83
Figure 55: Commercial Finance Market Sizing by Estimated Annual Volume ($B) 85
Figure 56: Equipment Finance Annual Market Size ($B) 86
Figure 57: Equipment Finance Market: Net Business Volume By Lessor Type 87
Figure 58: Equipment Finance Market: Net Business Volume By Market Segment 87
Figure 59: Asset-Based Lending Market Size: Total Asset-Based Lending Commitments ($B) 88
Figure 60: Asset-Based Lending Market Composition: Commitments by Lender Type 88
Figure 61: Equipment Finance Drivers: GDP Growth and E&S Investment 90
Figure 62: Commercial Finance Landscape 92

List of Tables

Table 1: 2020 Specialty Finance Initial Public Offerings........16
Table 2: 2020 Specialty Finance SPAC Mergers........17
Table 3: 2020 Specialty Finance Mergers & Acquisitions........18
Table 4: Largest Announced Financial Services Transactions of 2020........20
Table 5: 2020 BNPL Strategic Financings........55
Table 6: 2020 BNPL Mergers & Acquisitions........55
Table 7: Universe of Investable Alternative Mortgage Assets........78

Introduction

Specialty finance plays a vital role within financial services, in some cases competing on the fringe of the regulated financial system and in others simply replacing it. The competitive landscape continues to rapidly evolve and 2020 did more than its part to accelerate many longstanding trends that threaten to upend the traditional way business has been conducted for decades. In this report, we examine these fundamental dynamics and their implications on the sector, as well as specific themes affecting individual subsectors within specialty finance. To survive and prosper in the decade ahead, senior executives, in partnership with their boards, will need to adapt their strategies to seismic shifts that were vastly accelerated in 2020.

Interest Rates Interest rates are lower and despite credible speculation of the impact stimulus will have on them, inflation has failed to materialize for over a decade. For most sectors in specialty finance, this will pressure revenue growth and force discipline that will necessitate scale to improve operating margins and funding efficiencies.

Credit Quality Credit quality, while surprisingly resilient, is far more uncertain. This will restrain confidence in near-term deal making despite what is arguably the most critical time in more than a decade to be strategically bold.

Regulation The regulatory paradigm is shifting and it is difficult to discern how the new administration will manage its diverse coalition, let alone what the ramifications will be. Even less obvious, but critical for consideration, is how this will impact the balance of lending between the less regulated specialty finance players and their regulated cohorts.

Digitalization Digital strategies and technology-forward operating infrastructures are now essential for survival. This requires both scale and material ongoing investment to thrive in the decade to come. Reliance on a patchwork of service providers in place of proprietary technology will not be acceptable for those with aspirations to build scale and be a leader in their sector.

ESG Standards Environmental, social and governance standards need to be acknowledged and adopted to achieve efficiencies in the capital markets. Scale is predicated on efficient access to capital, which will require careful consideration of these ESG standards.

2021 Board Room Topics and Questions

Despite the uncertainty remaining in the market, forward and creative strategic thinking will be critical in 2021. For many, that means fundamental changes requiring outside-the-box thinking and a relentless pursuit to execute. We summarize key questions we have been asked to address in board discussions and the areas we urge decision makers to focus on as we enter 2021.

Mergers & Acquisitions

Strategic — Is now the time to do something bold and off script? Should we enter a new business, acquire digital capabilities, or buy a bank charter or insurance entity for strategic funding and other benefits?

Scale — Do we have the financial resources and acumen to be a consolidator and/or leader in our sector? If so, how do we execute on an M&A strategy now to be the scale winner in the marketplace (or at least protect our position)?

Timing — Are there unique buyers with excess liquidity and optimal funding access willing to stretch to achieve strategic objectives? Does that make selling now the optimal outcome for shareholders?

Preparation — How do we protect ourselves from activists or a suboptimal sale/merger as we define and execute on our long-term strategy in a post-pandemic world?

Capital Structure

Was capital structure a purposeful, strategic agenda item prior to 2020? It should be now.

Diversity — Are we overly exposed to individual markets or small groups of investors and/or lenders?

Durability — Have we appropriately embedded duration and flexibility into our liability structure? Have we limited, or appropriately hedged, the use of short-term, mark-to-market financing facilities?

Unsecured — What is the most efficient source of unsecured debt? Is it worth paying more for unsecured capital versus secured alternatives? How do we communicate more flexible but cost-dilutive funding strategies to investors?

Credit Ratings — Which rating agencies should we approach? How will the agencies view our business under their ratings methodology? How can we advocate for ourselves to optimize the outcome?

Thematic Considerations

Marketplace Model Investors are ascribing value to capital-light origination models. Will augmenting our fundamental strategy or replacing it altogether maximize shareholder value relative to the status quo?

Growth vs. Value Which do the markets value more: revenue growth or profitability? How do investors think about growth at the expense of profitability? Does pursuing mergers or acquisitions that create near-term dilution actually improve our long-term valuation?

COVID-19 has changed many consumer habits entirely and accelerated other trends already in place prior to the onset of the pandemic. Recognize it, plan for it and execute.

Digital Initiatives Meet the customer in a user-friendly format where they are and when they are ready to transact. Form strategic partnerships to reduce customer acquisition costs and augment or replace inefficient lead acquisition strategies.

Behavioral We have witnessed a rise of new trends in 2020 such as suburban sprawl, work from home, digital/online preference, evolving spending patterns, increased savings rates, and changing debt payment priorities. Consider the impact of these and other trends on your customer and design your business to adapt accordingly.

Cost Discipline Can cost discipline driven in response to COVID-19 in early 2020 be sustained so operational efficiencies and improvements can be baked into the go-forward profit model? How can we leverage technology, created either in-house or in partnership with specialized service providers, to build a more cost-competitive operating infrastructure?

Capacity Utilization Can we expand the way we make money with our clients without taking undue risk or providing products/services that lack utility? Do we have excess origination capacity that is idle simply because we cannot fund certain assets on our own balance sheet?

This report is designed to help senior executives and board members recognize and focus on these issues, provide insights into what others are doing across the sector, and offer our views on where to prioritize resources going into 2021.

We segment this report into four parts:

I.	**2020 Year in Review**	Review of trends across all financial services with specific observations regarding their implications on specialty finance companies.
II.	**Consumer Finance**	Review of the broader consumer finance market, followed by specific subsector reviews on credit cards, student lending, auto finance, installment lending, pawn lending, and debt collection.
III.	**Mortgage Finance**	Review of the residential mortgage landscape, including specific subsector reviews on nonbank mortgage companies, mortgage REITs, and investor real estate loan providers.
IV.	**Commercial Finance**	Review of the commercial finance sector, with specific commentary on the equipment leasing and finance and asset-based lending markets.

Given the diverse backgrounds of the intended audience for this report, we provide brief overviews of each subsector for the benefit of those with less familiarity with any individual market to help contextualize the observations and insights offered. We hope you find it useful as you chart your path forward in uncertain times. We fundamentally believe those who make bold, strategic decisions today will benefit in the years to come. Those that do not adapt will find themselves trailing the pack and may be left behind altogether.

Part I

2020 Year in Review

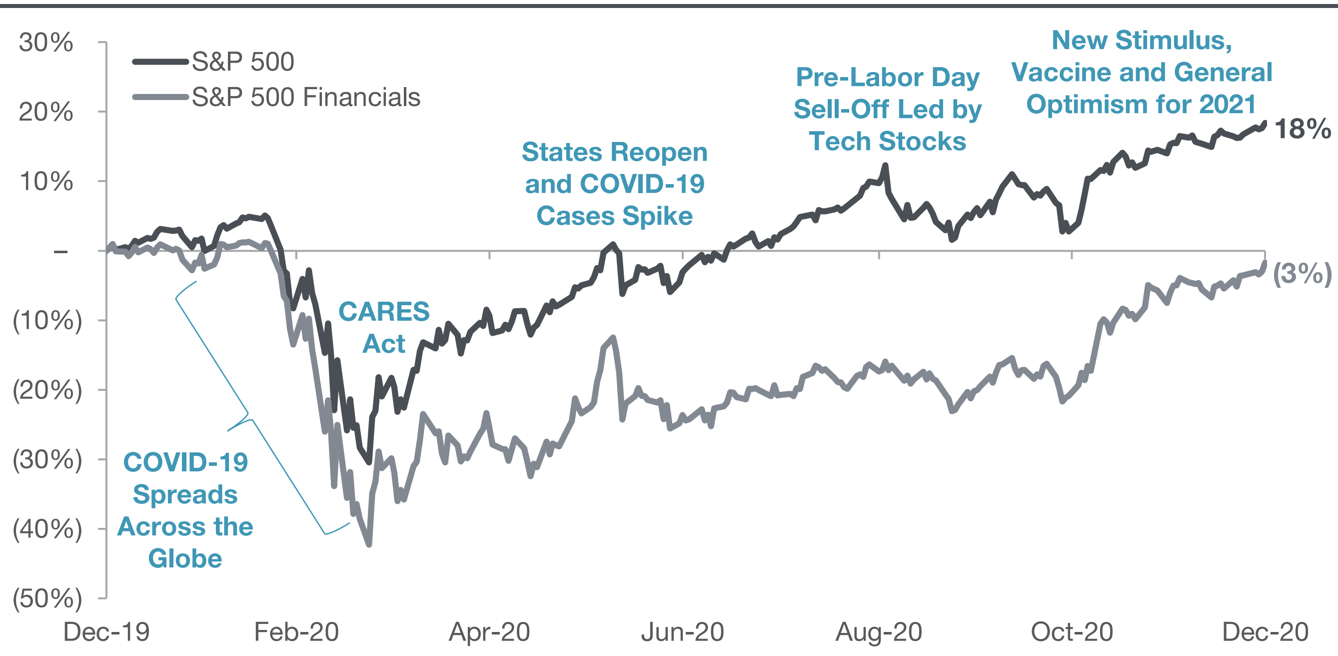
Introduction

No one predicted what 2020 had in store for the economy when we kicked the year off. Markets were setting fresh records and brushing off concerning geopolitical tensions in the Middle East; recall that on January 8, Iran actually launched ballistic missiles into a United States military base in Iraq and incidentally shot down a commercial Ukrainian airliner as retribution for the killing of Qasem Soleimani several days earlier. Six weeks later, on February 19, the S&P 500 hit another all-time record. It was not an unsettled geopolitical environment unfolding in a U.S. election year, but a curiously developing viral outbreak in the capital city of the Hubei Province in China that would ultimately shape 2020 into the most volatile year the global economy has experienced since the financial crisis.

The entire financial services sector was acutely impacted by the global pandemic brought on by COVID-19. The abrupt shutdown of the global economy highlighted vulnerabilities in the plumbing of the financial system, particularly in the United States where businesses rely more on the capital markets for funding than their global counterparts. The comeback from the depths of despair in March was equally astonishing. Central banking authorities flooded the markets with unprecedented liquidity and federal governments supplied $10 trillion of additional fiscal stimulus over the course of just two months, an amount that is roughly equivalent to ten times the total stimulus supplied during the entire financial crisis when measured as a percentage of gross domestic product (GDP).

Despite an impressive comeback that put the financial services sector generally in line with where it started the year, the landscape could not be more different, and 2021 promises to pose unique opportunities and threats that all companies will need to consider as they build, re-tool and execute upon their strategic plans in a post-pandemic world.

Figure 1: 2020 Stock Market Performance



Source: S&P Global Market Intelligence. Market data for December 31, 2019, through December 31, 2020.

Specialty Finance Review

2020 Specialty Finance Summary

As a higher beta industry than its regulated cohorts, the specialty finance sector experienced extreme volatility during 2020. While the entire sector plunged in unity in March as nationwide lockdowns took effect, each subsector experienced divergent fates. As a whole, the sector is in better shape than many of those in the regulated segments of financial services, since asset yields tend to be stickier to the upside, funding costs have gone down more or less in lockstep with broader interest rates, and credit conditions remain benign as yet another round of stimulus is on its way in the United States. Nevertheless, not all things are relative and yield compression did have a negative impact on revenue growth for most during the second half of the year, which will continue into 2021.

Residential mortgage originators were the clear winners across specialty finance in 2020, as a rapid decrease in interest rates effectively left every mortgage across the country in the money for a refinance and wider pricing was the only way lenders could control volumes that overwhelmed operating capacity. Balance sheet lenders across both commercial and consumer asset classes ultimately fared well in a year marked by the formal implementation of the Current Expected Credit Losses (CECL) standard due to unprecedented fiscal and monetary stimulus, although there continues to be real stress in certain shutdown-affected segments of the commercial finance sector such as storefront retail and hospitality. Similarly, decreased loan demand and higher payoff rates constrained balance sheet growth, and in many cases drove portfolio shrinkage, across most consumer finance asset classes. Credit quality across the board will face continued uncertainty going into 2021, but for now appears resilient and appropriately, if not overly, reserved.

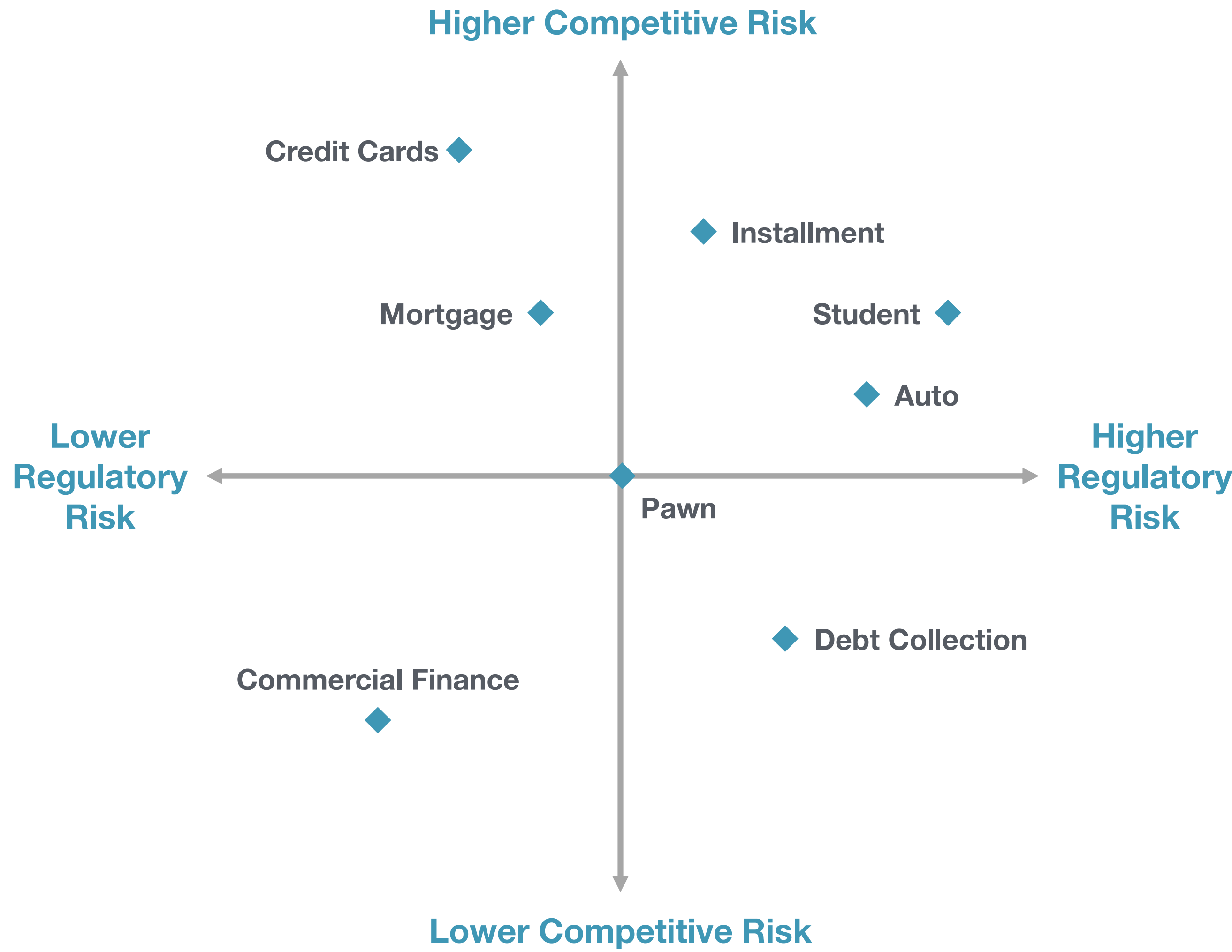
Mortgage REITs (mREITs) suffered the worst fate across the sector, as short-term mark-to-market repurchase financing on retained subordinated bonds disappeared and credit-sensitive securities faced sharper price deterioration than that seen even during the financial crisis (at least in pace of decline). Funding strategies were not resilient and many were forced to accept costly and dilutive financings to survive the storm and/or sell assets at distressed prices. As a result, mREIT senior management teams and their boards enter 2021 with more imminent need for bold, value-enhancing strategies than any other segment in specialty finance.

Risk and Opportunity Across Specialty Finance

We provide some context across the spectrum of specialty finance asset classes for consideration as companies within the entire financial services ecosystem consider product extension and/or entering new markets. For decades, financial services companies have had to contend with a continually evolving regulatory landscape, and 2021 will offer outsized uncertainty as the sector faces a starkly different administration. Generally speaking, sectors that endured more stringent regulation in response to the financial crisis, notably credit cards, residential mortgage and debt collection, will face less uncertainty than those such as auto finance and student lending which have proliferated post-crisis. Separately, the accelerated shift to e-commerce and ensuing need for digital capabilities has facilitated recent success for a number of new, well-funded technology-enabled competitors that will continue to encroach on the turf of traditional financial services providers, both within and outside of the regulated financial system. We illustrate a continuum that force ranks the specialty finance asset classes according to the relative

risks posed by the evolving online/digital landscape and the uncertain regulatory backdrop heading into 2021 (see **Figure 2**).

Figure 2: Considering Relative Risk and Opportunity Across Specialty Finance



We characterize strategic changes in the online/digital landscape as posing the highest risk for the residential mortgage, credit card, installment lending and student lending subsectors, where emerging digital payments alternatives that seamlessly meet customers when and where they transact and an acceleration towards online/digital origination will require strategic reorientation to remain relevant over the next decade. With well-funded platforms, newcomer point of sale lenders will likely find their way into other segments of consumer finance in the same way Ant Group has grown to dominate financial services in Asia (although that dominance is now being challenged by regulators). We view these particular subsectors as requiring the highest relative level of technology investment to prosper, which will necessitate scale and drive further consolidation, either through strategic mergers and acquisitions or smaller players simply ceding ground. Profitable lenders with branch footprints in place today do

have a unique competitive advantage, as credit performance tends to be better when borrowers visit a branch and have a relationship versus loans sourced online, but these lenders must recognize the shifting landscape and invest today to remain competitive as origination channels continue to evolve in the decade to come, as branch visits will inevitably decline over the long-term. Student lenders face a more pronounced dual threat than any other segment in specialty finance, as these competitive dynamics pair with heightened regulatory uncertainty from an incoming administration that has long made elevated student debt loads an important pillar of its platform.

The auto finance and pawn lending subsectors sit somewhere in the middle. Saturated from a wave of post-crisis capital formation, the auto finance industry continues to require lenders to find creative ways to differentiate their strategies. In pawn, while the market remains highly fragmented, consolidation over the last five years has left some considerable scale benefits to the two largest lenders which does provide some safe harbor in competition versus other consumer asset classes. Origination strategies and digital disruption, while certainly not irrelevant, have also been relatively more stable for auto and pawn lenders compared to other segments of consumer finance, although auto lenders' required response to the shift away from dealerships during the pandemic does have longer-term implications that will need to be considered. Potentially more concerning for auto lenders is uncertainty around long-term vehicle ownership trends posed by the gig economy and less miles being traveled for in-store shopping and work commutes, which, according to KPMG's *Automotive's New Reality* report, accounted for 40% of the 3 trillion annual miles that Americans logged in 2019. KPMG estimates that changes in driving habits from COVID-19 alone could lead to a drop of up to 10% of annual vehicle miles driven. It seems unlikely that vehicle ownership levels will drop materially over the next decade, particularly as people have dispersed from urban centers to suburban and rural areas, but small reductions in growth rates can have profound implications on long-term returns. Compared to other segments of consumer finance, auto lenders also face relatively higher regulatory risk from the new administration, which includes potential subjection of auto loans to maximum terms and ability to repay underwriting standards. We do not believe pawn lenders will be immediate targets for the new administration, but changes to policy designed to bring underbanked and unbanked consumers back into the lower-cost, regulated financial system poses some risk (as it does for all nonbank lenders).

Following a decade of consolidation that has left a smaller number of platforms controlling the mainstream market, the debt collection industry is less exposed to secular risks posed by the digital/online evolution. On the other hand, an emboldened Consumer Financial Protection Bureau (CFPB) under the new administration, which plans to nominate Rohit Chopra as its director, will undoubtedly reintroduce regulatory risks across the consumer finance landscape that had become less relevant during the previous administration.

Commercial finance sits in the most enviable position, as the regulatory environment will likely remain supportive and competition, for the most part, has been more focused on cost of capital than on redesigning origination channels or business models (the exception perhaps being in the tech-enabled, small business-focused segment of the market). Nevertheless, unprecedented capital formation in the private markets and an overcapitalized bank sector searching for yield in an even lower interest rate environment will continue to pressure the space to build scale and drive funding efficiencies, or concentrate on niche segments of the market that require unique underwriting expertise and/or well-established relationships.

2020 Specialty Finance Strategic Activity

There was a significant amount of strategic activity across specialty finance during 2020, led by a robust start and then a remarkable comeback in the second half of the year. Nonbank mortgage companies drove an outsized share of the transactions in light of the origination environment, but we also saw some much needed cleanup of subscale public companies in the mix. We expect "cleanup" consolidation to be a meaningful contributor to M&A in the years to come, as the number of sub-$500 million market cap public companies in specialty finance has proliferated post-crisis. These businesses are not large enough to enjoy the benefits of being public, but still bear the cost of maintaining a public company infrastructure. We do not suggest that all sub-$500 million market cap companies need to imminently sell, but they all need a credible near-term plan to get above that threshold that is scrutinized and agreed at the board level, which must consider transformative M&A. Assuming markets remain resilient, we expect most sectors within specialty finance will be active during 2021 in response to the pressures set forth at the beginning of this report, a robust equity market supporting new issue activity, and a special purpose acquisition company (SPAC) universe with limited time horizons to deploy an unprecedented amount of dry powder.

On the following pages, we summarize notable strategic activity during 2020, split amongst initial public offerings (**Table 1**), SPAC mergers (**Table 2**), and (controlling stake) mergers and acquisitions (**Table 3**).

Shortly before publishing this report, we saw a number of marquee transactions at the beginning of 2021. On January 6, Affirm Holdings, Inc. (NASDAQ:AFRM) launched its long anticipated IPO, ultimately pricing above its target range in a deal that valued the lender at $11.9 billion, or nearly 20x trailing revenue for the twelve months ended September 30, 2020; Affirm has yet to turn a profit and lost $97 million on $596 million of revenue during that same twelve month period. In demonstration of investor enthusiasm for the model, Affirm's shares doubled on their first day of trading. The day after Affirm launched its IPO, on January 7, Social Finance, Inc. (SoFi) announced its plans to merge with Chamath Palihapitiya-backed Social Capital Hedosophia Holdings Corp. V, a SPAC whose founder also struck deals with Virgin Galactic Holdings Inc. (NYSE:SPCE) in 2019 and Opendoor Technologies Inc. (NASDAQ:OPEN) in October 2020. The transaction values SoFi, who has not turned a profit and expects to lose $238 million on $980 million of revenue in 2021, at $8.7 billion, representing a 21x multiple of 2024 projected net income of $406 million and a 14x multiple of 2025 projected net income of $635 million (or approximately 14x 2020 expected revenue, for comparison with the Affirm transaction). These transactions demonstrate investor willingness to supply capital to technology forward financial services competitors with the implicit bet that these investments will help build future industry titans.

Table 1: 2020 Specialty Finance Initial Public Offerings

	velocity Financial, Inc.	ROCKET Companies, Inc.	Guild mortgage	Upstart
Company	Velocity Financial	Rocket Companies	Guild Holdings	Upstart Holdings
Exchange and Ticker	NYSE:VEL	NYSE:RKT	NYSE:GHLD	NASDAQ:UPST
Subsector	FNF / SFR Investor Real Estate Finance	Residential Mortgage Originator & Servicer	Residential Mortgage Originator & Servicer	Consumer Finance Marketplace Lender
Pricing Date	January 16, 2020	August 5, 2020	October 23, 2020	December 15, 2020
Filing Range	$14.00 – $16.00	$20.00 – $22.00	$17.00 – $19.00	$20.00 – $22.00
IPO Price	$13.00	$18.00	$15.00	$20.00
Gross Proceeds	$108 Million	$2,070 Million	$98 Million	$276 Million
% Primary / % Secondary	100% / 0%	100% / 0%	0% / 100%	65% / 35%
Implied PF Equity Value	$261 Million	$35,976 Million	$900 Million	$1,449 Million
PF Book Value Multiple	1.04x (1)	–	1.39x (2)	5.16x
LTM Adjusted Earnings	14.8x	8.0x	2.0x	> 50.0x
2020E Adjusted Earnings	7.4x	5.7x	1.7x	> 50.0x
2021E Adjusted Earnings	5.2x	12.3x	4.4x	> 50.0x
2022E Adjusted Earnings	–	12.2x	3.8x	34.7x
1-Day Trading Performance	3.9%	19.5%	(0.7%)	47.4%
2020 Trading Performance	(52.1%)	12.3%	12.9%	103.8%

Source: Company Filings, S&P Global Market Intelligence. Forward estimates based on equity research consensus estimates at time of offering.
(1) Based on midpoint of estimated book value range at December 31, 2019 provided in S-1 pro forma for initial public offering including overallotment.
(2) Based on midpoint of estimated book value range at September 30, 2020 provided in S-1 pro forma for initial public offering (overallotment not exercised).

Table 2: 2020 Specialty Finance SPAC Mergers

	FINANCE of AMERICA – MORTGAGE –	UWM UNITED WHOLESALE MORTGAGE	Katapult
Announcement Date	August 13, 2020	September 23, 2020	December 18, 2020
Subsector	Nonbank Mortgage	Nonbank Mortgage	Consumer Finance
Acquiror Name	Replay Acquisition	Gores Holdings IV	FinServ Acquisition
SPAC IPO Completion Date	April 3, 2019	January 23, 2020	October 31, 2019
Cash from SPAC Trust (1)	$288 Million	$425 Million	$250 Million
Proceeds from PIPE Raise	$250 Million	$500 Million	$150 Million
Cash Proceeds to Seller (1)	$518 Million	$895 Million	$325 Million
Seller Rollover	$1,337 Million	$15,021 Million	$508 Million
Total Consideration to Seller (2)	$1,855 Million	$15,916 Million	$833 Million
Consideration Cash / Stock (1) (2)	28% / 72%	6% / 94%	39% / 61%
Seller Pro Forma Ownership (1) (2)	69.9%	93.6%	52.8%
Pro Forma Equity Valuation	$1,912 Million	$16,052 Million	$962 Million
PF Equity Value / 2020E Earnings	6.5x	7.3x	35.6x
PF Equity Value / 2021E Earnings	9.1x	9.5x	20.5x
PF Equity Value / 2022E Earnings	7.0x	9.1x	10.1x

Source: Company Filings, S&P Global Market Intelligence.
(1) Assumes no SPAC shareholder has exercised its redemption rights to receive cash from the trust account. The cash amount to selling shareholders will be reduced by the amount of cash used to satisfy any redemptions.
(2) Assumes nominal share price of $10.00 per share. Excludes impact of earn-out to selling shareholders.

Table 3: 2020 Specialty Finance Mergers & Acquisitions

Buyer / Target	Spec. Fin. Subsector	Date Announced	Deal Value ($ Millions)	P / TBV	P / E	Buyer Stock Performance
Rent-A-Center / Acima Credit	Consumer	12/20/20	$1,653	–	–	8.7%
Apollo/Blackstone/Nelnet / WF Student Loan Portfolio	Consumer	12/18/20	–	–	–	–
Ready Capital Corp. / Anworth Mortgage	Mortgage	12/07/20	292	1.0x	–	(9.8%)
Solar Capital / Kingsbridge Holdings	Commercial	11/03/20	216	–	10.8x	9.8%
Alliance Data Systems / Bread (Lon Operations)	Consumer	10/28/20	450	–	–	64.5%
Pretium Partners/Ares / Front Yard Resi. Corp.	Mortgage	10/19/20	960	3.2x	–	–
Gallatin Point Capital / First Investors Financial	Consumer	10/12/20	–	–	–	–
Western Alliance Bancorp. / Galton Funding	Mortgage	10/09/20	–	–	–	60.9%
American Express / Kabbage	Commercial	08/17/20	–	–	–	20.4%
Enova International / On Deck	Commercial	07/28/20	90	0.4x	26.5x	80.8%
Triumph Bancorp / Transp. Factoring Assets	Commercial	07/08/20	132	–	–	119.5%
Zip Co / QuadPay	Consumer	06/02/20	343	–	–	41.1%
Jefferson Capital Systems / Canaccede Financial	Consumer	03/10/20	–	–	–	–
Regions Financial Corp. / Ascentium Capital	Commercial	02/27/20	–	–	–	10.6%
LendingClub Corp. / Radius Bancorp	Consumer	02/18/20	188	1.7x	28.6x	(19.8%)
Average			**$480**	**1.6x**	**22.0x**	**35.2%**
Median			**$292**	**1.3x**	**26.5x**	**20.4%**

Source: Company Filings, Press Releases, S&P Global Market Intelligence. Includes reported specialty finance controlling stake acquisitions. Transactions sorted by date of announcement. Valuation metrics reflect announced metrics as reported by buyer or as estimated by S&P Global Market Intelligence. Buyer stock performance reflects change in buyer's stock price from the date one day prior to announcement through December 31, 2020.

Strategic Trends Impacting Financial Services Broadly

The broader financial services sector faces many of the same threats posed to specialty finance companies, as interest rates continue to fall and the market further adapts to a growing digital economy. In response, we have observed increasing strategic alignment across financial services verticals. Despite the uncertainty introduced by COVID-19, we saw banks expanding into asset management in search of enhanced customer relationships and fee streams to improve return on equity (ROE), and asset managers partnering with life insurance companies to mutually address needs for assets under management (AUM) growth and unique capital deployment opportunities. Moreover, the entire sector continues to strategically invest in financial technology to enhance operating leverage, compete in evolving distribution ecosystems and improve the customer experience. One trend we concede has moved in the opposite direction is the relationship between banks and insurance companies, as banks have been shedding legacy insurance operations, while insurance companies have likewise withdrawn from pre-crisis banking ambitions. While specialty finance has generally carved its niche outside the regulated financial system, we believe we will see more convergence there as banks, asset managers and insurance companies alike search for asset manufacturers to expand their customer base and/or contend with a lower for longer interest rate environment that, despite credible speculation of future inflation, has yet to materialize in over a decade.

Despite a collapse in global mergers and acquisitions during the first half of the year, 2020 produced a surprising number of large, strategic transactions across the financial services landscape. While the year brought several intra-vertical scale trades, the variety of cross sector transactions was also striking. This provides further evidence of the struggle the financial services sector continues to endure as investors demand sustainable ROEs in excess of levered returns achievable from the traditional financial products. Meanwhile, customers are doing business differently and technology continues to upend the supply chain of finance. These trends have forced a strategic rethinking of business models across the entire financial services ecosystem and the specialty finance sector would do well to observe how others are competing and which ones are outperforming.

Table 4 outlines the largest announced transactions that occurred across the financial services sector during 2020. Following the table, we examine some high level trends and drivers within each sector to contextualize the implications that bank, asset management and insurance M&A strategies have on specialty finance companies.

Table 4: Largest Announced Financial Services Transactions of 2020

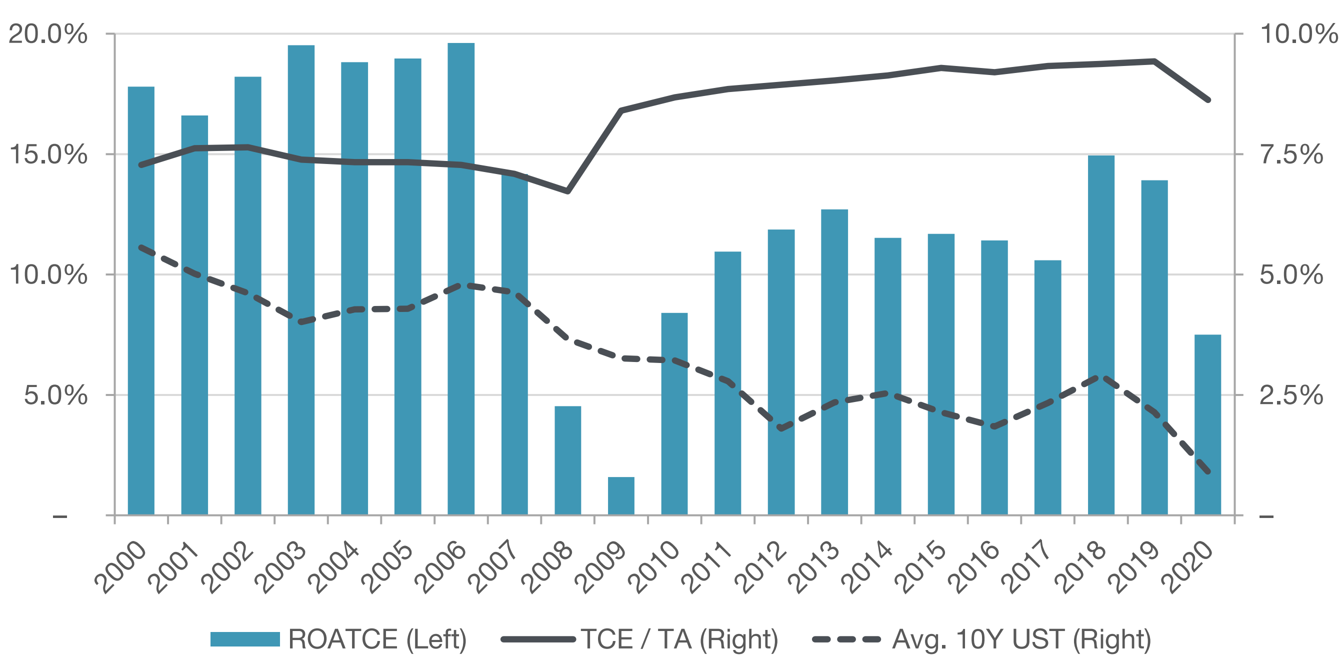
Buyer / Target	Subsector	Date Announced	Deal Value ($ Millions)	P / TBV	P / E	Buyer Stock Performance
Morgan Stanley / E*TRADE	Asset Mgmt.	02/20/20	$13,127	–	14.9x	21.7%
PNC Financial / BBVA USA	Banks	11/16/20	11,567	1.3x	–	21.4%
Morgan Stanley / Eaton Vance	Asset Mgmt.	10/08/20	6,932	–	16.2x	40.7%
Huntington Bancshares / TCF Financial	Banks	12/13/20	5,925	1.5x	11.8x	(2.3%)
Franklin Resources / Legg Mason	Asset Mgmt.	02/18/20	4,481	–	12.0x	2.6%
KKR & Co. / Global Atlantic	Insurance	07/08/20	4,039	1.0x	6.7x	31.5%
Zurich Insurance Group / Metropolitan P&C	Insurance	12/11/20	3,940	1.9x	11.3x	2.1%
Allstate / National General	Insurance	07/07/20	3,727	2.1x	10.3x	14.9%
South State Corporation / CenterState Bank Corp.	Banks	01/27/20	3,212	2.0x	13.7x	(15.5%)
Great-West Lifeco / Mass Mutual Retirement	Insurance	09/08/20	2,350	–	–	17.8%
First Citizens BancShares / CIT Group	Banks	10/16/20	2,159	0.4x	9.5x	62.5%
MetLife / Versant Health	Insurance	09/17/20	1,675	–	–	24.8%
Rent-A-Center / Acima Credit	Spec. Finance	12/20/20	1,653	–	–	8.7%
Macquarie Group / Waddell & Reed	Asset Mgmt.	12/02/20	1,563	2.6x	16.8x	(1.2%)
BlackRock / Aperio Group	Asset Mgmt.	11/23/20	1,050	–	–	7.3%
Pacific Premier Bancorp / Opus Bank	Banks	02/03/20	1,031	1.4x	14.7x	5.1%
Great-West Lifeco / Personal Capital Corp.	Asset Mgmt.	06/29/20	1,000	–	–	30.4%
Third Point Reinsurance / Sirius International Group	Insurance	08/06/20	788	0.8x	–	16.8%
ProAssurance Corp. / NORCAL Mutual Insurance	Insurance	02/20/20	600	1.1x	–	(45.7%)
FB Financial Corp. / Franklin Financial Network	Banks	01/21/20	588	1.5x	13.8x	(10.5%)
Average			**$3,570**	**1.5x**	**12.6x**	**11.7%**
Median			**$2,254**	**1.4x**	**12.9x**	**11.8%**

Source: Company Filings, S&P Global Market Intelligence. Includes 20 largest bank, insurance asset management, and specialty finance transactions announced in 2020. Transactions sorted by deal value. Valuation metrics reflect announced metrics as reported by buyer or as estimated by S&P Global Market Intelligence. Buyer stock performance reflects change in buyer's stock price from the date one day prior to announcement through December 31, 2020.

Banks

Prior to the financial crisis, higher interest rates, lower capital requirements, and an accommodative regulatory environment allowed banks to dominate lending and generate lucrative returns doing so. **Figure 3** highlights the gravity of the impact that lower interest rates, higher capital requirements and regulatory imposed limits on certain lending and proprietary investing activities has had on bank ROEs. Punitive regulatory backlash and fear of headline risk has also moved some historically lucrative businesses, like residential mortgage and subprime lending, further out of the banking system. With an interest rate and leverage environment that make it difficult to generate adequate returns, many banks are recalibrating their models towards wealth management and specialty lending, although most remain wary of material goodwill creation in executing M&A strategies. Separately, scale has become ever more important and we expect continued bank-to-bank mergers to address the massive technology investments required across the sector in the decade to come. Low rates are a big part of the challenge, but as more commerce shifts online and customers move away from branch footprints in preference for digital ecosystems, banks will be forced to deploy shrinking resources towards technology development and maintenance. Other changes, including the recent pronouncement from the Office of the Comptroller of the Currency (OCC) that federally regulated banks can use “stablecoins” to conduct payments and other activities, set the groundwork for continued innovation in the use of digital currencies. Despite general reluctance amongst the banking community, digital currencies will force them to invest the time and resources necessary to understand the operational, compliance and fraud risks associated with these activities while developing ways to evolve with the technology. While not doing so poses limited competitive challenges in the immediate term, the inevitable existential threat to the business over the coming decade makes it a critical but challenging priority to address.

Figure 3: Capital Requirements and Declining Rates Pressure Bank ROEs Post-Crisis



Source: S&P Global Market Intelligence. Data presented on an annual basis except for 2020 which is presented for the nine months ended September 30, 2020. Reflects all U.S. commercial banks based on aggregate call report data. ROATCE (left hand axis) is return on tangible common equity. TCE / TA (right hand axis) is the ratio of tangible common equity to tangible assets.

Bank appetite in specialty finance has varied across the landscape. Post-crisis engagement around consumer finance has been mostly concentrated in the residential mortgage sector with strategies geared towards prime borrowers. As it relates to bank M&A appetite with respect to subprime borrowers, the market's reaction to Ally Financial Inc.'s (NYSE:ALLY) announced acquisition of subprime credit card lender CardWorks, Inc., a transaction that was ultimately terminated, summed it up as Ally's shares fell nearly 12% the day of announcement and wiped off $1.4 billion from Ally's market capitalization (versus the $2.65 billion reported deal value). The negative reaction to the subprime orientation of the deal was a bit surprising, although the meaningful book value dilution resulting from the transaction, approximately half of which was to be paid in new stock issued below book value, made the deal difficult to swallow. While loss rates at the subprime end of the credit spectrum are certainly large and volatile, the excess spread generated provides strong margin for error, as Capital One Financial Corporation (NYSE:COF) figured out decades ago. For context, Merrick Bank, CardWorks' bank subsidiary that funds the vast majority of its subprime credit card assets, generated positive aggregate net income across 2008 and 2009. We believe bank appetite in consumer finance could evolve in the future, as politicians grapple with how to get under and unbanked consumers back into the regulated financial system. We have already seen some evidence of that in recent history, including Green Dot Corporation's (NYSE:GDOT) launch of GO2bank, a mobile bank designed to help Americans living paycheck to paycheck, and the Venmo credit card launched through Synchrony Bank, which we discuss further in this report. However, we would be surprised to see any large strategic activity from banks at the subprime end of the spectrum in 2021, with most bank strategies geared towards prime and near-prime borrowers. We do believe many banks with smaller footprints in residential mortgage will seriously evaluate that strategy as a way to grow fee income and take advantage of pent up home buying demand, particularly given much of it is from first time homebuyers that represent potentially attractive long-term customers when captured early in their financial lives.

Bank sentiment in commercial finance has been significantly different than the consumer end of the spectrum, as they push to regain ground ceded post-crisis to nonbank lenders. While much of this competition has been pursued organically, equipment finance companies have enjoyed particularly strong bank M&A appetite post-crisis. 2020 saw yet another large transaction in the space with Regions Financial Corporation's (NYSE:RF) acquisition of Ascentium Capital, which had an approximately $2 billion portfolio. Despite the funding logic of these combinations, a vibrant securitization market has offered a reasonable debt alternative to deposits and the lack of regulatory restrictions make operating outside the banking system an acceptable, and oftentimes better, option. Nevertheless, we expect banks to continue to be active acquirers in the commercial segment of the market, particularly for niche lenders where there are opportunities to provide other complimentary products, as even lower interest rates than we started 2020 off with and increased capital levels from suspended buybacks compel further activity.

Insurance

While the P&C segment of the insurance sector has fared better post-crisis than its life insurance brethren, whose profits are more dependent on interest rate sensitive investment portfolio returns than pricing and underwriting performance, the segment has not been immune to the challenges of the post-crisis environment. Mounting pressure to increase capital and operational efficiency in a soft pricing (i.e., insurance premiums are relatively low) and low interest rate environment has encouraged consolidation among larger P&C insurers. The need to increase capabilities, scale and footprint spurred a number of transactions across the sector, including several megadeals (i.e., transactions over $1.0 billion), as insurers turned to inorganic growth strategies to compete. The sector has made notable plays in the

"InsurTech" space in search of digital platforms and new underwriting capabilities, but has otherwise stayed largely within its insurance lane rather than exploring other parts of the financial services ecosystem for strategic growth.

P&C insurance mergers slowed materially in 2020 as uncertainties created by the COVID-19 pandemic forced many companies to focus on capital preservation and organic growth. Deal activity was virtually nonexistent during the second quarter, but began to rebound in the second half of the year beginning, most notably, with the announcement of The Allstate Corporation's (NYSE:ALL) $3.7 billion acquisition of National General Holdings Corporation (NASDAQ:NGHC) in July. Through the first eleven months of the year, this marked the only deal in the sector in excess of $1 billion. In December, MetLife, Inc. (NYSE:MET) announced that it is selling its P&C business (Metropolitan Property and Casualty Insurance Company) to Farmers Group, Inc., a subsidiary of Zurich Insurance Group (SWX:ZURN), for $3.9 billion. The sale follows a broader industry trend of insurers separating their P&C and life insurance businesses. In October, AIG announced that they also intend to split their P&C operations from their life and retirement operations. We expect M&A activity to continue into 2021 as the pandemic and related fallout create new urgency for inorganic strategies to help restore profitability.

The life insurance industry experienced a similar pullback in deal activity through the first half of the year, but acquisitions and divestitures are coming back strongly as insurers become resigned to a lower for longer interest rate environment. Driven by the economic repercussions of the pandemic, we expect sustained pressure on the sector to continue to fuel deal activity in 2021 as insurance companies shift their focus to de-risked core strategies. As the recovery unfolds, life insurers are now assessing the implications of an economic environment with even lower interest rates and increased asset volatility, and are evaluating how to position their portfolios and their businesses to deliver the greatest returns.

Prior to the onset of the pandemic, insurers were already grappling with compressed yields and diminished returns driven by the interest rate and regulatory landscape. While strong demographic-driven demand for fixed annuities has provided stability to the right side of the balance sheet, a lack of places to lucratively deploy the capital has constrained profitability. This dynamic has laid the foundation for unique marriages between life insurance companies and alternative asset managers, and 2020 ushered in another wave of acquisitions and strategic investments between the two sectors. These partnerships are largely driven by a mutual desire for AUM growth and access to accretive capital deployment opportunities. The timing of new capital entering the space has been fortuitous allowing many existing life insurance companies to shed legacy blocks of business in an attempt to refocus operations. While the valuation arbitrage between asset managers (high teens to low twenties earnings multiples) and life insurance companies (mid to high single digit earnings multiples) has typically led the former to be the acquiror, there are instances of the opposite, such as Sun Life Financial Inc.'s (TSX:SLF) acquisition of a 51% interest in Crescent Capital Group in October. We discuss the evolving partnerships between asset managers and life insurers beginning on page 24.

As it pertains to specialty finance, the life insurance segment tends to have a more stated impact on the sector than the P&C insurance segment. As the perfect owner for many of the financial assets specialty finance companies create, life insurers have been surprisingly quiet as M&A players. Rather, the sector has played an indirect, albeit critical, financier role as a foundational owner of a large portion of the asset-backed securities issued across asset classes. That said, there are a number of instances of specialty finance companies having controlling ownership by life insurance companies, such as Athene Holding Ltd.'s (NYSE:ATH) ownership of correspondent mortgage lender AmeriHome Mortgage Company and commercial lender MidCap Financial, or Security Benefit Corporation's ownership of commercial lender Stonebriar Commercial Finance. As an alternative to direct platform ownership, many

have opted for exposure through partnerships with alternative asset managers. While we expect this indirect involvement to continue, the opportunity for scaled life insurance companies to eliminate the margin of a middleman or loan acquisition premiums paid to originators by directly owning a platform is worthy of consideration. This strategy has been more evident in the private credit sector, with the aforementioned Sun Life acquisition of Crescent Capital this year, and then New York Life Insurance Company and Massachusetts Mutual Life Insurance Company's ownership of Madison Capital Funding and Barings, respectively, both leading heavyweights in the middle-market credit space.

Asset Management

Despite share prices sitting at all-time highs, a stock market that has mostly gone up over the last decade, and an abundant supply of capital to manage, asset management firms face a variety of existential threats to their businesses as fees compress across the board, baby boomers retire and become spenders rather than savers, and distribution channels evolve. As a result, 2020 saw a number of large, scale-driven strategic combinations in the space. Perhaps more notably, the sector also saw more convergence transactions than any other, including Morgan Stanley's (NYSE:MS) back-to-back acquisitions of E*TRADE Financial Corporation (NYSE:ETFC) and Eaton Vance Corp. (NYSE:EV), KKR & Co. Inc.'s (NYSE:KKR) acquisition of Global Atlantic Financial Group, and American Equity Investment Life Insurance Company's partnerships with Brookfield Asset Management Inc. (TSX:BAM.A) and Pretium Partners.

Specialty finance has long played an integral role within the asset management sector. Many specialty finance companies such as business development companies (BDCs) and mREITs are in fact fee-paying managed investment vehicles. Several managers, such as Pretium Partners in their acquisitions of Deephaven Mortgage and Selene Holdings, or Angel Oak Capital Advisors in its ownership of the largest non-qualified mortgage originator in the United States, have gone a step further and built and/or acquired operating platforms to provide differentiated investment offerings to limited partners (LPs), promising better or more stable returns through a more vertically integrated strategy. We expect this trend to continue, particularly for newer managers that are vying for shelf space with larger, well known institutions that have longer track records. Similarly, we expect more asset management M&A in the mREIT and BDC spaces since public company management contracts remain in high demand as new IPOs become more difficult to complete amidst an abundance of supply at the same time that managers are continuing their quest for permanent capital, which is more highly rewarded by investors.

Evolving Partnerships Between Life Insurers and Asset Managers

Life insurance has caught a new flare post-crisis, despite a historically staid reputation. On the funding side, demographic-driven demand for retirement products such as fixed income annuities continues to attract more capital to a global insurance industry that already has over $30 trillion in total assets. However, on the investment side, plain vanilla strategies don't work in the current interest rate environment so a prudent plan to produce returns has to contemplate increasing allocations to alternatives and strategies across the portfolio that generate alpha. The resulting impact has been a reimagined relationship between asset managers and life insurers, with the former managing the left side of the balance sheet and the latter managing the right. No one was earlier to see this opportunity than Apollo Global Management, Inc. (NYSE:APO), which founded Athene in partnership with current chief executive officer Jim Belardi in 2009 and now directly owns approximately 35% of the insurer, including related parties and employees (Athene in turn owns an approximately 7% stake in Apollo). In addition, Athene represents just over 40% of Apollo's total AUM, further demonstrating the strategic

value embedded within the relationship. **Figure 4** provides a summary of specific partnerships between asset managers and life insurers.

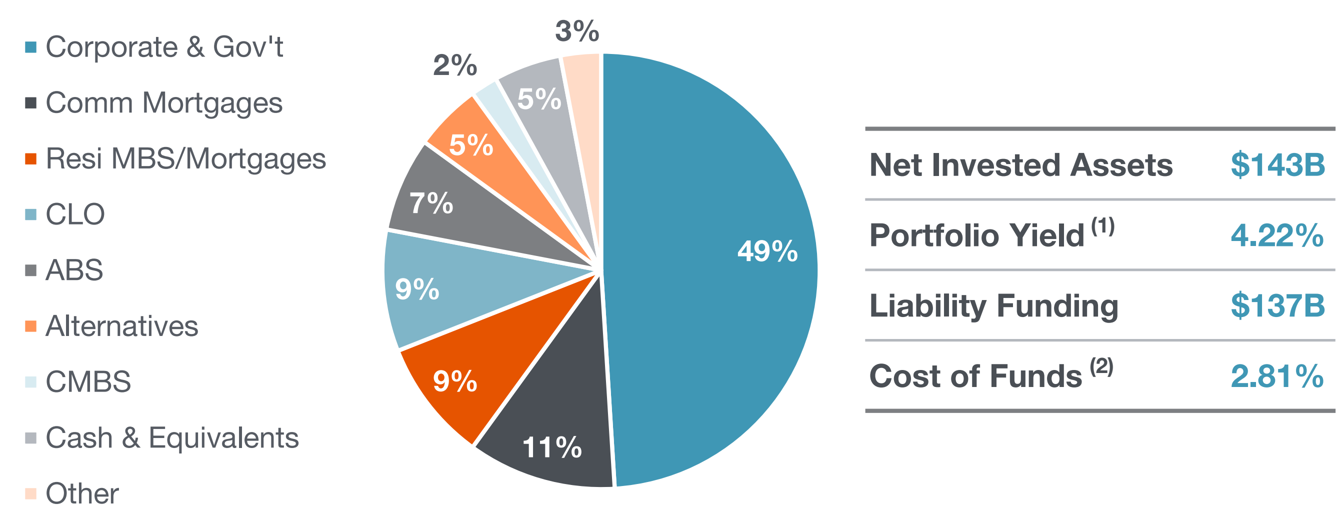
Figure 4: Notable Partnerships Between Asset Management and Insurance Companies

Alternative Asset Manager | **Insurance Partner**

APOLLO

Increased general account allocations to alternatives isn't the only envy of the alternative asset management world, and certainly weren't the driving force for strategic transactions such as KKR's recently announced acquisition of Global Atlantic. Asset managers are competing fiercely for capital from LPs at the same time they are trying to expand into new strategies for growth. An insurance company balance sheet is effectively a one-stop shop, with pockets for every part of the capital structure and an ability for managers to be more relevant in a wider variety of markets. This has a multiplier effect, as it increases AUM at the same time it increases the overall investable universe. In addition to these strategic underpinnings, the wide valuation disparity between alternative asset managers and life insurers that we previously noted has helped facilitate deal making. **Figure 5** outlines high level characteristics of the asset and liability structure of Athene, which illustrates the diverse types of capital that life insurers are able to leverage in fulfilling their investment ambitions.

Figure 5: Athene Portfolio Composition and Characteristics



Net Invested Assets	$143B
Portfolio Yield (1)	4.22%
Liability Funding	$137B
Cost of Funds (2)	2.81%

Source: Company Filings. Financial data as of September 30, 2020.
(1) Reflects reported total net investment earned rate, including alternative investments, for the three months ended September 30, 2020.
(2) Reflects reported cost of funds for the three months ended September 30, 2020.

What relevance does this have to specialty finance company executives and boards, the intended target of this report? The creativity. Alternative asset managers expanded into life insurance not because of a fundamental view that the space was undervalued, but rather, because they reimagined it as a way to raise money and increase the overall investable universe that they supply capital to. While we commented earlier in this report on the surprising lack of M&A activity amongst insurance companies in the specialty finance sector, we are similarly surprised at the lack of effort on behalf of specialty finance companies to acquire non-captive insurance subsidiaries which could serve as strategic funding vehicles and offer other potential benefits such as Federal Home Loan Bank funding access. Given the continually shifting landscape and yet another interest rate reset down during 2020, we expect seemingly far out ideas like this to gain attention in a year where capital structure becomes a more strategically managed aspect of the business. As evidenced in the next section of this report, specialty finance has already availed itself in another key market as specialty lenders seek to regain access to the regulated banking sector.

Nonbanks Pursuing Bank Charters

After almost a decade of inactivity following the financial crisis, the arrival of the Trump Administration brought a renewed enthusiasm, focus and wave of activity around FDIC-insured industrial loan companies (ILCs) and other special purpose banking charters, including a new “FinTech” charter for financial technology companies from the OCC. While the Dodd Frank-imposed moratorium on ILC activity for “commercial firms” (i.e., nonbanks) technically expired in 2013, there was little to no optimism for a successful application or acquisition in the world of heightened post-crisis regulation that persisted prior to Trump’s election victory in late 2016.

However, when Trump came into office the OCC was not yet ready to accept FinTech charter applications, so the immediate response between 2017 and 2019 was a roller coaster of ILC applications and withdrawals and refiling. SoFi and Square Inc. (NYSE:SQ) were the first to apply in 2017 but withdrew within six months. The OCC finally opened the door for FinTech charter applications in mid-

2018, and while the charter does provide a parent company exemption from the Bank Holding Company Act, it does not offer the highly sought after deposit gathering capabilities afforded by an ILC charter, nor does it provide a reprieve from the more stringent oversight synonymous with the OCC itself. Not surprisingly, both charters continue to receive stiff opposition from the traditional bank lobby which has been fighting against ILCs for decades and helped instigate the initial 2006-2008 ILC moratorium that was parlayed into part of the Dodd-Frank Act.

Early in 2020, the FDIC announced its intentions to formalize the ILC approval process, a move aimed at returning the charter to viability, which provided tailwinds to events over the balance of the year. In March, the FDIC approved Square and Nelnet, Inc.'s (NYSE:NNI) ILC applications, marking the first such approvals since the 2006-2008 moratorium was instituted. In December, the FDIC approved a final rule formalizing its ILC approval process, opening the door for future applications.

Square is preparing to launch its ILC, Square Financial Services, in 2021. Deposit gathering and deposit-funded lending capabilities should greatly increase Square's competitiveness across both its "Seller" merchant acquiring and "Cash App" consumer finance and payments segments. Square already competes with banks such as Bank of America Corporation (NYSE:BAC), Citigroup Inc. (NYSE:C), and JPMorgan Chase & Co. (NYSE:JPM) in its Seller segment and its Cash App is already a quasi-deposit gathering platform. The charter will also open a path for Square to transform into a diversified banking franchise over time and differentiate itself from nonbank competition. Whereas nonbank payments competitor PayPal Holdings, Inc. (NASDAQ:PYPL) had to partner and share economics with Synchrony Financial (NYSE:SYF) to launch its Venmo Credit Card, Square will be able to issue its own Cash App credit card and maintain full control over economics.

In a somewhat surprising approach, in October 2020 SoFi leapfrogged the ILC and FinTech charters and received conditional approval from the OCC to form a full service national bank. For SoFi, this not only leveled the playing field with direct student lending competitors SLM Corporation (NASDAQ:SLM), the owner of long-standing ILC Sallie Mae Bank, and the aforementioned Nelnet, which took a similar step as Sallie Mae when it opened its ILC subsidiary, Nelnet Bank, in November 2020, but will also provide the same diversified banking capabilities and allow SoFi to compete more holistically with the likes of Ally, American Express Company (NYSE:AXP), Capital One, Discover Financial Services (NYSE:DFS), Marcus by Goldman Sachs Group, Inc. (NYSE:GS) and other consumer-oriented banking franchises. A similar approach was taken by Oportun Financial Corporation (NASDAQ:OPRT), an unsecured consumer lender, which applied for a full service national charter with the OCC in November 2020.

Similarly, specialty lender LendingClub Corporation (NYSE:LC), which had been evaluating a potential charter application, announced its pending acquisition of Radius Bancorp, Inc. in February 2020. Radius is a Boston-based bank operating a digital, "branch-lite" online lending and deposit gathering model that made it uniquely positioned as a target for a nonbank. LendingClub estimated a 220 basis point reduction in its cost of funds when it announced the transaction, but its stock traded roughly flat on the day of announcement as synergistic optimism was mixed with skepticism around its ability to secure regulatory approval. When LendingClub announced that it had received regulatory approval in January 2021, its stock traded up almost 15% on the day. While the fit, synergies and potential valuation tailwinds are obvious, there are few non-ILC bank targets like Radius and this marked the first-ever nonbank FinTech acquisition of a bank. As such, future activity is expected to center around de novo chartering, with an outright ILC acquisition unlikely given the value and economics of the charters to their existing owners.

In terms of other notable chartering activity, 2020 brought pending ILC applications for two more traditional specialty finance companies: GreatAmerica Financial Services and GM Financial Co. Inc. GreatAmerica is a leading independent small ticket equipment lessor with a successful track record operating through the financial crisis and funding in the securitization markets, but still a firm that will benefit from the permanence and marginal cost benefit of deposit funding. GM Financial is General Motor's (NYSE:GM) captive finance company that emanated from GM's 2010 acquisition of AmeriCredit Corp. The proposed GM Financial Bank is a natural parlay off precedent automobile manufacturer-backed ILCs BMW Bank of North America and Toyota Financial Savings Bank.

In our view, GreatAmerica and GM Financial are arguably as well positioned as any finance company could be in terms of successfully securing FDIC approval. In addition to its performance track record, GreatAmerica at its core offers a leasing product that supports small business growth and that is primarily offered by large and select regional banks versus the broad universe of community banks. Similarly, GM Financial offers a product that allows consumers to buy or lease vehicles from one of the few remaining U.S. manufacturers and that is less of a competitive threat to the community bank lobby, and which also has the aforementioned ILC precedents.

Chartering activity should continue as a key theme into 2021 and beyond and center around consumer- and FinTech-oriented businesses that now have a clearer path to the type of success already enjoyed by SoFi, Square and Nelnet. We also expect other commercial finance companies, like GreatAmerica, that serve customers and provide products that fit within the regulated financial services universe to seriously evaluate the pros and cons of applying for, and conducting business with, a banking charter.

Figure 6: 2020 Total Return Performance Across Financial Services Sectors

Sector	Series	2020 Total Return
Banks	SNL U.S. Bank & Thrift Index	(13.2%)
Insurance	SNL U.S. Insurance L&H Index	(8.3%)
Insurance	SNL U.S. Insurance P&C Index	1.8%
Asset Management	Alternative Manager Average	21.6%
Asset Management	Traditional Manager Average	19.7%
Specialty Finance	Alternative Consumer Average	(4.1%)
Specialty Finance	Credit Card Average	(5.3%)
Specialty Finance	Student Lending Average	13.9%
Specialty Finance	Nonbank Mortgage Average	39.9%
Specialty Finance	Residential mREIT Average	(26.2%)
S&P 500	S&P 500	18.4%
S&P 500	S&P 500 Financials	(1.7%)

Source: S&P Global Market Intelligence. Market data for December 31, 2019, through December 31, 2020. Alternative asset managers include APO, ARES, BX, CG, and KKR. Traditional asset managers include AMG, AMP, BLK, CNS, AB, BEN, IVZ, JHG, SEIC, and TROW. Alternative consumer lending index includes auto finance (ALLY, CACC, SC), debt collection (ECPG, PRAA), installment lenders (OMF, OPRT, RM, WRLD), pawn lenders (FCFS, EZPW), and other digital consumer lenders (ELVT, ENVA, GSKY, LC). Credit cards include ADS, AXP, COF, DFS, and SYF. Student lending includes NAVI, NNI, and SLM. Nonbank mortgage companies include COOP, GHLD (since initial public offering), OCN, PFSI, RKT (since initial public offering), and VEL (since initial public offering).

Part II

Consumer Finance Review

Introduction

CECL implementation, fast-moving digital transformation and the outcome of the U.S. presidential election were top of mind for the consumer finance sector as we entered 2020. By the end of the first quarter, however, COVID-19 had filled the entire priority list as companies across the landscape quickly shifted to a work from home environment while striving to protect both the left and right sides of the balance sheet.

The U.S. consumer was disparately impacted by COVID-19, with many surprisingly ending up net beneficiaries from the fiscal and monetary reactions to the virus-induced economic slowdown while others have borne the brunt of the quickest increase in unemployment in the United States since the Great Depression (for perspective the economy shed a net 9.37 million jobs, nearly double the 5.05 million jobs lost in 2009). White collar employees largely maintained strong levels of job stability and settled into new lifestyles, driving a suburban sprawl that had elsewise been on a two-decade decline. On the other hand, the service sector economy, which directly provides approximately 27 million jobs, representing 20% of the total workforce, was disproportionately impacted by the shutdown in bars, restaurants and other in-person entertainment venues. The latest wave of infections has only elongated the pain inflicted by these curtailments.

Unprecedented government stimulus helped fill the cash hole for the newly unemployed, and created a cash buttress for many of those that retained their jobs but still received stimulus checks, allowing the consumer broadly to keep current on its bills, and in fact pay down debt, bucking the age-old correlation between delinquency and unemployment (for now). Despite this strong performance, the Federal Reserve Bank of New York's *Survey of Consumer Expectations Credit Access* released in December demonstrates some stark realities facing the entire space:

- Reported application rates for any kind of credit over the past 12 months dropped 11 percentage points (or 24%) over the course of 2020, slipping from 45.6% in February to 34.6% in October, a new series low. The decline was broad-based across credit score and age groups, but largest for those with credit scores below 760 and those aged 60 or older. Overall, the average 2020 application rate of 39.8% was well below the 2019 average of 45.8%.

- Reported rejection rates among applicants increased by 3.8 percentage points (or 27%) during 2020 from 14.2% in February to 18.0% in October. The increase was largest for respondents with scores under 680, consistent with a general tightening of lending standards since February. Overall, the average 2020 rejection rate of 15.7% was moderately below its 2019 level of 17.6%. These findings, as reported by households, are consistent with the July and October 2020 results of the Federal Reserve Board's Loan Officer Opinion Survey on Bank Lending Practices, revealing a tightening of lending standards on consumer loans.

- The share of respondents who were too discouraged to apply for credit over the past 12 months (despite needing it) increased slightly, rising from 6.9% in February to 7.2% in October. The 2020 average of 7.0% was slightly above the 2019 average of 6.4%.

Asset owners came out ahead in 2020, as government stimulus and monetary support provided by the Federal Reserve and other central banking authorities drove markets and asset values to all-time highs. That helped drive consumer confidence at the higher end of the wealth spectrum, creating unexpected pockets of spending growth across a variety of things including home improvement projects, at-home

coffee products and even all-terrain vehicles. While the broader impact of these fiscal and monetary stimulus programs will play out over a longer period of time, 2021 will undoubtedly provide helpful near-term evidence of their success or failure as the global economy continues to contend with the latest resurgence of the virus.

Top Themes of 2020

Return of Consumer-Focused, Tech-Enabled Lender IPOs

Rocket Companies, Inc. (NYSE:RKT), the parent of leading nonbank mortgage company Rocket Mortgage, raised $1.8 billion in August, which was the first initial public offering of a consumer-focused, tech-enabled lender since the May 2018 debut of GreenSky, Inc. (NASDAQ:GSKY). Former Google engineer Dave Girouard-backed Upstart Holdings Inc. (NASDAQ:UPST), which provides consumer installment loans based on alternative underwriting criteria and sells them to banks and other counterparties, followed that up later in the year when it raised $240 million in its December debut. As of December 31, 2020, Rocket's shares were up 12% from their August debut and Upstart shares were up a striking 101% in just two weeks since pricing their IPO in mid-December.

Affirm Holdings, Inc. (NASDAQ:AFRM) kicked off a continuation of the frenzy in 2021, ultimately pricing its IPO approximately 30% above the high end of the launch range and then doubling on its first day of trading. SoFi announced its SPAC merger a day after the launch of the Affirm IPO. Swedish company Klarna, a "buy now, pay later" provider like Affirm, is also expected to evaluate the public markets in 2021, which is already shaping up to be the busiest year ever for transformative disrupters in financial services.

Accelerated Technology Adoption: Digital Transformation and Alternative Underwriting

A decade of digital evolution was compressed into 2020, as borrower preference for seamless, online applications and independent online research of alternatives prior to selecting a lender was only accentuated. The cost competitiveness of digital strategies versus branch or store-based approaches is undeniable, although up-front capital investments to get there does necessitate scale for adoption. As evidenced by the Affirm and SoFi transactions, as well as general trading levels for online or tech-enabled competitors versus traditional lenders, investors are willing to supply capital for these up front investments if there is a credible path to long-term, sustainable revenue growth. The investment community firmly recognizes the existential threat this digital revolution poses to traditional financial services providers and is making its bets on who it believes the titans of the industry will be in the decades to come, even if operating losses are required in the near-term to build the platforms necessary to compete for those positions.

Additionally, static underwriting models continue to be replaced with more dynamic applications that utilize machine learning and artificial intelligence to continuously enhance risk pricing and reduce reliance on FICO. While the very factors that derive a FICO score play a significant role in alternative underwriting decisions, it has statistically expanded the borrower base and, heretofore, credit performance continues to support adoption (although this trend will be important to watch given the benign credit environment we've been in for the last decade and the masking effect that recent government stimulus efforts have had on consumer credit quality).

Resilient Credit

Delinquency and charge off rates remain suppressed, with most asset classes seeing improved credit quality during 2020 (mortgage forbearance being the exception, although home price appreciation in 2020 coupled with low loan to values going into the year make the likelihood of material losses remote).

Congress's recent $900 billion fiscal stimulus package, which in addition to other benefits, includes a $300 per week federal unemployment supplement and $600 direct payment for each adult and child in households below certain income thresholds, will support consumer credit going into 2021. While credit will remain uncertain in the near to medium term, we do not advise restraint in commitment to bold, strategic priorities as the landscape continues to evolve, as over-caution may ultimately prove perilous.

Renewed Pursuit of Bank Charters

As previously highlighted in this report, the onset of the Trump administration emboldened FinTech and specialty finance companies alike to rethink the viability and merits of pursuing bank charters. While the new administration may change the amount of momentum seen in recent years, we believe there is bipartisan interest in seeing the regulated financial system support all Americans, for which a large portion presently fall within the confines of the under and unbanked. That could help the case for additional chartering during the Biden administration.

Incoming Biden Administration

After a prosperous four years of regulatory pullback across the consumer finance sector, the incoming Biden administration is expected to bring more scrutiny back amongst nonbank lenders (particularly those with higher cost or lower dollar-denominated products). With COVID-19 likely to extend well into 2021 and consumers continuing to face an incredibly burdensome economic backdrop, a new regime focused on consumer protection and an emboldened CFPB are grounds for some contingency planning as lenders continue to refine their strategic plans. Equally concerning to watch for will be a potential shift back into the regulated financial system of certain activities, effectively a reversal of a decade-long trend that's been in place since the financial crisis.

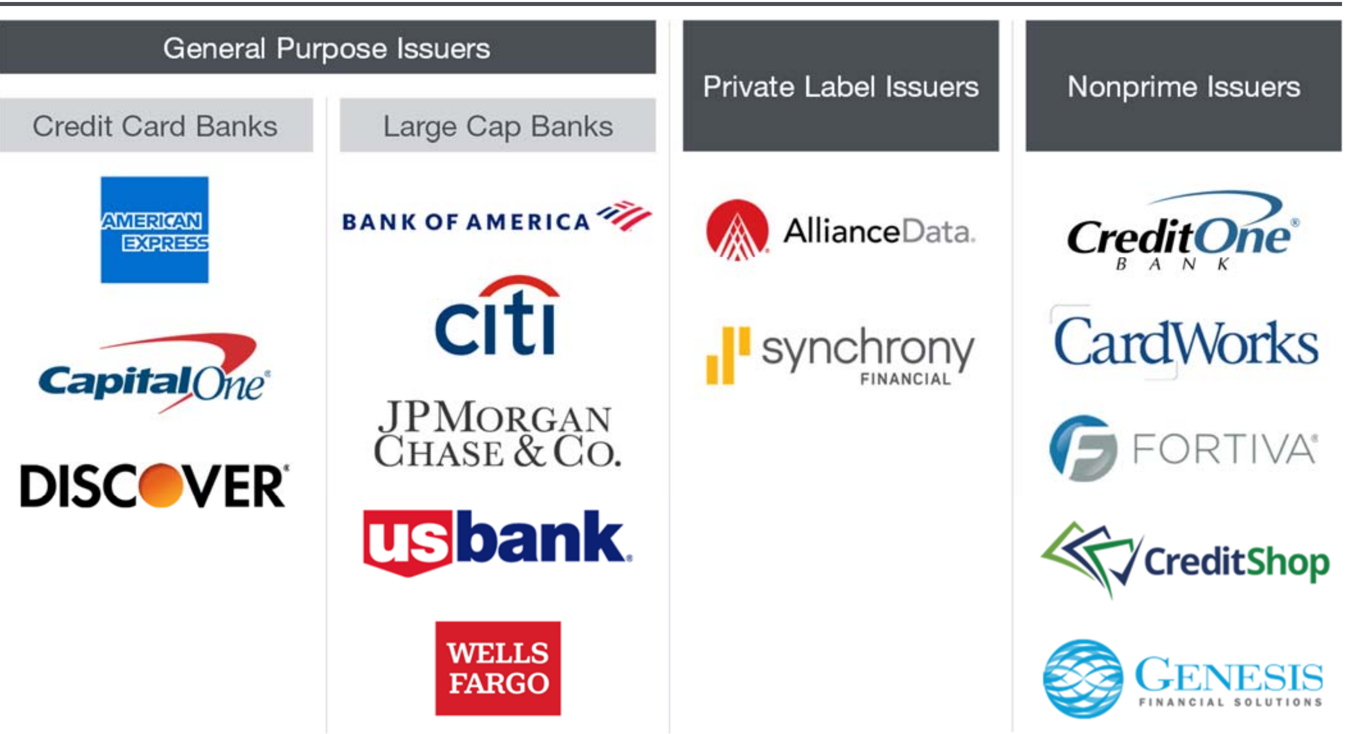
Subsector: Credit Cards

Industry Overview

The U.S. credit card market is arguably one of the most consolidated and concentrated but also one of the largest subsectors within specialty finance. According to data from the Nilson Report, the seven largest issuers accounted for 78% of total purchase volume for U.S. credit cards in 2019, a level that has remained consistent over the past decade. According to data from the FRBNY, U.S. consumer credit card debt peaked at $866 billion in the fourth quarter of 2008 before falling 24% to a trough of $659 billion in the first quarter of 2014 and then returning to pre-crisis levels in 2018 and 2019, reaching a new peak of $927 billion in the fourth quarter of 2019.

That the absolute debt level is up only 7% over more than a decade is more of a function of the credit excesses of the pre-crisis era and prudent household debt levels since than it is a reflection of underlying fundamentals. Credit cards and the issuers themselves are becoming increasingly larger contributors to the U.S. consumer payments ecosystem and digital economy, with credit card transactions totaling 44.4 billion in 2019, up almost 55% from 28.7 billion in 2014 according to data from the Nilson Report. For comparison, FRBNY data indicates total credit card debt rose 32% from 2014 to 2019, reflecting a more transactional and disciplined credit environment than what preceded the financial crisis.

Figure 7: U.S. Credit Card Landscape



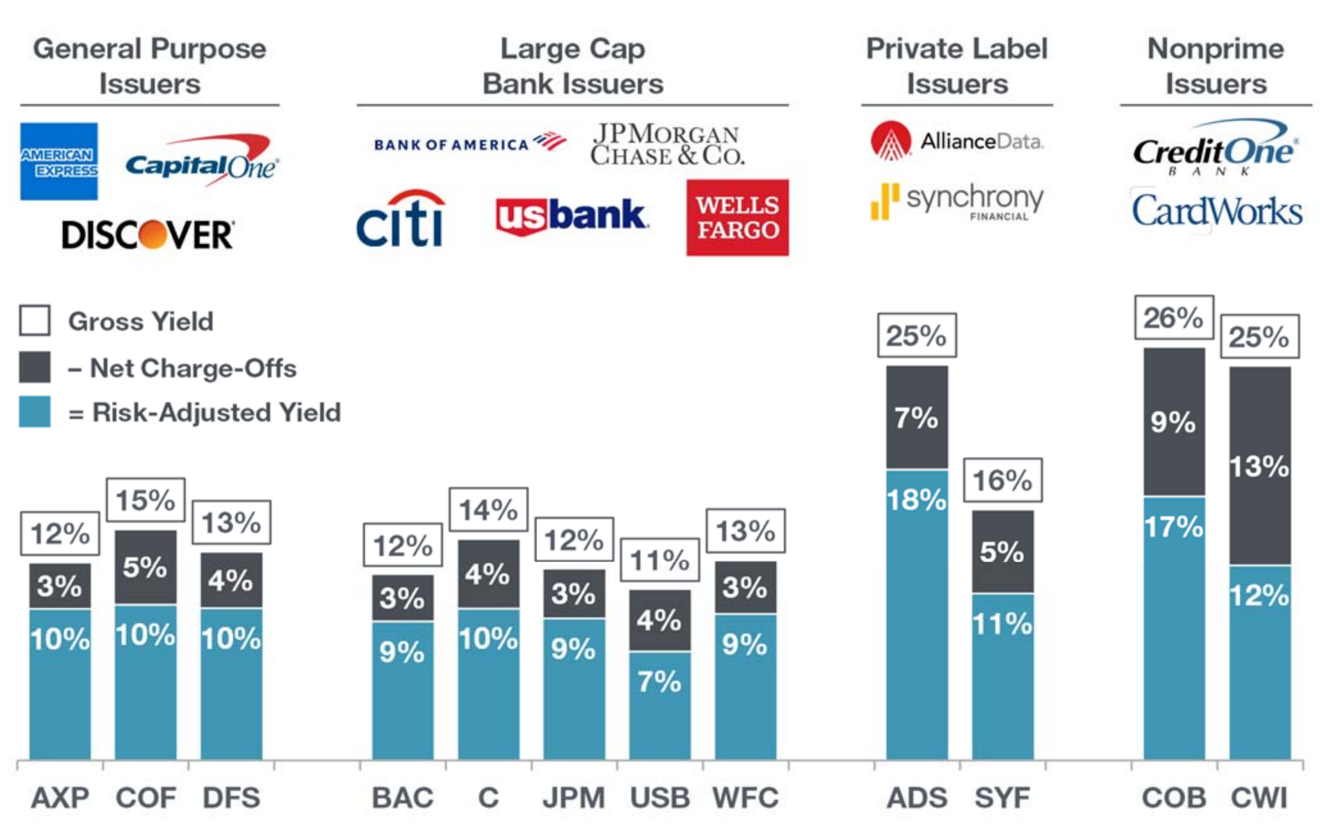
Note: Intended to reflect representative, not comprehensive sampling of market participants.

Credit cards can generally be segmented into three product types: (i) general purpose cards, (ii) co-brand cards, and (iii) private label cards. General purpose cards are usable anywhere in network (i.e., American Express, Discover, MasterCard, Visa) and, in recent times, generally offer some form of issuer-specific cash back or rewards program (e.g., Chase Sapphire Preferred). Co-brand cards are general

purpose cards in which an issuer partners with a third-party loyalty program to offer program-specific rewards on a co-branded card (e.g., Chase Marriott Bonvoy Boundless Card by JPMorgan Chase). Private label cards were traditionally only for use with a specific retailer or merchandiser that would "white label" an issuer's card platform as an affinity product for the retailer's or merchandiser's customer base (e.g., Lowe's Advantage Card issued by Synchrony Bank), but have evolved to also include hybrids that are for use anywhere in the particular network (e.g., Verizon Visa issued by Synchrony Bank).

The large bank holding company issuers offer some form of one or more of these products to consumers in the near-prime (credit scores between 620 and 659), prime (660-719) and super-prime (720 and above) segments, with co-brand typically skewing higher on credit score, private label typically skewing lower and general purpose spanning the spectrum. In addition, Alliance Data Systems (NYSE:ADS), which has two ILC bank charters, and Synchrony, a savings and loan holding company for Synchrony Bank, specialize in private label cards for these consumer segments. The subprime (credit scores between 580 and 619) segment is served by Credit One Bank, a special purpose national credit card bank owned by Sherman Financial Group; Merrick Bank, the ILC owned by CardWorks; and other specialty finance companies such as Genesis Financial Solutions, Fortiva Financial LLC and Credit Shop, Inc. that "rent a charter" from a small group of specialty issuing banks. Some lenders also serve deep subprime (credit scores below 580) consumers on a more limited basis, including via secured card products.

Figure 8: Credit Card Risk-Reward Profile



Source: Company Filings, S&P Global Market Intelligence. Financial data for the twelve months ended September 30, 2020.
Based on standardized regulatory data from bank-level call report filings. Data for multi-charter companies aggregated and presented at parent level.
CardWorks data reflects Merrick Bank. Figures may not sum due to rounding.

2020 Review

2020 brought the long-anticipated implementation of CECL, but that wasn't the only driver of increased reserves as the COVID-19 pandemic spread to the U.S. before issuers were able to produce their initial results. "Day one" CECL implementation on January 1, 2020 still drove the majority of reserve building in the first quarter of 2020, but each of the pure play U.S. card issuers disclosed at least some degree of additional reserve building as COVID-19 materialized later in the quarter.

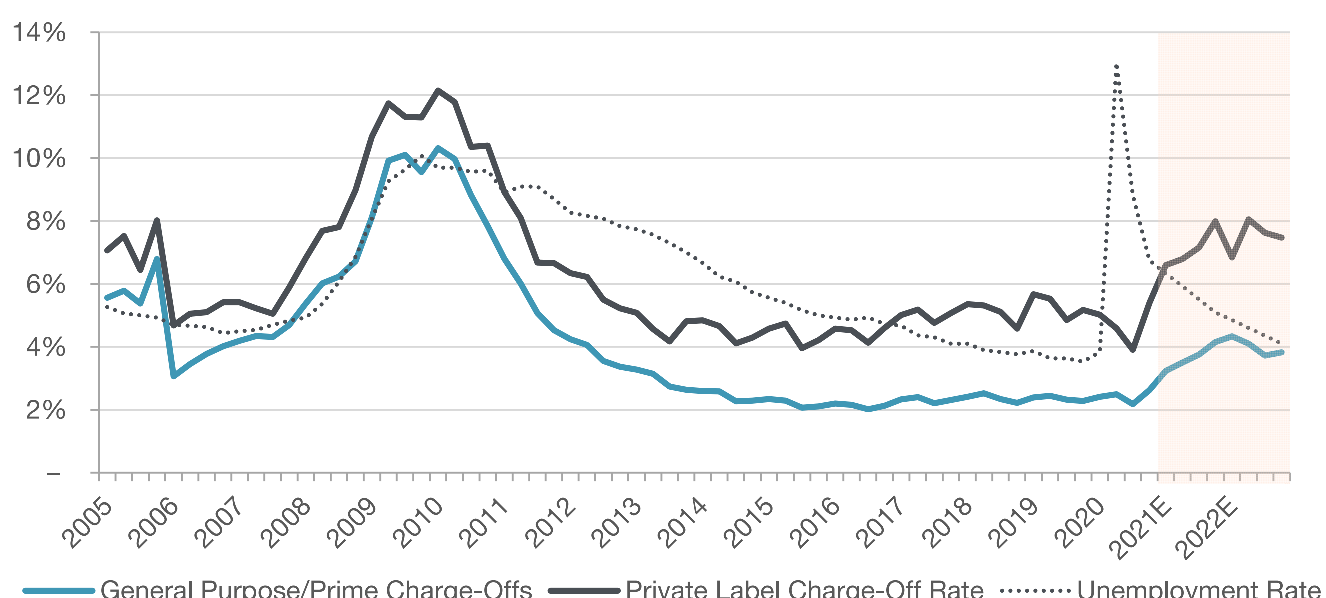
While reserve levels effectively doubled in the first quarter, credit card delinquencies and net charge-offs remained stable, and frankly benign, in March and into April and May. Beginning in June, delinquencies and net charge-offs began an essentially constant decline through the rest of 2020 as consumers benefited from a much needed elixir of issuer-provided deferrals and government-provided stimulus, and issuers benefited from accelerated payment rates and reduced exposures. According to data compiled by S&P Global Market Intelligence from master trust filings for the major U.S. credit card issuers, the average 30+ day delinquency rate remained in the area of 150 basis points from March to May, consistent with the same period the prior year, before falling to the 110-120 basis points area late in the third quarter and into the early portion of the fourth quarter. According to the same data, average annualized charge-offs remained in the 250 basis points area between March and May, only slightly above the 240 basis points recorded a year prior, before falling below prior year levels in each month from June to November.

Credit Fallout Should Be Modest

Whether unprecedented fiscal stimulus prevented or simply masked credit deterioration was a key theme putting downward pressure on credit card stocks in 2020 and will remain at the forefront as we move into 2021. However, there is growing optimism around consumer credit broadly, with credit card stocks slowly recovering from their March lows to end 2020 effectively breakeven from an annual total return perspective (with the exception of ADS which was recovering in lockstep before facing outsized headwinds to end the year in reaction to worse than expected guidance for the fourth quarter). The most recent stimulus package, for which even more is likely on the way, should provide a safety net to bridge the U.S. consumer to the coming vaccine which is widely expected to reopen and restart the economy, particularly the service economy and travel and entertainment spending. With that said, there is still likely to be some loss content that falls out over the back half of 2021.

Like most in consumer finance, credit card charge-offs have historically exhibited a natural correlation to unemployment, and the unprecedented initial COVID-19 shock had industry expectations for loss rates at or near crisis levels. As such, issuers built significant reserves in early-to-mid 2020 using significantly higher unemployment forecasts than were experienced over the balance of the year and that are now expected for 2021. This leaves issuers well, if not overly, reserved and current analyst estimates forecast charge-offs for public issuers (i.e., near-prime cards and higher) to peak modestly at approximately 100-200 basis points above normalized levels in the second through fourth quarters of 2021.

Figure 9: Historical Credit Card Charge-Off Trends and Near-Term Projections



Source: Federal Reserve Bank of St. Louis, S&P Global. Historical general purpose / prime card data based on S&P Global Ratings' Credit Card Quality Index (CCQI) for U.S. Bankcard ABS. Estimates based on equity research consensus for AXP, COF, and DFS. Historical private label card data based on S&P Global Ratings' CCQI for U.S. Private Label Credit Card ABS. Estimates based equity research consensus for ADS and SYF.

However, it should be noted that there is an increasing potential for late stage white collar layoffs emanating from both the short- and long-term effects of COVID-19, a risk that would disproportionately impact public issuers. To date, these near-prime, prime and super-prime focused issuers have been largely insulated from COVID-19 related layoffs which generally skewed towards the lower wage non-prime consumer, but this second wave could drive greater loss volatility given the higher balance and more discretionary nature of this segment versus non-prime. While non-prime issuers were the most exposed to initial layoffs, they have and should continue to perform well given their cards tend to be much smaller balance and higher utility products with significantly more excess spread to absorb losses, and this segment of consumers has benefited the most from the fiscal stimulus offered in response to COVID-19.

Return to Growth

Tightened underwriting standards and elevated, stimulus-induced payment rates drove Y/Y receivables compression of as high as 10% to 15% for most issuers in the second through fourth quarters of 2020, with shrinkage expected to continue into the first quarter of 2021. Moving into the second quarter, vaccine adoption and its resurgent effect on the economy is expected to drive mid-to-high single digit balance growth through the remainder of the year with issuers able to avoid "growth math" in the near- to intermediate-term by growing into existing reserves and/or taking reserve releases versus having to record punitive provisions to support new accounts and balances. This return to growth is further validated by positive mailing trends in the second half of 2020, with mail volumes returning to more normalized levels above 200 million per month in October and November.

While the most significant credit transaction announced in 2020 (Ally's aforementioned $2.65 billion acquisition of CardWorks) was subsequently terminated amidst a confluence of negative investor

reaction and uncertainty around COVID-19, Synchrony, American Express and Alliance Data Systems each made notable announcements that should begin to bear fruit in 2021. Synchrony announced new private label partnerships with Verizon and PayPal's Venmo in June and October, respectively, providing a fresh wave of new accounts and balance growth. American Express announced and closed its acquisition of Kabbage, Inc.'s operating and technology platform in August and October, respectively, accelerating and expanding American Express' presence in B2B payments and the SMB market more broadly. Lastly, in the fourth quarter, Alliance Data Systems announced and closed its $450 million acquisition of Lon, Inc. (d.b.a. Bread), a "buy now, pay later" FinTech company, in a highly strategic transaction that will open a new growth channel for ADS outside of its core private label card business.

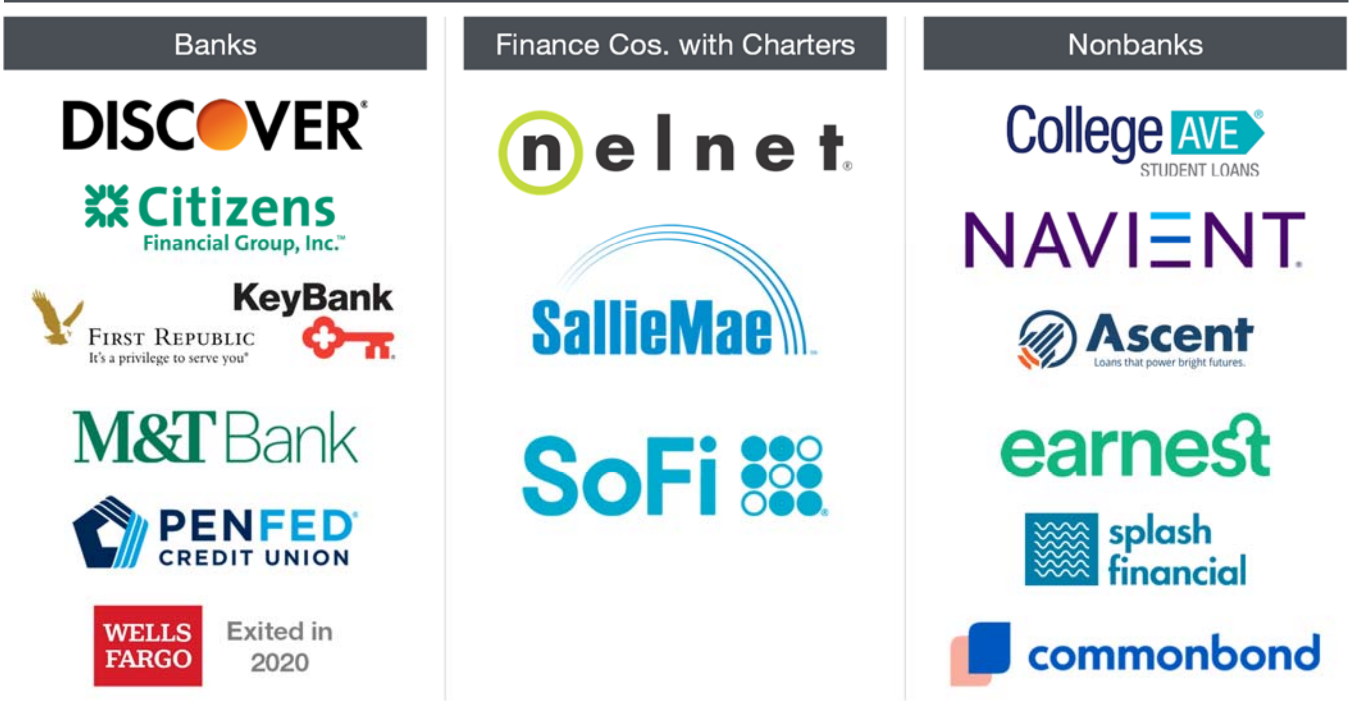
Subsector: Student Lending

Introduction

Student loans comprise the second largest consumer debt class in the United States, behind residential mortgage, and often represents the first material debt obligation a consumer takes on in their life. Like the residential mortgage market, the U.S. government via the Department of Education (DOE) heavily influences the sector, effectively backing the credit risk of over 90% of the entire $1.7 trillion market.

For almost 50 years prior to the Health Care and Education Reconciliation Act of 2010, the DOE backed the sector using the Federal Family Education Loan Program (FFELP), which was initiated by the Higher Education Act of 1965. Since that time, the DOE has been a direct lender, relying on third-party servicers to manage their portfolio. While innovators continue to find creative solutions for current and former students, the preponderance of the sector is dedicated to the government-backed system which comprises 90% of the market. The private portion of the student lending market is mostly served by bank lenders that have made students a strategic priority, as well as a select number of nonbanks, many of which as we described earlier are shifting back into the traditional banking system.

Figure 10: U.S. Student Lending / Servicing Landscape



Note: Intended to reflect representative, not comprehensive sampling of market participants.

Federal Student Lending Industry Background

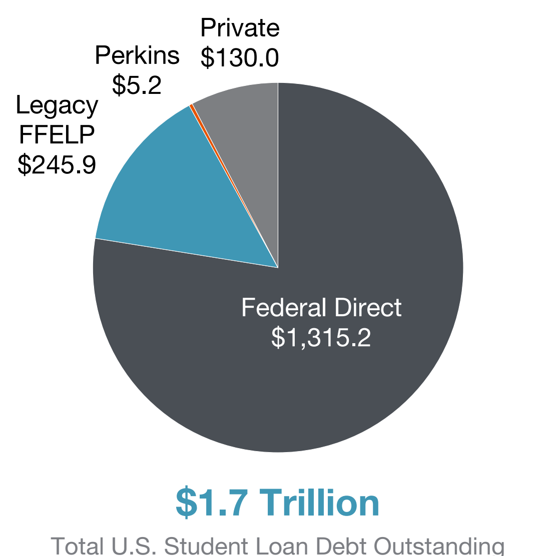
Prior to passage of the Health Care and Education Reconciliation Act of 2010, which established the DOE as a direct lender, the DOE backed student loans using a program created by the Higher Education Act of 1965, called the FFELP. This was a private/public partnership not completely dissimilar from how the U.S. mortgage market functions that aimed to align private-sector loan originator/servicers with the

ultimate credit risk carrier (the U.S. government). Legacy FFELP loans are, for the most part, serviced by those that originate (or acquire) the loans, whereas direct loans are serviced by 35 pre-defined third-party providers (31 non-profits and four private sector entities) in accordance with a defined allocation policy that is revisited twice a year. Private student loans, which represent approximately 10% of new annual originations, are done away from the U.S. government and are generally funded by deposits (for bank lenders) or the asset-backed securities market (for nonbank lenders).

DOE Direct Loan Servicer Landscape

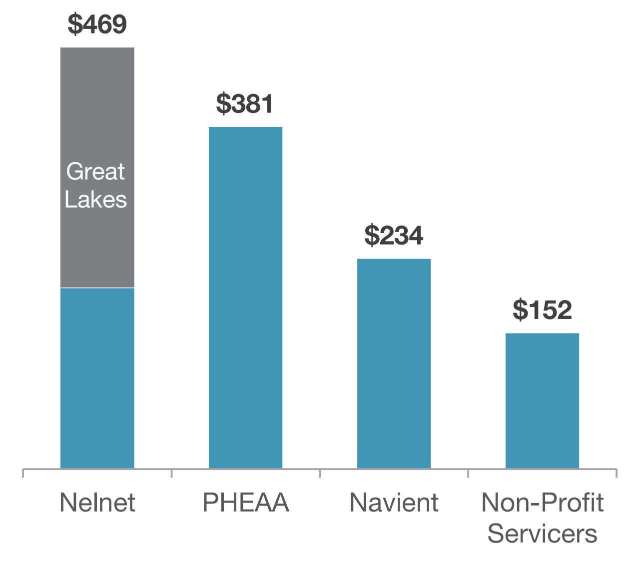
The DOE is currently undergoing a contract procurement process entitled "Next Generation Financial Services Environment" to reassign responsibilities under these servicing contracts. While the process has evolved over several years, there are presently two components that are up for renewal. The first of those two components, Business Process Operations, represents the back office and call center operational functions. In June 2020, the DOE signed Business Process Operations contracts with five counterparties: Edfinancial Services LLC, F.H. Cann & Associates LLC, MAXIMUS Federal Services Inc., Missouri Higher Education Loan Authority and Texas Guaranteed Student Loan Corporation (Trellis Company). The second of those two components, Enhanced Process Solution, remains ongoing. There was a third component to the original solicitation, Optimal Processing Solution, but that component was cancelled in April 2020.

Figure 11: Total U.S. Student Loan Debt ($B)



Source: National Student Loan Data System (NSLDS). Includes outstanding principal and interest balances as of September 30, 2020. Private loans reflect Piper Sandler estimate. Pie chart data presented in billions

Figure 12: Federal Direct Loan Servicing ($B)



Source: National Student Loan Data System (NSLDS). Reflects servicing portfolio UPB in billions as of September 30, 2020. Includes direct loans and ED-owned FFELP loans.

2020 Review

COVID-19 upended the world of higher education and exposed what has been limited adoption of high-end technology and digital capabilities for universities and colleges across the country (not surprising as some measures suggest less than 5% of college budgets are dedicated to IT spending). Private capital has made note of the opportunity and come in to help fill the void, as the first half of 2020 saw

the second largest half year of global educational technology investment on record (at $4.5 billion, 3x the average 6-month period over the last decade).

The cash flow plumbing of the student lending market was also greatly impacted by COVID-19, as federal student loan borrowers were automatically placed in an elective administrative forbearance through the end of the year and private lenders similarly offered a range of payment options to borrowers to assist during the pandemic. As of the end of the third quarter, 63% of the $1.7 trillion in DOE direct loans and legacy FFELP loans were in forbearance (versus merely 10% at the end of 2019). Lending volumes were down double digit percentages versus last year in the most acutely impacted in-school segment, but the entire market shared in reduced volumes. While each lender will ultimately be impacted differently, particularly between those providing loans to in-school borrowers versus offering refinancing options for those presently in the workforce, it remains too early to tell the ultimate credit impact COVID-19 will have on the sector (notwithstanding how politics will influence repayment trends).

The most impactful result of 2020 on the student lending industry, however, will be the evolving political landscape and the incoming Biden administration. While many industry insiders agree that revolutionary changes to the system, such as free college for all or new policy that would govern existing private student borrower rights, seem unlikely, concern around the usage of existing authority under the Higher Education Act to cancel up to $50,000 in Federal student loan debt by executive order is entirely plausible in 2021, although no such relief was contemplated in the $1.9 trillion stimulus plan currently underway. Elevated student debt levels have long been a key issue for the left part of Biden's coalition, and new CFPB director nominee Rohit Chopra in particular, so we expect real uncertainty to cloud this sector in the near term, as we describe later in this report.

Wells Fargo Exits Private Student Lending

The most notable transaction in the sector during 2020 was undoubtedly Wells Fargo & Company's (NYSE:WFC) agreement to sell its $10 billion private student loan portfolio to Apollo and The Blackstone Group Inc. (NYSE:BX) after discontinuing new originations of the product earlier in the year. Apollo and Blackstone tapped Nelnet to service the portfolio, which greatly expanded its participation in the private student lending market at a critical juncture for the firm following the DOE's decision to not renew the BPO portion of its direct loan servicing contract. Other diversified bank lenders in the private student loan market include Citizens Financial Group, Inc. (NYSE:CFG), Discover, First Republic Bank (NYSE:FRC), and M&T Bank Corporation (NYSE:MTB), none of which at this point have publicly indicated similar desires to Wells Fargo but will nonetheless evaluate the businesses fit within the go-forward strategy. Wells Fargo admittedly is under disproportionate stress in allocating capital as it contends with a Federal Reserve mandated asset cap, so their conclusion should by no means be considered a panacea for other banks.

Incoming Biden Administration

While Congress will play a significant role in education reform, the Biden administration was built with support from both leftist and centrist Democrats and there is a significant divergence of appetite and prioritization of issues within that coalition. These dynamics will impact what gets done via policy over the next four years, but we highlight some near- and medium-term issues that will rise to the forefront. Executive order may ultimately be used in lieu of policy, which presents a bit of a wild card for the landscape as we step into 2021.

Debt Cancellation	Biden has recommended canceling federal student loan debt related to undergraduate tuition for those that attended a public college/university and earn less than $125,000. Biden had previously recommended that $10,000 be offered in federal student debt cancellation as part of the next round of COVID-19 relief (approximately one-third of federal student borrowers have less than $10,000 in remaining student debt), however, we note that this was not ultimately included in the most recent $1.9 trillion stimulus plan outlined as this report goes to press.
Revised Income-Driven Repayment	For undergraduate loans only, Biden would reduce what is currently a requirement to pay 10% to 20% of your discretionary income towards debt repayment down to 5%, with the balance forgiven after 20 years (tax free).
Pell Grants	Biden would increase these grants, which provide approximately $30 billion to approximately 7 million at-need students per year, and expand eligibility to cover more of the middle class.
Public Service	Biden would introduce a new federal student loan forgiveness program for borrowers providing public service, up to $50,000 in total at $10,000 per year of providing such service. Biden would also rework "public service loan forgiveness," which is available to government workers, teachers and other nonprofit employees.

It is difficult to discern what the long-term ramifications of such policies will be on industry volumes, let alone which ones will ultimately make their way through legislation, but this uncertainty will create real anxiety for the student lending business in the near to medium term, and will necessitate strategic thinking around diversification options.

Subsector: Auto Finance

Industry Overview

Behind residential mortgages (70%) and student loans (11%), automobile financing (10%) represents the third largest source of household debt in the United States. Entering 2020, the outstanding balance on automobile loans and leases reached a record $1.3 trillion, up from $0.7 trillion (+84%) at the beginning of the previous decade. [1]

Figure 13: Total U.S. Auto Loans Outstanding ($B)

Source: Federal Reserve Bank of New York

The automotive finance industry is large and highly competitive. The market is currently served by a variety of lenders, both publicly and privately owned, that can be broadly classified as one of the following: banks or bank-owned/affiliated lenders, captive finance affiliates of automobile manufacturers, credit unions, independent (nonbank) finance companies, or “buy here, pay here” (BHPH) dealerships.

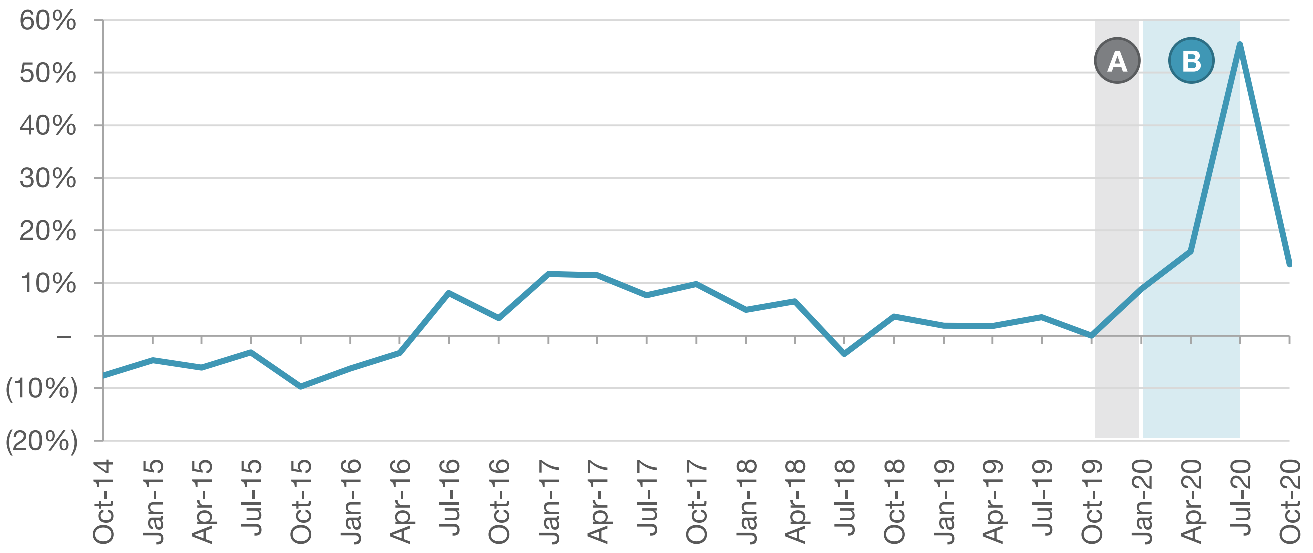
Banks and credit unions, which skew towards higher credit borrowers, comprise around 50% of the overall financing market (combined loans and leases), but captives in particular, as well as finance companies and BHPH dealers, are gradually gaining market share as banks tighten credit standards (see **Figure 15**). Since the start of the pandemic, captives have captured additional market share from other lenders due to aggressive financing incentives to encourage consumers to purchase vehicles (see **Figure 16**).

[1] Source: Federal Reserve Bank of New York

Figure 14: U.S. Auto Finance Landscape

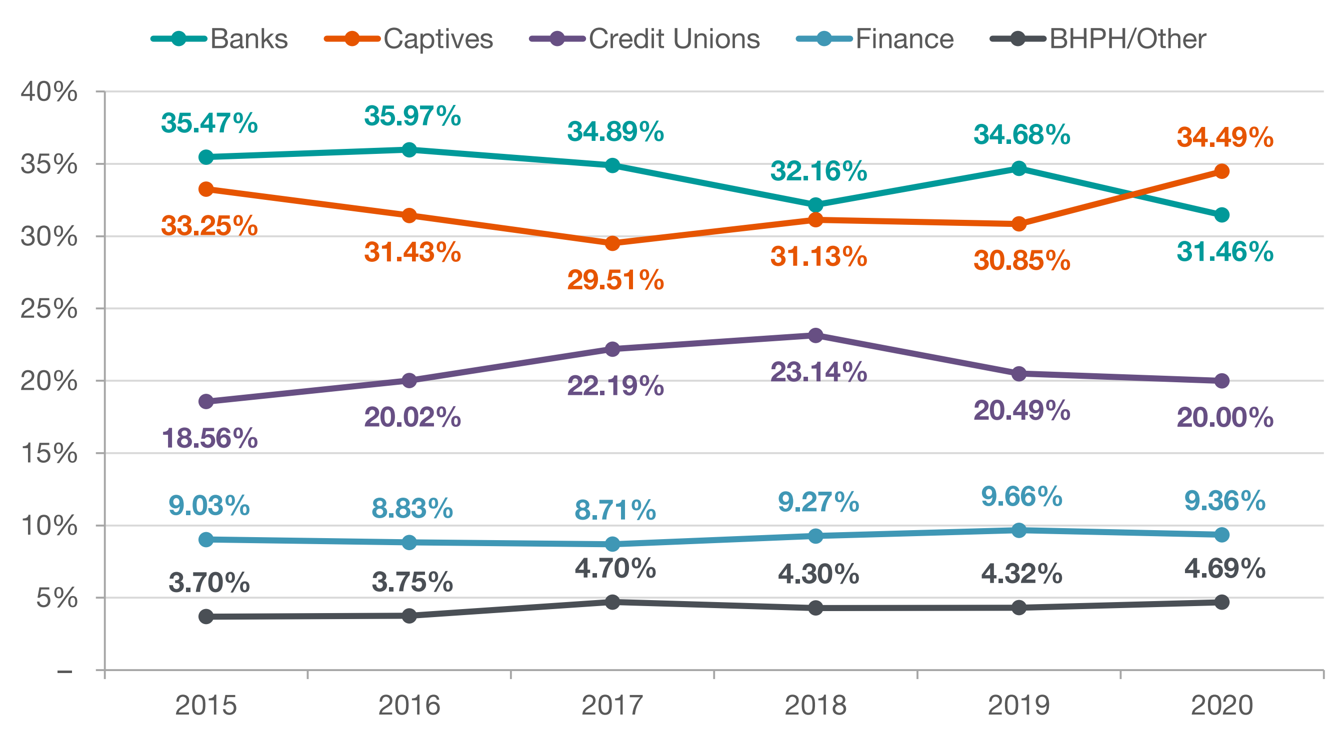
Note: Intended to reflect representative, not comprehensive sampling of market participants.

Figure 15: Net Percentage of U.S. Banks Tightening Standards for Auto Loans



Source: Board of Governors of the Federal Reserve System's Senior Loan Officer Opinion Survey on Bank Lending Practices

Figure 16: Overall U.S. Auto Finance Market Share by Lender Type (New and Used)



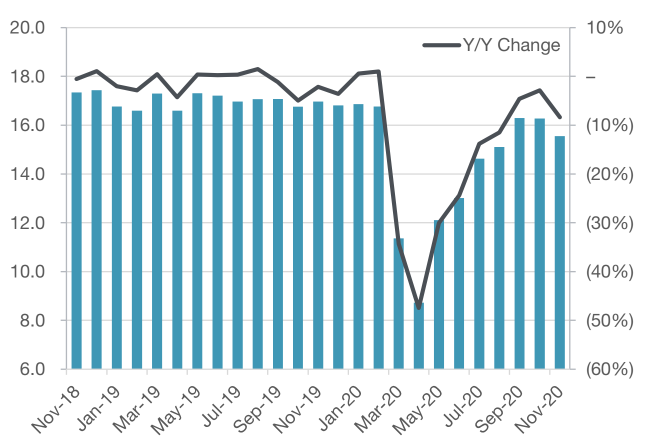
Source: Experian's State of the Automotive Finance Market Q3 2020. Years reflect date of purchase. Data through third quarter of 2020.

2020 Review

Despite the profound initial impact of COVID-19 that shut down vehicle production across the world, the U.S. automotive market and its associated financing industry are staging somewhat of a comeback albeit in a unique environment.

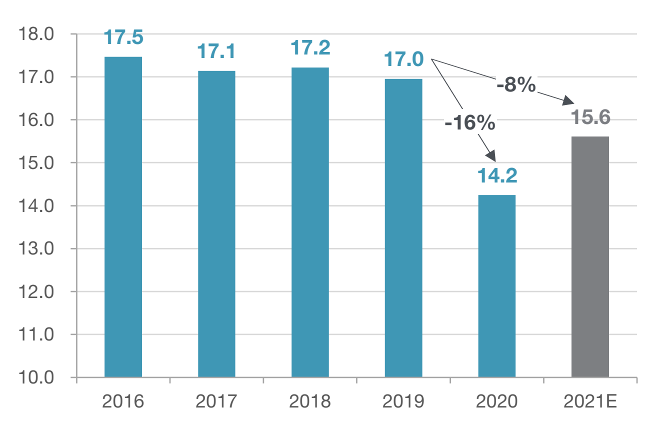
In November, the SAAR (a measure of light weight new vehicle sales in the United States) reached 15.6 million units, an 8.4% decline from the prior year, but a significant improvement from just a few months earlier when the SAAR dipped to 8.7 million units (down almost 50% Y/Y), its lowest level since the data started being recorded in 1976 (worse even than the height of the financial crisis). Fitch is forecasting light vehicle sales of 14.2 million for 2020, a 16% decline from 2019, but expects sales to rebound in 2021. Their current projection, which assumes macroeconomic conditions improve and widespread lockdowns do not return, of 15.6 million sales in 2021 reflects a 10% increase over their 2020 forecast. Although the trend will be improving in 2021, new vehicle sales are expected to be about 8% below 2019. Fitch does not expect sales to return to 2019 levels until 2022 at the earliest even if a COVID-19 vaccine becomes widely available by mid-2021.

Figure 17: U.S. Light Vehicle SAAR (Monthly)



Millions of units, seasonally adjusted annual rate. Source: U.S. Bureau of Economic Analysis, Light Weight Vehicle Sales: Autos and Light Trucks, Federal Reserve Bank of St. Louis.

Figure 18: U.S. Light Vehicle SAAR (Annual)



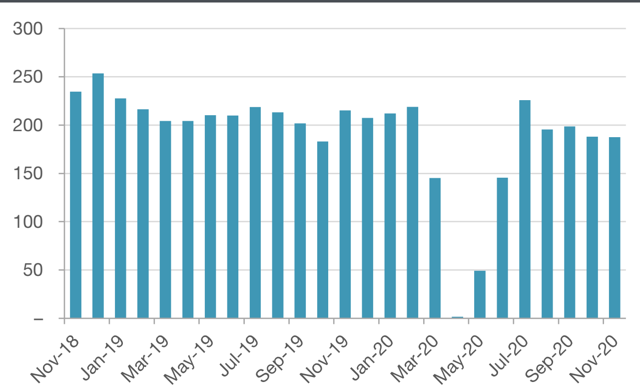
Millions of units, seasonally adjusted annual rate. 2021E based on estimate from Fitch Ratings as of December 2020. Source: U.S. Bureau of Economic Analysis, Light Weight Vehicle Sales, Federal Reserve Bank of St. Louis.

The precipitous decline in vehicle sales at the onset of the pandemic reflects a confluence of factors as governments acted to temporarily close businesses, including car dealerships, and consumers changed their behavior in response to government mandates and health advisories. Vehicle manufacturers and their suppliers also took measures to slow or shut down production in response to the pandemic, which negatively impacted inventory levels.

Sales began to rebound towards the end of the second quarter as governments loosened restrictions and consumers adapted to a new environment which saw people avoiding mass transportation and leaving large urban centers. Met with a reduction in manufacturing, this heightened demand drove vehicle inventories to new lows causing used car sales to boom, particularly as consumers became more cautious about spending on large purchases and turned to the used car market to save money. As inventory diminished, used vehicle pricing rose sharply over the summer and, though it is starting to show signs of waning, remains elevated above pre-pandemic levels. Used vehicle supply likewise remains tight, but is also showing signs of loosening. Although some of these trends could be attributed

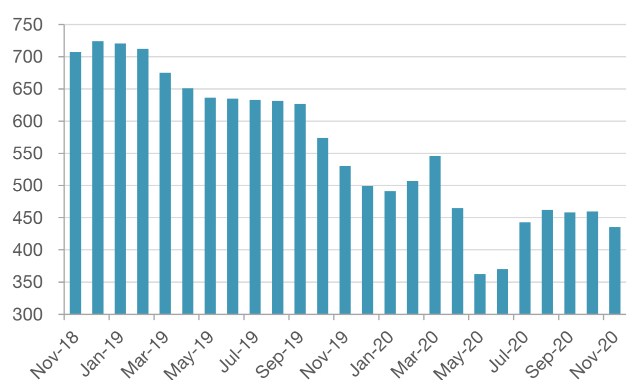
to seasonality, we expect used vehicle pricing to continue to soften over the next few months as production returns to pre-pandemic levels and demand from the post-pandemic surge fades.

Figure 19: Light Vehicle Production (#000)



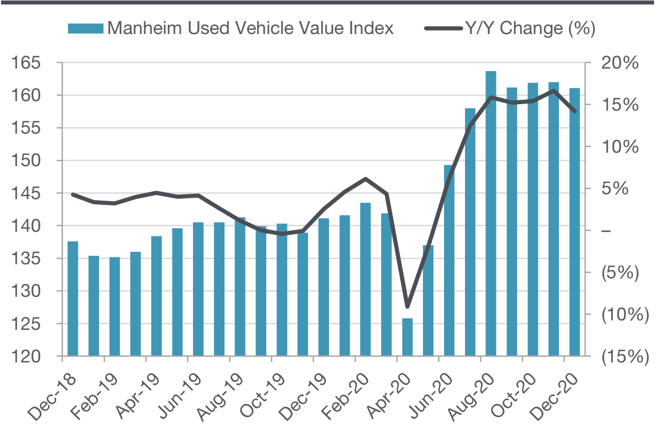
Source: U.S. Bureau of Economic Analysis, Domestic Auto Production, Federal Reserve Bank of St. Louis. Thousands of units, seasonally adjusted.

Figure 20: Automobile Inventory Levels (#000)



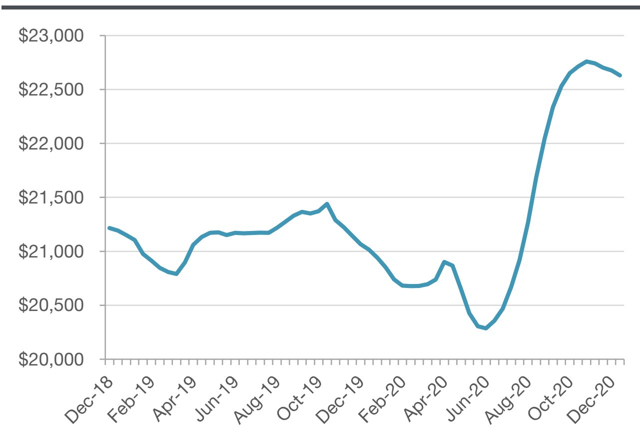
Source: U.S. Bureau of Economic Analysis, Domestic Auto Inventories, Federal Reserve Bank of St. Louis. Thousands of units, seasonally adjusted.

Figure 21: Manheim Used Vehicle Index



Source: Manheim

Figure 22: Car Gurus Used Car Price Index

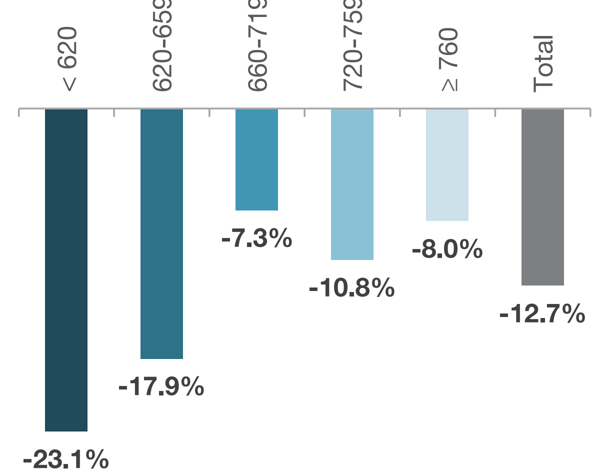


Source: Car Gurus

On the financing side, the pandemic has created a unique scenario with heightened demand for vehicles (and related financing) occurring against a backdrop of rising unemployment. The result is that lenders must navigate a complex environment to meet their customers' financing needs while protecting their investments in the face of an uncertain financial future.

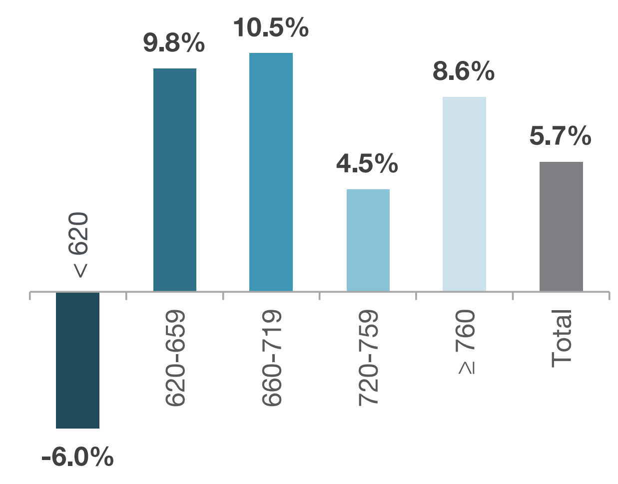
In the second quarter of 2020, according to data from the New York Fed Consumer Credit Panel, U.S. auto loan originations (which includes both loans and leases) fell 12.7% Y/Y with subprime (consumer credit scores below 660) originations falling 21.2% Y/Y. Originations picked up significantly during the third quarter, reaching a record $168.2 billion, rising 23.8% from the prior quarter and 5.7% from the same period of 2019, and grew for all segments of the credit spectrum (as classified by the FRBNY) except for the deepest subprime segment (consumer credit scores below 620) where originations continued to fall on a Y/Y basis.

Figure 23: Second Quarter 2020 Y/Y Change in Auto Loan Volume by Borrower Credit Score



Source: New York Fed Consumer Credit Panel/Equifax from FRBNY Quarterly Report on Household Debt and Credit. Credit score is Equifax Riskscore 3.0.

Figure 24: Third Quarter 2020 Y/Y Change in Auto Loan Volume by Borrower Credit Score

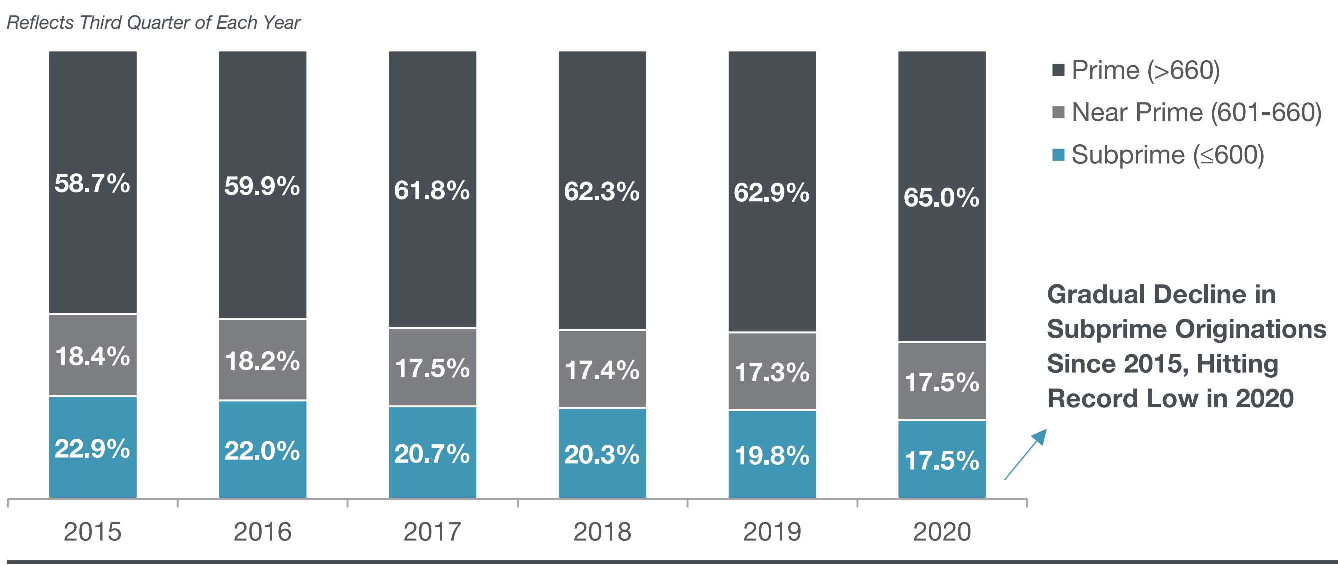


Source: New York Fed Consumer Credit Panel/Equifax from FRBNY Quarterly Report on Household Debt and Credit. Credit score is Equifax Riskscore 3.0.

According to Experian's *State of the Automotive Finance Market* report, subprime (which Experian classifies as credit scores below 600) originations comprised only 17.5% of total (loans and leases) automotive originations in the third quarter, which is a historic low. While COVID-19 has certainly impacted subprime originations, it is unlikely the only factor driving this trend, as subprime originations have been steadily falling for some time. As shown in **Figure 25**, subprime comprised 22.9% of total automotive originations in the third quarter of 2015 and has gradually decreased since then.

Figure 25: Risk Distribution of Total (Loan and Lease) Auto Originations

Reflects Third Quarter of Each Year



Source: Experian's State of the Automotive Finance Market Quarterly Reports. Includes total (loan and lease) originations on both new and used vehicles.

Experian notes that there are likely several factors influencing the subprime origination trend. At the same time that subprime originations have been declining, the average credit scores for both new and used vehicle loans have increased (see **Figure 27** and **Figure 28**). This is also reflected in Experian's annual *State of Credit* report, which found that the average VantageScore was 688 in 2020, up from 682 in 2019, and the highest average score reported since 2011. Ultimately, this could mean that there are fewer consumers who fall into the subprime tiers.

Figure 26: Average Credit Scores on Total Used Vehicle Originations

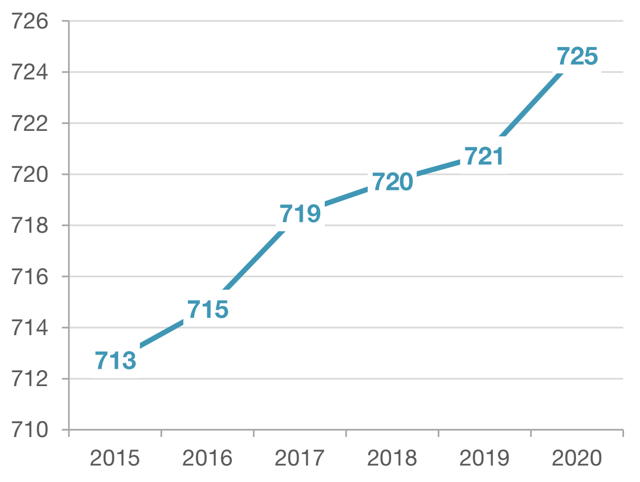
670
665
660
655
650
645
640
635
630

First Quarter
Second Quarter
Third Quarter
Fourth Quarter

2015 2016 2017 2018 2019 2020

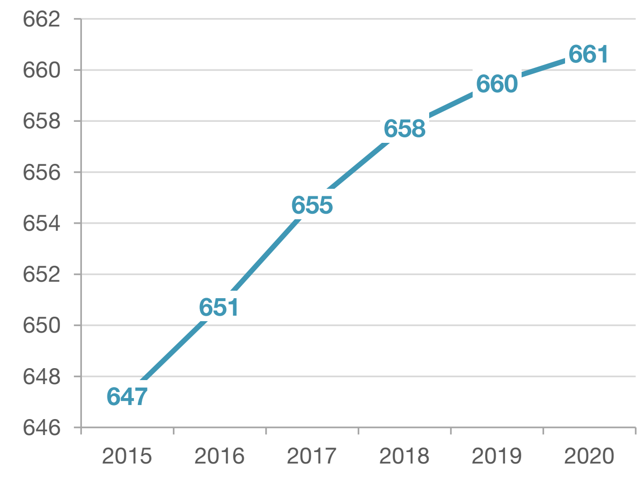
Source: Experian's State of the Automotive Finance Market

Figure 27: Average Credit Scores on Total (Loan and Lease) New Vehicle Originations



Source: Experian's State of the Automotive Finance Market Reports. Each year reflects four quarter average. 2020 includes only the first three quarters.

Figure 28: Average Credit Scores on Total (Loan and Lease) Used Vehicle Originations



Source: Experian's State of the Automotive Finance Market Reports. Each year reflects four quarter average. 2020 includes only the first three quarters.

While there is also evidence of some lenders (noticeably banks) tightening credit standards, it is worth noting that the current economic environment is quite different from that of the financial crisis, as the causes are drastically different. In 2007 and 2008, subprime loans comprised a much larger portion of lenders' portfolios, and subprime borrowers struggled to obtain financing as lenders didn't want to take on additional risk. Experian notes that this is not what we are seeing now; loans are still available for subprime consumers from a variety of lenders.

On the other hand, while financing is still available, Cox Automotive has cited evidence that the loans being offered to subprime borrowers are coming at less attractive terms, including larger down payments and higher interest rates. In fact, Experian data for the first three quarters of 2020 shows that interest rates on used vehicle loans increased (Y/Y) each quarter for deep subprime and during the first two quarters for subprime loans, while the rate on prime and subprime loans fell markedly following the broader interest rate environment. Used vehicle loans comprise the majority of subprime originations, accounting for 95% of deep subprime (credit scores between 300 and 500) originations and 85% of subprime (credit scores between 501 and 600) originations.

Figure 29: Y/Y Change in Rates on Used Vehicle Loans Across Credit Scores

	1Q20	2Q20	3Q20
Deep Subprime (300-500)	0.21%	0.58%	0.24%
Subprime (501-600)	0.22%	0.42%	-0.13%
Near Prime (601-660)	-0.15%	0.03%	-0.21%
Prime (661-780)	-0.53%	-0.49%	-0.49%
Super Prime (781-850)	-0.52%	-0.69%	-0.74%
Total (All Scores)	-0.41%	-0.38%	-0.66%

Source: Experian's State of the Automotive Finance Market Quarterly Reports

Strategic Activity

There was limited strategic activity in the auto finance sector during 2020, although several subprime auto portfolios hit the market in search of buyers and some of the larger private auto finance companies continue to evaluate the public markets. Gallatin Point Capital's acquisition of FIFS Holdings Corp, the parent company of subprime auto finance company First Investors Financial Services Group, in October from Aquiline Capital Partners who took the business private in 2012 in a deal valued at $100 million was the most notable transaction in the sector. In general, the sector has seen a relative lull in activity

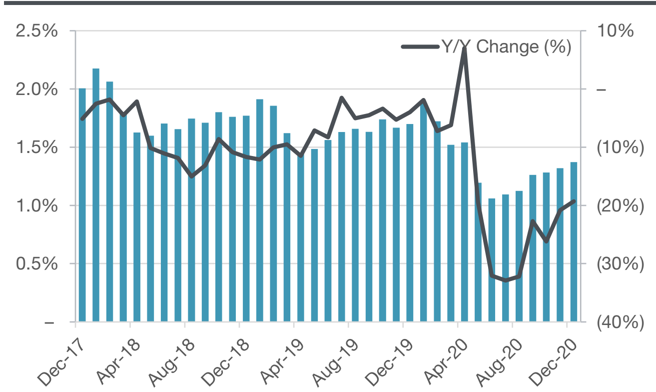
over the last few years as private equity interest has been sparse and public markets have not presented overly compelling valuations.

Credit Resilient, But Vulnerable to Expiring Extensions

Consistent with the broader consumer finance space, credit metrics across the auto finance sector have been resilient given the combination of unprecedented government stimulus dollars and widespread payment relief programs offered by lenders. Credit performance in the auto finance sector has been further bolstered by exceptionally strong used vehicle values due to high demand and low inventories, which has supported lease residual values.

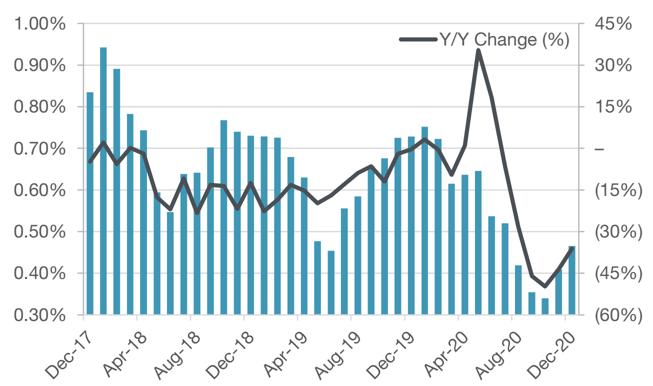
Since the start of the pandemic, delinquent and nonaccrual balances have reached record lows. Of course, due to the significant number of loan extensions and modifications granted to borrowers, these metrics are likely artificially low making it difficult to accurately assess the full impact of the pandemic. Delinquencies and losses have started to rise on a month-over-month basis, but remain well below recent historical levels.

Figure 30: Delinquencies (30+ DPD) on Prime Auto Loan Securitizations



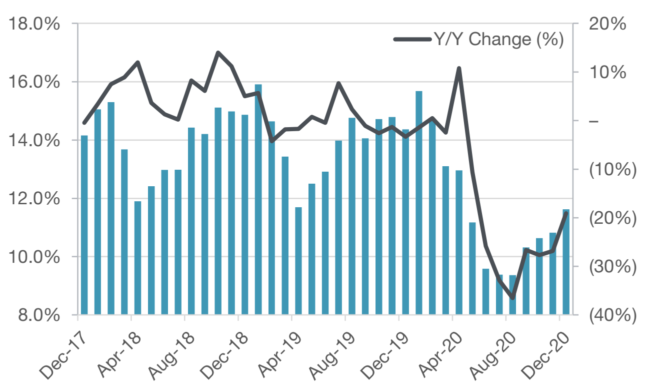
Source: Kroll Bond Rating Agency, KBRA Prime Auto Loan Index.

Figure 31: Annualized Net Losses on Prime Auto Loan Securitizations



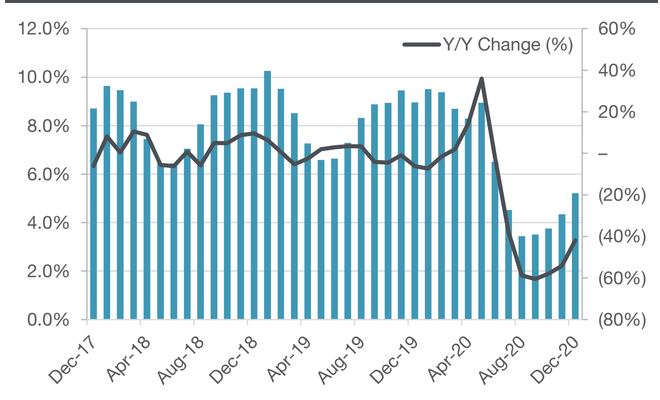
Source: Kroll Bond Rating Agency, KBRA Prime Auto Loan Index.

Figure 32: Delinquencies (30+ DPD) on Nonprime Auto Loan Securitizations



Source: Kroll Bond Rating Agency, KBRA Nonprime Auto Loan Index.

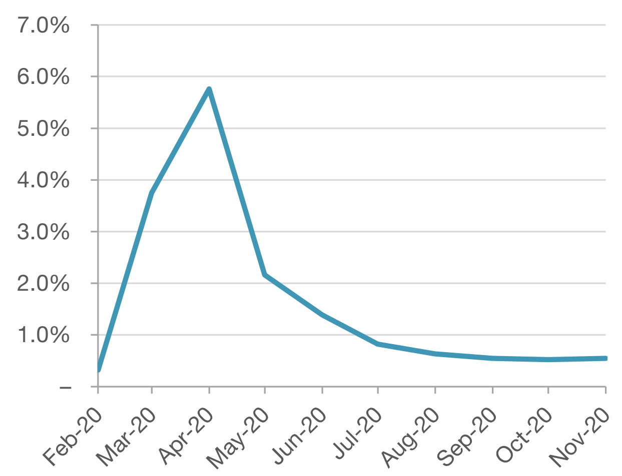
Figure 33: Annualized Net Losses on Nonprime Auto Loan Securitizations



Source: Kroll Bond Rating Agency, KBRA Nonprime Auto Loan Index.

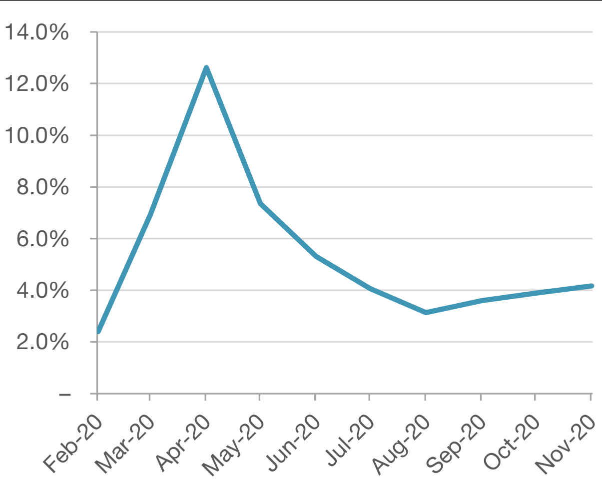
While lenders have not experienced meaningful credit deterioration to date, they remain vulnerable to pressures from expiring payment deferrals and extensions, particularly in the subprime segment. Data from S&P Global Rating's *U.S. Auto Loan ABS Tracker* shows a divergence in extension requests between prime and subprime borrowers. While extensions on prime loans declined for the fifth consecutive month in October, subprime borrowers increased their use of payment relief programs, suggesting that the subprime segment has been disproportionately affected by the slowing economic recovery and reduced unemployment benefits. In November, subprime extensions increased for the third straight month, reaching their highest level since June, while prime extensions rose only slightly, which was the first increase since April. S&P expects loan extension rates to remain elevated until another fiscal relief package is approved and the money reaches the unemployed.

Figure 34: Extensions on Prime Loans



Source: Standard & Poor's U.S. Auto Loan ABS Tracker. Prime index includes all outstanding prime auto loan securitizations, which S&P generally classifies as those backed by loan pools with initial expected cumulative net losses of less than 3.00%, average FICO scores of at least 700, and APRs up to 5.00%.

Figure 35: Extensions on Subprime Loans



Source: Standard & Poor's U.S. Auto Loan ABS Tracker. Includes outstanding subprime auto loan securitizations from both Reg AB II and 144a issuers, including DriveTime Automotive Group's data beginning in April 2020. S&P generally categorizes subprime securitizations as those backed by loan pools with initial expected cumulative net losses of at least 7.50%, average FICO scores of less than 620, and APRs that exceed 14.00%.

Subsector: Installment Lending

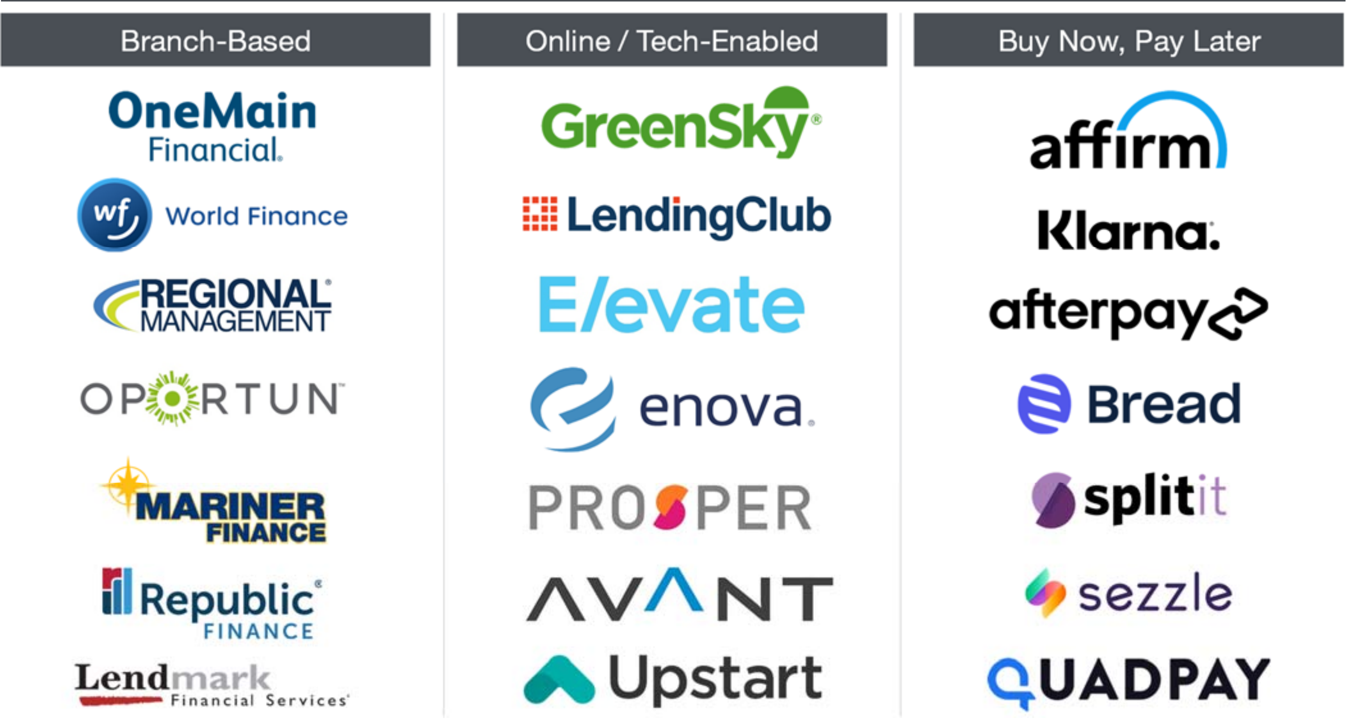
Industry Overview

Installment lending has a multi-decade history within specialty finance that has typically been comprised of several nationally scaled competitors and a wide variety of regionally based lenders. The competitive landscape shifted for a short time in the early 2000s, which ushered in a wave of acquisitions by banks and insurance companies of the larger lenders in the space (a trend that quickly reversed post-crisis as the regulated cohorts of financial services generally spurned all but the highest quality borrowers).

Installment lenders provide prime, near-prime and/or subprime borrowers access to amortizing loans that are generally used for debt consolidation, household repairs/expenses, medical bills, holiday gifts, auto repairs and/or other retail purchases. The core specialty finance segment of the market tends to focus on the near prime and subprime segments, and the lower end of the prime population (credit scores up to 720). Most lenders in this segment of the market offer a variety of products, including unsecured and secured installment loans, open-end credit lines and in select instances, payday-like products (although most have discontinued such products following the post-crisis regulatory crackdown on short-term, high APR financing alternatives). Banks, and some online lenders that operate a marketplace model, tend to be more active in the 720+ credit score segment of the market.

Pre-crisis, the sector was almost entirely a branch-based business. As in other segments within consumer finance, the digital revolution has created a new wave of competitors in the sector that administer their business online, and in certain instances, at the point of sale tied to consumer purchases in a sector termed "buy now, pay later" (BNPL) providers, which we describe later in this report.

Figure 36: U.S. Installment Lending Landscape



Note: Intended to reflect representative, not comprehensive sampling of market participants.

2020 Review

Lenders battened down the hatches in preparation for a wave of recession-driven credit challenges that ultimately never materialized in 2020. However, as we discuss further in this report, the BNPL segment of the market was very active during the year, with six M&A transactions and six strategic financings. Katapult, a non-prime BNPL provider that announced a SPAC merger in December, also provided a significant boost to traditional lender CURO Group Holdings Corp. (formerly known as Speedy Cash), as the lender's approximate 40% stake in Katapult provided $365 million in cash and stock consideration in the new company, before any potential earn-out (CURO's shares traded up 89% the day of the merger announcement).

Outside of the BNPL segment of the market there was a limited amount of activity as traditional branch-based and online lenders alike worked to contend with the quickly deteriorating U.S. economy. In June, online non-prime lender Elevate Credit, Inc. announced it was exiting the U.K. market and put those operations into administration, citing a lack of regulatory clarity and the COVID-19 pandemic. In July, online lender Enova International, Inc. announced its opportunistic acquisition of merchant cash advance and small-business lender OnDeck Capital, Inc., a $90 million transaction (at the time of announcement) completed as OnDeck was contending with material COVID-19 induced stress.

We expect 2021 will bring more strategic activity in the space as well-funded platforms leverage their access to capital to make strategic moves that COVID-19 did not permit in 2020 and explosive growth in BNPL leads to more strategic combinations and IPO activity in that segment of the market, as we've already seen with Affirm. We also expect continued evaluation of new product alternatives, including shifts into prime lending and smaller dollar balance loans, as well as investments into online and digital efforts to counterbalance the evolving preference of borrowers to transact outside of the branch footprint (which we believe will impact all borrower segments and product types over the next decade, not just prime and near-prime millennials).

Buy Now, Pay Later Review

Arguably a blend between the white-hot digital payments sector and traditional consumer lending, these providers have grown in prominence over the last few years on the heels of explosive growth in the use of their delayed payment products. Recent estimates peg global sector volume in the $500 billion to $1 trillion range by 2025, over 10x the current market. Typically, the BNPL option is presented to a consumer online, or in a store, at the point of sale. The consumer either logs in or creates an account digitally while the BNPL provider does a real-time credit check, resulting in a nearly instantaneous credit decision at which point the merchant receives the up-front purchase price from the BNPL provider and the customer concurrently enters into an installment contract which typically lasts up to 12 months. The real-time approval process and increased purchasing power greatly benefits the consumer, and at the same time, increases sales for the merchant.

The BNPL sector competes head to head as a payment alternative to traditional lenders and the strategy bears sincere consideration across the consumer finance landscape, and most notably within installment and credit card lending. Origination channels are fast evolving away from the branch-based, storefront model, and while 2020 didn't necessarily introduce that as a new trend, it certainly accentuated the need for at least an omni-channel approach. Meeting the customer where they want to spend or borrow in an easy, digital format is going to be a more logical and cost-effective strategy for loan originations for a large portion of the borrower population going forward. Having a strategy in recognition of that will benefit lenders over the course of the next decade. We believe currently profitable

branch-based lenders do have a unique advantage, but must be disciplined and invest for the long-term today as consumers reduce usage of branches in preference for an online/digital interface.

As previously mentioned, the BNPL sector saw twelve strategic transactions globally during 2020, split evenly between strategic financings (**Table 5**) and mergers and acquisitions (**Table 6**).

Table 5: 2020 BNPL Strategic Financings

Date Announced	Company / Country	Lead Investors	Amount ($M)	Raised to Date ($M)	Valuation ($M)
9/17/2020	affirm (US)	Durable Capital Partners, GIC	$500	$1,300	–
9/14/2020	Klarna. (Sweden)	Silver Lake, HMI Capital, GIC	$650	$2,100	$10,600
8/5/2020	splitit (US)	Woodson Capital Management	$72	$90	$382 (1)
6/13/2020	sezzle (US)	Institutional Placement	$60	$272	$374 (1)
5/1/2020	afterpay (Australia)	Tencent 腾讯	$251	–	$5,500 (1)
4/9/2020	paidy (Japan)	Itochu, Unusual Ventures	$48	$281	–

Source: Company Filings, Press Releases, Industry Reports.
(1) Reflects market capitalization at or immediately prior to announcement date.

Table 6: 2020 BNPL Mergers & Acquisitions

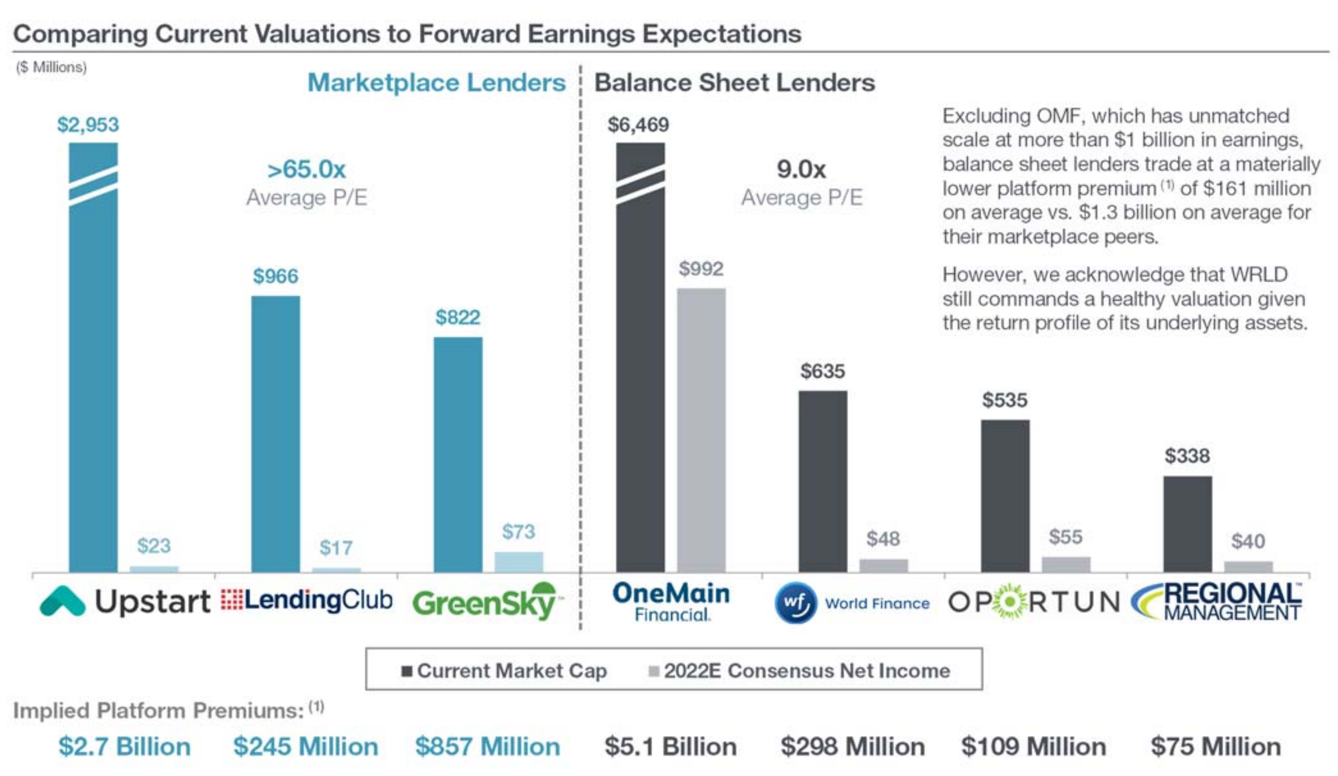
Date Announced	Target / Country	Buyer	Amount ($M)
10/29/2020	Bread (US)	Alliance Data	$450
08/27/2020	empatkali (Indonesia)	afterpay	$2
8/25/2020	Pagantis (Spain)	afterpay	$59
8/9/2020	QuadPay (US)	zip	$403
7/23/2020	FuturePay (US)	NewOak Finance	–
2/12/2020	Moneymour (Italy)	Klarna.	–

Source: Company Filings, Press Releases, Industry Reports.

Driving Enterprise Value: Marketplace vs. Balance Sheet

The traditional finance company model has been under pressure for years as low interest rates pressure ROEs, and therefore, the ability to deliver growth without raising dilutive equity. One of the post-crisis solutions has been a marketplace oriented model, effectively a gain on sale approach to the loan origination business, which is predicated on monetizing the loan at the point of origination, or very shortly thereafter, rather than over the life of it. The strategic underpinning to the model is a view that the lifecycle of a loan fits two separate investor groups: a growth oriented investor who supplies capital to invest in technology and systems to originate and service quality loans and then a value or yield oriented investor base to supply the capital to fund the loans. Marketplace lenders have achieved attractive valuations relative to the scale of their businesses versus many traditional finance companies (see **Figure 37**).

Figure 37: Marketplace vs. Balance Sheet



Source: FactSet, S&P Global Market Intelligence. Market data as of December 31, 2020.
(1) Implied platform premium reflects current market capitalization (as of December 31, 2020) less tangible common equity (as of September 30, 2020).

The fundamental risk to the marketplace model is the take out, which is dependent upon loan buyers showing up throughout cycles to buy loans at a price that compensates the originator for their costs to produce the loan, plus a margin. Scale is critical, the up-front investments required to build proprietary origination channels and support fixed operating costs are substantial and the platforms need to drive considerable volume to generate consistent profitability. There is also a potentially misaligned relationship between the originator, who is paid on volume, and the capital provider, who is paid upon the actual collection of principal and interest. This misalignment has been addressed in a variety of ways, mostly through some form of incentive payment to the originator, but also more practically to

address the biggest fundamental risk in the business described at the beginning of the paragraph: that unhappy loan buyers won't keep buying loans at a profitable price to the originator, or at all.

Lenders don't need to necessarily take one side. Tooling a business to what the public markets are paying for at any point in time is rarely a recipe for long-term success, but rethinking how to maximize the productivity of the platform is worthwhile. There may be opportunities to service existing customers or merchants using an existing platform that doesn't make sense on balance sheet, but may with other funding partners. If this can be done in scale, it can materially enhance profitability and valuation. The recent interest rate reset has only increased demand for high quality loans. We suggest that manufacturers not sit on the sidelines with spare capacity if they can find a productive use for it.

Subsector: Pawn Lending

Introduction

Pawn lending is one of the oldest sources of consumer credit, but, despite growing public interest in pawn shop operations (as evidenced by the popularity of television shows such as "Pawn Stars" and "Hardcore Pawn"), the industry is sparsely researched and often overlooked within the consumer finance ecosystem. Nevertheless, pawn loans are an important lending option for millions of unbanked, underbanked and credit-challenged consumers throughout the United States who depend on them to meet short-term financial needs when traditional forms of credit are inaccessible. According to the National Pawnbrokers Association, pawn stores serve an estimated 30 million customers nationwide.

Pawn shops offer small, non-recourse loans to individuals who provide items of personal property as collateral. The borrower leaves a possession of value, including jewelry, electronics, musical instruments, tools, sporting goods, firearms and more, in exchange for an agreed upon loan amount based on the estimated value of the item. Given its nature, just about anyone can borrow with a pawn loan. The transaction does not require a bank account, income verification or credit check, and does not impact an individual's credit rating. Pawn loans also have a significant advantage in terms of processing speed. Unlike traditional loans, which can take up to weeks to be processed and approved, borrowers can walk into a pawn shop and receive immediate cash in exchange for their collateral.

Pawn shops generate revenue through two distinct channels: pawn lending activities and pawn merchandise sales. Through their lending activities, pawn shops earn fees and service charges on outstanding pawn loan balances. In the United States, pawn loans typically earn between 10% and 25% per month depending on the size of the loan and the state in which the loan is made. Loan terms generally range between 30 and 90 days with an additional grace period of 10 to 60 days depending on local regulations. The size of the loan varies depending on the collateral with pawn shops lending a percentage (we estimate up to 65%) of the anticipated resale value of the collateral. In the United States, these loans are often no more than a couple hundred dollars (according to the National Pawnbrokers Association, the national average loan amount is around $150).

At the end of the loan term, the borrower can repay the loan in full with accrued fees and service charges or forfeit the pawned item. The National Pawnbrokers Association estimates that around 85% of borrowers redeem their loans. In the event that the borrower does not redeem the loan, the pawn shop becomes the owner of the collateral, in which case the recovery of the principal and realization of profit depends on the initial assessment of the collateral value and the pawn shop's ability to sell that collateral in a timely manner through its retail network. Retail sales may also consist of used goods purchased directly from the general public without the use of a pawn loan. On average, margins on pawn merchandise sales have historically ranged between 30% and 40%. As a significant portion of inventory and sales often involve gold and jewelry, profits can be heavily influenced by the market price of gold and diamonds. In some cases, pawn shops also melt certain quantities of non-retailable scrap jewelry and sell the gold, silver and diamonds in the commodities market.

Industry Landscape

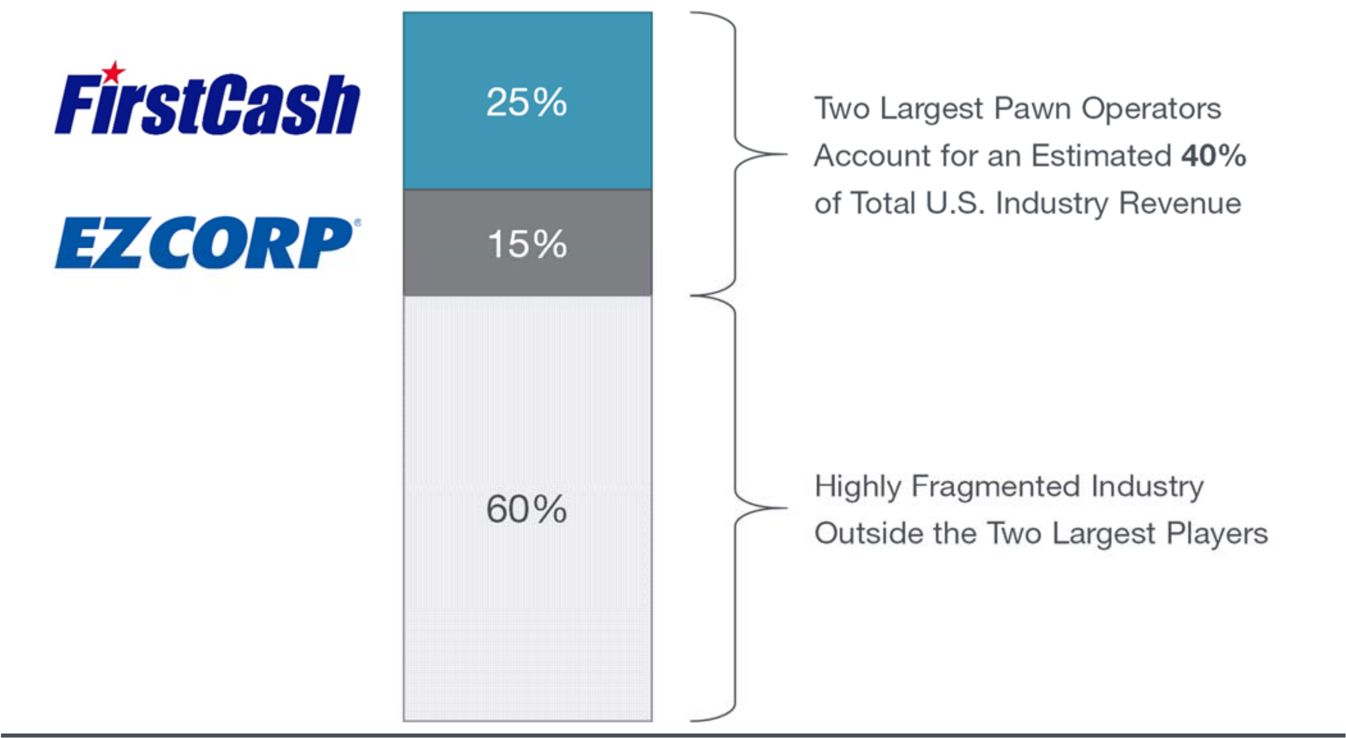
The pawn industry in the United States is well established, with the highest concentration of pawn stores located in the Southeast, Midwest and Southwest regions of the country. The operation of pawn stores is governed primarily by state laws and accordingly, states that maintain regulations most conducive to profitable pawn operations have historically seen the greatest concentration of pawn stores.

FirstCash Inc. (NASDAQ:FCFS) is the largest operator of pawn stores in the United States with more than 1,000 locations across 24 states and the District of Columbia. The company also operates more than 1,700 pawn stores across Latin America including Mexico, Guatemala, El Salvador and Colombia. The second largest operator is EZCorp Inc. (NYSE:EZPW) which owns more than 500 pawn stores throughout the United States and an additional 500 stores across Latin America including Mexico, Guatemala, El Salvador, Honduras and Peru.

Outside of the two largest players, which together account for an estimated 40% of U.S. pawn revenue, the industry, although mature, remains highly fragmented. We estimate that there are between 10,000 and 15,000 pawn stores nationwide, of which most are a family-owned small business and/or part of a local chain (up to five stores) of small independent operators.

The fragmented nature of the broader landscape creates compelling acquisition opportunities for leading pawn operators, like FirstCash and EZCorp, to continue expanding their market share. By purchasing smaller operations, large companies have gained access to new markets with relative ease. Between 2015 and 2019, FirstCash acquired 1,651 stores (906 in the United States and 745 in Latin America), including 815 stores through its merger with Cash America International in 2016. Over that same time period, EZCorp acquired 241 stores (40 in the United States and 201 in Latin America).

Figure 38: U.S. Pawn Landscape



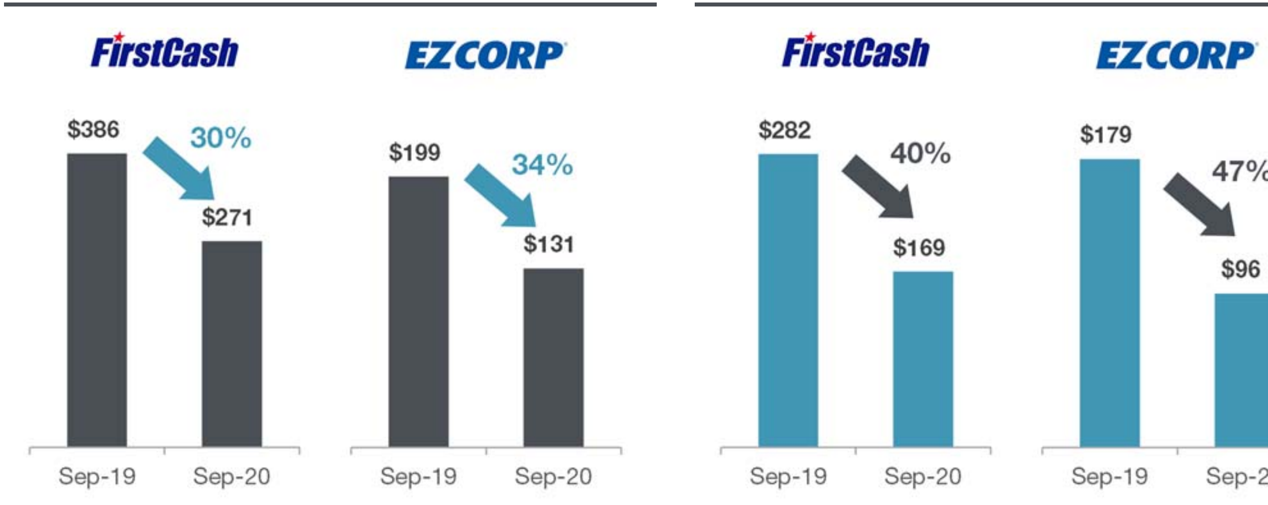
Source: Company Filings, Piper Sandler Estimates.

2020 Review

While most pawn stores were able to remain open as an essential business during widespread shutdowns, pawn operators were impacted by significant changes in consumer spending and borrowing behaviors related to COVID-19. Beginning in mid-March, pawn shops experienced a significant decline in pawn lending activities, including increased redemptions of existing loans and decreased originations of new loans, believed to be the result of the federal economic stimulus in response to the COVID-19 pandemic. Towards the end of the second quarter, pawn loan originations began to recover, although pawn loan balances remain significantly below pre-pandemic levels. The resulting decline in pawn loan fees was somewhat offset by improved merchandise sales which benefited from increased demand for stay-at-home products, such as consumer electronics, tools and sporting goods. Retail sales were further enhanced by federal stimulus dollars, unemployment benefits and lower household discretionary spend, which drove additional demand across most product categories, including jewelry. The strong retail demand experienced at the onset of the pandemic continued through much of the second and third quarter, but lower inventory balances, resulting from both increased merchandise sales and less forfeited merchandise from lower pawn loan balances, also negatively impacted retail sales.

Figure 39: Y/Y Decline in Pawn Loan Balances

Figure 40: Y/Y Decline in Pawn Inventories



Source: Company Filings. Figures presented in USD millions.

Source: Company Filings. Figures presented in USD millions.

Looking ahead, we expect pawn store revenues to remain under pressure in the near term. While we have seen a rebound in new pawn loan originations since the second quarter trough, the current economic environment remains challenging for loan demand, and the incoming round of additional stimulus could further impact demand. Even as pawn loan volumes begin to grow, a lack of inventory will continue to pressure retail sales. The delay in loan forfeitures that drive the majority of pawn shop inventories is, on average, at least 60-90 days after the time of origination. Based on that, we do not expect inventory levels to recover until at least the second quarter of 2021, and even as pawn loan balances and inventories begin to grow, it will likely take several quarters for pawn loan fees and merchandise sales to return to pre-pandemic levels given the inherent lag between assets and related revenue.

While consolidation and scale will continue to benefit platforms in the sector, we believe the space would also benefit from a strategic review of (i) potential long-term implications of the shift towards a more digital and online economy and (ii) how technology investment, including AI and machine learning,

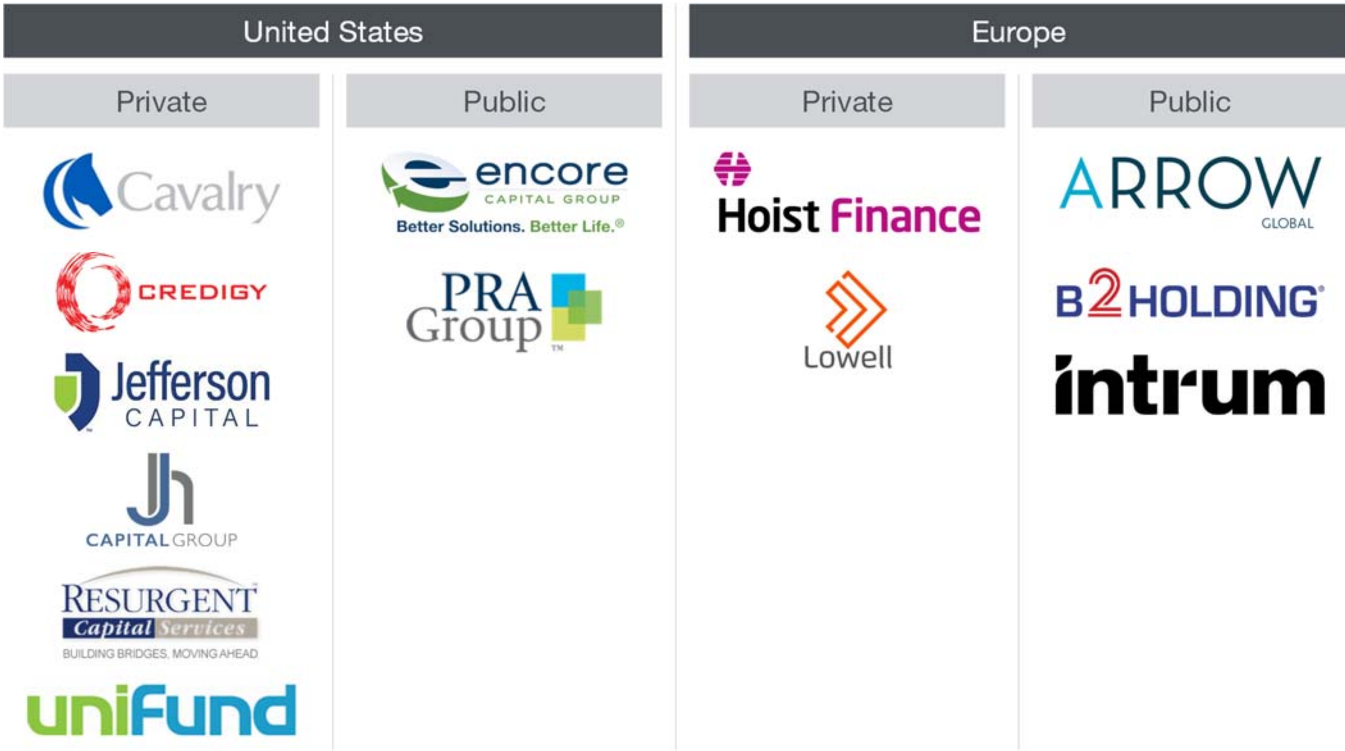
could improve autonomous workflow and decisioning procedures, further enabling scale benefits and improving the profit model. We concede that these dynamics are harder to implement in the pawn lending sector than in any other segment of consumer finance, but these shifting trends across the economy create opportunities for lenders to re-tool their business models for the future of competition, which will likely not just come from other pawn lenders.

Subsector: Debt Collection

Industry Overview

A public victim of Jake Halpern's *Bad Paper: Chasing Debt from Wall Street to the Underworld*, the debt collection industry has a long history in consumer finance and plays an integral role in the credit ecosystem. While the sector is fragmented at the lower end of the market, post-crisis consolidation has resulted in a much smaller number of more sophisticated U.S. and European players. These platforms acquire charged-off receivables from credit card issuers, auto lenders, utilities, telecom companies, student lenders, installment lenders and others, generally at pennies on the dollar, and attempt to generate mid- to high-teens unlevered IRRs by collecting more than the purchase price (net of operating costs). Unlike other verticals across the U.S. specialty finance ecosystem, many scaled players in this space compete globally (primarily in North America and Europe).

Figure 41: Debt Collection Landscape



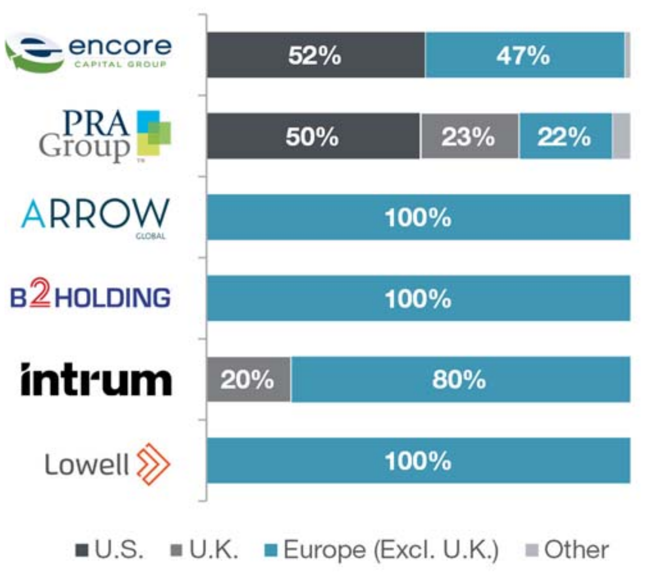
Note: Intended to reflect representative, not comprehensive sampling of market participants.

2020 Review

A countercyclical industry by nature, the onset of COVID-19 laid the groundwork for what most expected would be an unprecedented buying opportunity as increasing levels of consumer leverage built up over the last few years coupled with the largest and fastest increase in unemployment since the Great Depression would saturate the system with charged off accounts. Heretofore, that wave has not materialized as global government stimulus efforts, for which more is underway, allowed consumers to in fact de-leverage causing delinquency rates across most consumer asset classes to decline. However,

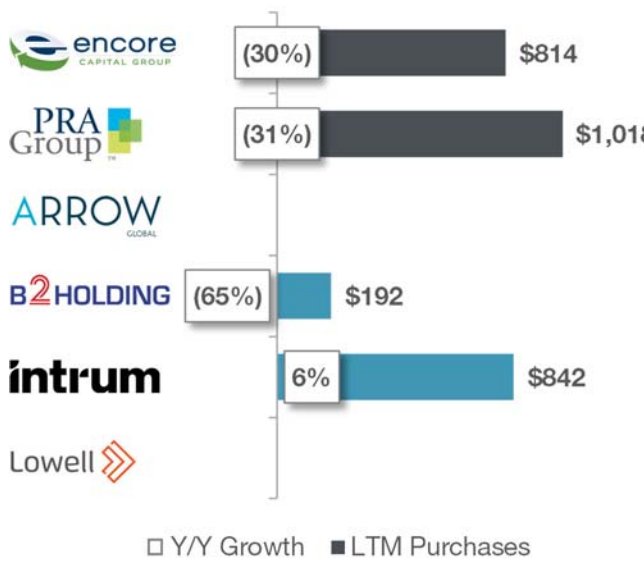
the impact of systematic forbearance programs offered in 2020, and in several cases extended into 2021, will undoubtedly provide a pipeline of investment opportunity that the sector is poised to take advantage of in the coming quarters.

Figure 42: ERC Compositions by Geography



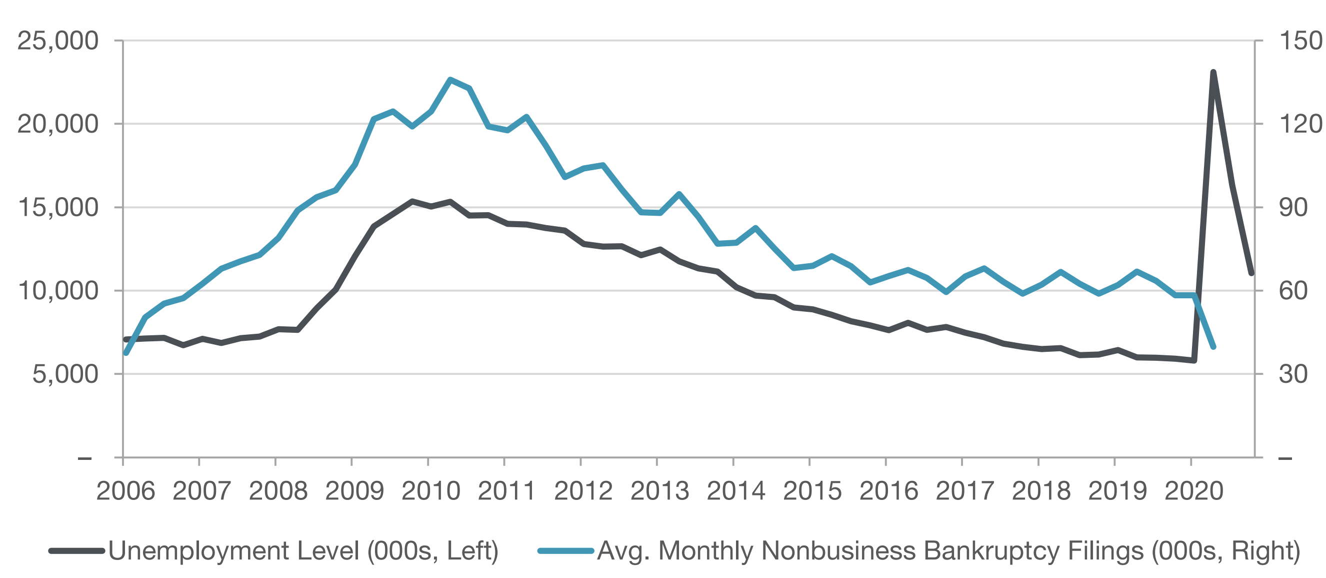
Source: Company Filings. Reflects breakdown of estimated remaining collections as of September 30, 2020.

Figure 43: LTM Purchase Volumes



Source: Company Filings. Total purchase volume (in USD millions) for the twelve months ended September 30, 2020. For comparability purposes, all figures converted from reported currency to USD at the respective prevailing USD exchange rate as of September 30, 2020.

Figure 44: U.S. Unemployment Level and Nonbusiness Bankruptcy Filings



Source: U.S. Bureau of Labor Statistics, Unemployment Level, Federal Reserve Bank of St. Louis and American Bankruptcy Institute.

Corporate Debt Markets Activity

Jefferson Capital's acquisition of Canaccede Financial, which bought them entrance into the Canadian market, was the only notable M&A transaction in the space during 2020. However, it was a very active year for the sector in the U.S. and European corporate debt markets, as issuers cleared out bank lines and simplified funding structures in anticipation of the yet to materialize COVID-19 induced buying opportunity. As we discussed earlier in relation to credit cards, the most recent stimulus package should bridge the U.S. consumer through the widespread adoption of the vaccine, but there is still expected to be at least modest credit fallout, which could present meaningful opportunity for the debt collection sector in 2021 and beyond as lingering effects of the pandemic are uncovered across the economy.

Figure 45: 2020 Global Corporate Debt Issuances Across Debt Collection Industry

Issuer	Month	Amount (Millions)	Security	Maturity	Rate
Encore Capital	December	€ 350	Secured, Floating	2028	E+425
	November	£300	Secured, Fixed	2026	5.375%
	September	€ 415	Secured, Fixed	2025	4.875%
PRA Group	August	$300	Unsecured, Fixed	2025	7.375%
Intrum	July	€ 500	Secured, Fixed	2025	4.875%
Lowell Group	November	€ 600	Secured, Floating	2026	E+625
		€ 740	Secured, Fixed	2025	6.750%
		£400	Secured, Fixed	2025	7.750%

Source: Company Filings, S&P Global Market Intelligence.

Corporate debt should be an important part of the capital structure for all debt collectors, particularly given the present exuberance in the capital markets. We encourage all potential issuers in this sector to get educated on the alternatives and pursue the most efficient path to help bring down overall cost of capital and enable greater buying power in the years to come.

CFPB Issues Final Rule on Disclosures

In December, the CFPB issued a final rule to implement Fair Debt Collection Practices Act requirements regarding certain disclosures for consumers. The final rule, which will be effective November 30, 2021, requires collectors to provide detailed disclosures about the consumer's debt and rights in debt collection, along with information to help them respond.

According to the final rule, before reporting information about the debt to a consumer reporting agency, collectors are required to take specific steps to disclose the existence of a debt and are prohibited from suing or making threats to sue consumers on time-barred debt. It also mandates that collectors wait a

reasonable period to receive notice of un-deliverability before furnishing information to a consumer reporting agency.

Overall, the final ruling had limited impact on the scaled players in the sector. However, while the CFPB has generally struck a more conciliatory tone under the Trump administration, we anticipate it to be rather unlikely that the regulatory environment for the sector improves under the Biden administration, granted it remains too early to tell what specific impacts could be on the table.

Part III

Mortgage Finance Review

Introduction

We bifurcate the residential mortgage finance sector into three groups: nonbank mortgage companies, mortgage REITs and investor loan providers. Nonbank mortgage companies originate and/or service loans that are typically backed or issued by Fannie Mae, Freddie Mac or Ginnie Mae. Some niche lenders focus on other products, such as non-qualifying mortgages, which are generally securitized on a private label basis or sold to banks that hold them in whole loan form. mREITs are pass-through investment vehicles that own mortgage loans and/or securities which are leveraged via a variety of financing markets with the goal of generating a current income stream which is paid out via dividends. For the purposes of this report, we focus on those invested in the residential market, not the commercial real estate market. Investor loan providers lend to commercial-oriented buyers of single family residential properties, either to rehabilitate and then resell the property or rent it out.

Figure 46: U.S. Residential Mortgage Landscape

(1) Source: Inside Mortgage Finance. Reflects top seven nonbank mortgage originators (in order) by volume over the nine months ended September 30, 2020.
(2) Source: S&P Global Market Intelligence. Reflects top seven residential mortgage REITs (in order) by market capitalization as of December 31, 2020.

While we conveniently group these sectors given their collective focus on single family residential housing finance, 2020 delivered a much different experience for each of these groups which we further examine in this report.

Subsector: Nonbank Mortgage Companies

Introduction

The residential mortgage market, at $11 trillion of outstanding debt, represents the largest consumer finance asset class in the U.S. multiple times over. For the last decade, most residential mortgage credit risk has been borne by the government, who directly or indirectly backs over 90% of the market through Fannie Mae, Freddie Mac and Ginnie Mae, quasi-government entities referred to as government sponsored enterprises (GSEs); Ginnie Mae is technically a wholly-owned government corporation rather than a GSE. The GSEs and Ginnie Mae are overseen by the Federal Housing Finance Agency, a governing authority established in response to the subprime mortgage crisis after the entities were bailed out by taxpayers in 2008 in an effort to keep the residential housing market functioning. As such, the vast preponderance of the mortgage market today consists of lenders making loans and selling them to the GSEs, or on an insured basis through Ginnie Mae, and in some instances, servicing them during the life of the loan.

Historically, mortgage lending and servicing had been dominated by banks. Following the financial crisis, and in response to significant reputational damage and legal fines in the banking sector, nonbank mortgage companies began a striking rise, growing their share of volumes from approximately 20% to 30% of total volume between 2000 and 2006 approximately 50% to 65% over the past five years according to data from Inside Mortgage Finance. These lenders have seen a similar, albeit less pronounced, rise in mortgage servicing, now managing over 50% of total outstanding mortgages versus less than 20% on the dawn of the financial crisis, according to data from Inside Mortgage Finance. While nonbank mortgage companies rose to power over the last decade largely by filling a void left by banks pulling back from the market, their ability to sustain their growth and market position has been driven in recent years by quicker adoption of digital capabilities, loan officer preference for nonbanks, better customer service and a variety of other competitive advantages.

Approximately 10% of annual mortgage lending over the last few years has fallen outside the purview of the GSEs and Ginnie Mae. These loans are generally referred to as non-QM loans, which don't meet the standards of a "qualified mortgage" (QM) as defined under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Most of this volume is represented by prime jumbo loans, which are generally mortgages with large down payments to high quality borrowers that are simply too large to be bought by the GSEs or insured by Ginnie Mae. However, there is a rapidly growing non-QM market comprised of loans to self-employed and other borrowers that have funds to make meaningful down payments but don't fully qualify for a GSE or Ginnie Mae loan program (need for bank statements to verify income, elevated debt to income ratios, past credit events, etc.).

The mortgage market is highly fragmented and comprised of both bank and nonbank lenders across different origination channels: retail, wholesale and correspondent. Many lenders participate in multiple channels but most tend to specialize in one. Each channel has its own unique characteristics but is generally defined by how the lender interacts with the end borrower.

Figure 47: Top 20 U.S. Mortgage Originators

Rank	Lender	Type	Market Share	Rank	Lender	Type	Market Share
1	Quicken Loans Inc.	Nonbank	**7.5%**	11	Guaranteed Rate Inc.	Nonbank	**1.8%**
2	Wells Fargo & Company	Bank	**6.0%**	12	Fairway Independent Mortgage	Nonbank	**1.6%**
3	United Wholesale Mortgage	Nonbank	**4.6%**	13	Amerihome Mortgage	Nonbank	**1.6%**
4	PennyMac Financial	Nonbank	**4.5%**	14	Truist	Bank	**1.5%**
5	Chase	Bank	**3.5%**	15	Home Point Financial	Nonbank	**1.4%**
6	Freedom Mortgage Corp.	Nonbank	**3.0%**	16	Mr. Cooper/Nationstar	Nonbank	**1.3%**
7	U.S. Bank Home Mortgage	Bank	**2.3%**	17	Flagstar Bank	Bank	**1.3%**
8	loanDepot.com	Nonbank	**2.3%**	18	NewRez	Nonbank	**1.1%**
9	Caliber Home Loans	Nonbank	**2.0%**	19	Citizens Bank	Bank	**1.1%**
10	Bank of America Home Loans	Bank	**2.0%**	20	Lakeview Loan Servicing	Nonbank	**1.0%**

Source: Inside Mortgage Finance. Based on total origination volume for the nine months ended September 30, 2020.

2020 Review

Aggressive monetary stimulus by the Federal Reserve laid the groundwork for an all-time record in origination volumes during 2020 as nearly the entire $11 trillion U.S. mortgage market became eligible for a refinance, which overlaid upon a system with finite lending capacity drove gain on sale margins similarly towards all-time highs. As a result, 2020 offered an unparalleled record for strategic activity in the space. Four companies announced and/or completed public equity debuts (versus three such transactions over the entire previous decade). Equally, seven different issuers raised $6 billion from the high yield bond markets, posting an all-time record for the space. Topping it off was Intercontinental Exchange, Inc.'s (NYSE:ICE) acquisition of Ellie Mae, a massive services provider to the nonbank mortgage company universe (approximately 70% of Ellie Mae's revenue comes from the space), in a transaction valued at $11 billion. Thoma Bravo had closed on the take private of Ellie Mae just 18 months prior for $3.7 billion, $2.2 billion in equity and the balance in financing, making it one of the most lucrative private equity buyouts ever. ICE had good reason to pay up, as the transaction cemented their leadership in end-to-end electronic workflow solutions for the entire residential mortgage market (which they believe represents a $10 billion revenue opportunity).

All this despite a regulatory landscape that proved almost as volatile as the markets, beginning with no-questions-asked forbearance options for anyone with a GSE or Ginnie Mae loan, an uncertain government commitment to helping nonbanks bridge massive advancing obligations tied to this previously unthinkable forbearance offering and a foreclosure moratorium that will likely be extended to September 2021. While the market, MBS investors and regulators alike worked to sort out whether servicers could bear the liquidity demands from these advancing obligations, scores of borrowers opted into forbearance which according to data from Black Knight peaked at 9% of all mortgages in May (although about half of those in forbearance did continue to pay their mortgages). Then in August, the GSEs announced a new loan level pricing adjustment called the "market condition credit fee in price," which caught most of the market off guard and created a scramble to incorporate the guidance into pricing and evaluate the impact it would have on volumes and profitability. Finally, the Biden victory in November cemented the fate of the long debated GSE privatization efforts, as the new administration

generally favors using the GSEs as a way to promote homeownership and affordability. While the Supreme Court is still reviewing whether President Biden has the right for any reason to replace FHFA director Mark Calabria, a known advocate of GSE-privatization, prior to the end of his term in 2024, GSE-privatization appears all but a pipe dream in the near to medium term. Nevertheless, we believe the shifting political landscape will prove positive for nonbank mortgage companies, and while the foreclosure moratorium will likely be extended from January 2021 to September 2021 as part of the next round of stimulus, its eventual removal will alleviate supply issues in the housing market, further supporting mortgage demand in the next two to three years.

Strong Momentum Going into 2021

Mortgage lenders sit in an enviable position with secular growth drivers in place to support elevated home purchase activity and augment an already robust refinance market going into 2021. Pent up home buying demand, limited supply of homes, high consumer savings rates and record low consumer debt loads all provide ample ammunition for 2021 to be another banner year for originations. The mortgage industry has been a boom and bust sector for decades, generally tied to the direction of interest rates, but these secular growth dynamics will help drive stable growth and outsized industry profitability for at least another 12 to 24 months, in our opinion. Those with leading digital capabilities and technology infrastructures capable of supporting autonomous workflow will have outsized success during this period and will be left in the best position when volumes inevitably decline back to long-term averages.

Figure 48: Record Mortgage Volumes in 2020

($ Trillions)

Year	Purchase	Refinance	Total
2010	0.5	1.2	$1.7
2011	0.5	0.9	$1.4
2012	0.6	1.5	$2.1
2013	0.7	1.1	$1.8
2014	0.8	0.5	$1.3
2015	0.9	0.8	$1.7
2016	1.1	1.0	$2.1
2017	1.1	0.6	$1.7
2018	1.2	0.5	$1.7
2019	1.3	0.9	$2.2
2020E (MBA Outlook)	1.4	2.0	$3.5
2021E (MBA Outlook)	1.5	0.9	$2.5

2010-19 Average: $1.8 Trillion

+95%

Source: Inside Mortgage Finance, Mortgage Bankers Association.

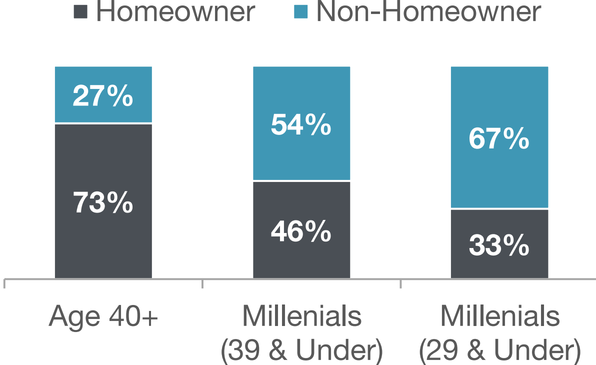
Figure 49: Market Backdrop Continues to Support Strong Performance in Near Term

Refinance Market

60%

Mortgages "In The Money"

Purchase Market



Approximately 60% of conforming, fixed-rate borrowers could save at least 0.75% on their mortgage if we were to see sustained mortgage rates in the 2.8% to 3.0% area.

Nearly 3 out of 4 first time home buyers are millennials. Suburban rebalancing and remote work will only accentuate an ongoing multi-year trend towards increasing homeownership rates in the U.S.

Source: Company Filings, Fannie Mae, Freddie Mac.

We also believe the current political backdrop, while admittedly uncertain for every area of consumer finance, could prove supplementary to the fundamental market growth drivers outlined above. Homeownership has long been a bipartisan goal and President Joe Biden's proposed tax credit of $15,000 for first-time home buyers, who tend to utilize nonbank mortgage companies more often than banks in getting a mortgage, would add firepower to consumer checkbooks that could support a virtuous feedback loop, as new homeowners enter the market and facilitate up-market moves by existing ones.

Needless to say, we are bullish on the prospects for the broader mortgage lending industry going into 2021 and believe this market backdrop will be looked back on for decades as the golden era. However, the industry is building massive capacity to cope with these known trends and with margins at present levels, everyone is profitable. Two things will be critical for executive management teams and their boards to plan for in light of the unprecedented near-term opportunity: (i) technology investment behind digital capabilities and scalable, low-cost operating infrastructures now when profits are available will prove critical and (ii) prudent capacity build-up to cope with the current refinance opportunity must not come at the expense of long-term profitability when volumes do normalize. Hiring people at exorbitant prices works with volumes and margins where they are today but "righting the ship" has always proven more difficult on the other side. These two items will be important to manage in defining who the long-term winners are out of this market.

Lenders Tap the Capital Markets in Unprecedented Fashion

The mortgage banking sector has had mixed success with public equity investors dating back even prior to the financial crisis, which is important to understand contextually in light of the significant public equity markets activity presently taking place. We categorize the mortgage banking sector's experience in the public markets over the two decades leading into 2020 in three phases: (i) subprime mortgage originators, (ii) subprime mortgage servicers and (iii) nonbank mortgage companies.

Figure 50: Timeline of Mortgage Sector in Public Markets

2000-06	2007-09	2010-12	2013-19	2020
Subprime Mortgage Originators	Financial Crisis	Subprime Mortgage Servicers	Nonbank Mortgage Companies	Mortgage Golden Era
Accredited Home Lenders		Nationstar Mortgage	PennyMac Financial Services, Inc.	AmeriHome mortgage
American Home Mortgage Group		Ocwen	Stonegate Mortgage	Caliber Home Loans
Countrywide Financial		Walter Investment Management Corp.	mr. cooper Changing the face of home loans FKA Nationstar Mortgage	Finance of America Mortgage
E-Loan				Guild mortgage
imb IndymacBank				Rocket Companies, Inc.
New Century Financial We Believe in the Entrepreneur				UWM United Wholesale Mortgage

Pre-crisis nonbank mortgage companies were predominantly focused on subprime mortgage lending and generally traded between 5x and 7x forward earnings before they all went out of business in 2007. Mortgage-focused banks (IndyMac and Countrywide) generally traded between 9x and 10x, a premium to their nonbank brethren but still a substantial discount to where diversified banks traded at the time. The performance of the mortgage sector through the financial crisis left a profound resentment in investor appetite for the space.

The post-crisis shift that saw mortgage lending flood out of the traditional banking system created new demands for capital and related investor interest in supplying it, most notably in the subprime mortgage servicing segment where massive advancing obligations were coupled with motivated bank sellers shedding legacy subprime servicing operations. The public equity, high yield bond and leveraged loan markets stepped in to supply billions of dollars of capital to Nationstar Mortgage Holdings, now Mr. Cooper Group Inc. (NASDAQ:COOP), Ocwen Financial Corporation (NYSE:OCN) and Walter Investment Management Corp., who collectively acquired servicing rights on over a half trillion dollars in pre-crisis

originated mortgages. Ultimately, overleverage, regulatory headwinds and business models predicated on growing in a market that continued to shrink drove poor performance, and despite promising returns between 2011 and 2013, ultimately fizzled and left investors with subpar, and in many cases negative, returns.

The brightest spot for investors in the post-crisis nonbank mortgage sector was PennyMac Financial Services, Inc. (NYSE:PFSI), a correspondent mortgage servicer and originator that went public in 2013 and has generated ROEs in excess of 20% in nearly every year since its IPO. Mr. Cooper has also persevered and become the success story amongst the three public, post-crisis subprime mortgage servicers as it continues to build out its lucrative Xome unit, offering another positive data point for investors. Offsetting these successes in part was the debut, challenging performance and eventual sale of Stonegate Mortgage Corporation, a subscale originator and servicer whose earnings were driven by high marks on originated MSR and ultimately was unable to generate sufficient cash to grow the business to scale.

All of this historical context was helpful coming into 2020, where COVID-19 drove a liquidity crisis on hedge positions that nearly sank the nonbank mortgage sector but subsequently resulted in an interest rate rally that drove a refinance boom unparalleled in recent history. The long-anticipated public debut of Rocket Companies, Inc. (NYSE:RKT), which broke through historical valuation constraints on the space and traded reasonably well in the aftermarket, opened a floodgate for other lenders to follow suit. Within two months of Rocket's IPO, United Wholesale Mortgage and Finance of America Equity Capital LLC announced mergers with SPACs and Guild Holdings Company (NYSE:GHLD), Caliber Home Loans and AmeriHome, Inc. all launched traditional IPOs. Guild, which was able to launch ahead of Caliber and AmeriHome, ultimately priced a downsized IPO after a difficult roadshow that saw PennyMac, the primary comparable for investors, decline 12%. Caliber and AmeriHome, which launched their IPOs at the end of the Guild roadshow, experienced an even more challenging backdrop, which ultimately resulted in both issuers postponing their IPOs. 2021 will undoubtedly see other issuers pursue IPOs. Home Point Financial Corporation and loanDepot Inc. have already added to the list of private issuers publicly filing S-1s to kick off the year.

While the public equity markets did experience fatigue in new issue, the high yield bond market all too happily supplied $6 billion of debt to seven issuers in the space, four of which were new to the markets in 2020. We expect the high yield market to be more heavily used to capitalize the sector going forward as it continues to mature and solidify its position in the go-forward mortgage landscape.

Non-QM Sector Update

After years of strong momentum in volumes, particularly for bank statement and high debt to income borrowers, COVID-19 erased years of progress in the non-QM market as the capital markets shut down and cut off funding access for the sector. The impact was particularly acute in the correspondent channel where smaller lenders reliant on aggregators as a takeout were hung with loans on short-term warehouse facilities at the same time they were battling margin calls on their hedge positions related to their more core agency lending businesses, forcing fire sales at, in some cases, as low as 70 cents on the dollar (larger trades from more reputable sellers with better credit to back representations and warranties were generally in the low 90s). For many of these lenders, non-QM was a small part of their broader business and became a big part of the pain they experienced in March. These smaller lenders that were negatively impacted by their non-QM production formed a critical backbone of the momentum in volumes over the last few years, as loan officers were encouraged to expand their customer base in response to wavering refinance volumes. This, in addition to low interest rates and high gain on sale

margins for agency loans, will likely dominate loan officer attention in 2021, further depressing supply of non-QM loans.

The wholesale channel will be a bright spot for the sector in the year to come, as brokers only lost potential income on loans that didn't close rather than out-of-pocket investment dollars as those that formally banked the product did. This channel will face the same headwinds resulting from low rates that the correspondent channel will, but many brokers in this market have niche strategies around non-QM borrowers and the capital markets have enabled lenders to offer relatively attractive coupons at a time where demand for new homes is high, so we expect this channel to regain its footing in 2021.

We believe the non-QM asset class, and mortgage credit in general, remain an attractive place to allocate capital. Robust funding markets and a massive investment landscape will continue to draw investor capital to this sector over time and those that make platform investments today will benefit from a disproportionate share of volumes in the future when the current refinance wave inevitably funnels through the system and loan officers resort back to other products to meet production targets.

Subsector: Residential Mortgage REITs

Introduction

Somewhat of a cottage industry prior to the financial crisis, mREITs proliferated in market presence over the last decade. At $40 billion as of December 31, 2020, the residential mREIT sector aggregate market capitalization is now more than three times what it was in 2007. mREITs differentiate themselves primarily on their investment strategy and the types of assets they allocate capital to. The first post-crisis wave of public mREITs was predominantly focused on levered agency MBS strategies as the yield curve easily facilitated strong ROEs and capital could be deployed into bonds overnight given the depth and liquidity of the market. Beginning in 2011, most mREITs that completed IPOs focused at least in part on non-agency residential mortgage assets as investors eventually fatigued on the number of mREITs solely dedicated to agency MBS (and who consequently were raising secondary capital alongside the new IPO entrants, thus competing with them for capital). Leverage strategies across the sector are dictated by asset allocation, but are typically a mix of short term repurchase debt, secured warehouse financing and/or term securitization, with some REITs also supplementing this asset leverage with corporate leverage.

Figure 51: Residential Mortgage REIT Landscape

Note: Intended to reflect representative, not comprehensive sampling of market participants.

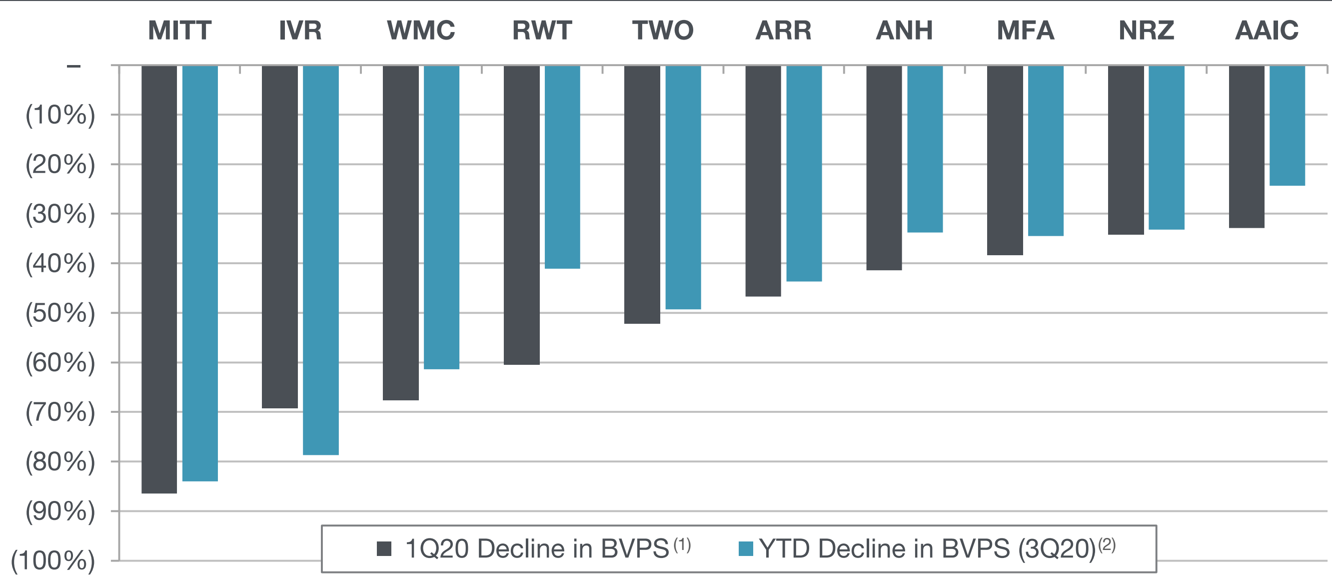
2020 Review

mREITs did not fare well through the liquidity crunch resulting from the early market reaction to COVID-19. Usage of mark-to-market repurchase financing against non-investment grade and unrated residual securitization interests in an effort to boost ROEs and generate returns investors have required of the space proved costly as margin calls overwhelmed access to cash and liquid securities and borrowers generally asked for forbearance from repurchase providers (or pleaded for time and mercy when lenders were trying to collect).

Fortunately, the dislocation was relatively short-lived, but hindsight is 20/20 and most were forced or opted into asset sales at depressed prices and/or costly new financings to repay repurchase providers. In total, 18 issuers saw book value declines of over 20% in their results for the first quarter of 2020, with a number of issuers taking on expensive corporate capital with costs in the mid-teens to low-20s area all-in, considering dilutive warrants.

We expect 2021 to be an active year on the strategic front across the sector. As we outline below, the market is saturated with issuers. Smaller platforms with similar investment strategies to others will need to demonstrate to investors that independence is the right path and many larger players will need to redefine strategies to generate alpha and maintain investor appetite. This was evident in Anworth Asset Mortgage Corporation's sale to Ready Capital Corporation, which was announced in December 2020. We discuss this transaction and broader observations on M&A in the sector in the following pages.

Figure 52: Top 10 mREIT BVPS Reductions from YE 2019 Through Q1 2020 and Q3 2020



Source: S&P Global Market Intelligence. Ordered from left to right based on size of reduction in first quarter.
(1) Reflects change in book value per share from December 31, 2019 through March 31, 2020.
(2) Reflects change in book value per share from December 31, 2019 through September 30, 2020.

M&A Landscape

With the market saturated in capital and most issuers trading below book value, one would expect more sector consolidation. While a handful of transactions have been completed over the past five years, they represent in aggregate less than a quarter of the total issuers trading as of the end of 2020. Misaligned and divergent incentives between management teams, external managers and shareholders have been the root cause for the lack of consolidation. Large management contract termination fees and change of control payments deter deal making as the friction costs involved drive book value deterioration which is difficult for acquirers to sell to shareholders.

There are two primary benefits of M&A in this sector: (i) scale, which improves trading liquidity and access to funding; and (ii) investment strategy, when used as a way to diversify into new asset classes or change capital allocation altogether. Scale has a direct correlation to valuation. The top ten mREITs by market cap have traded at a premium of approximately 12% to the next ten mREITs by market capitalization over the past two years, with the premium consistently closer to 20% prior to the COVID-

19 market dislocation. Investment strategy is harder to evidence, but the number of bandwagon strategies in the market is undeniable and funneling that capital into assets with better relative value is sensible, assuming the M&A partner has something differentiated to offer.

Ready Capital Acquisition of Anworth Mortgage Asset Corporation

On December 7, Ready Capital Corporation (NYSE:RC) announced the acquisition of Anworth Mortgage Asset Corporation (NYSE:ANH) for $302 million, representing a 25% premium to the closing stock price the day prior. The transaction will be funded with a mix of 20% cash and 80% stock, with Ready Capital shareholders owning approximately 76% of the combined company. If shareholders approve the transaction, which is expected to close in the first quarter of 2021, the combination would create a mREIT with a pro forma equity base of over $1 billion, a key scale milestone in the space. For Anworth shareholders, the transaction represented a shift in investment strategy away from agency MBS and more aligned with mREITs in the commercial mortgage segment of the market (a segment of the mREIT space that we do not explicitly cover in this report). For Ready Capital, the transaction was directly geared at increasing scale, as the intention going forward will be to recycle Anworth's capital into Ready Capital's core assets.

Despite a management fee waiver of $4 million for the first year post-closing by Waterfall, Ready Capital's external manager, Ready Capital's shares fell over 10% on the day of announcement, wiping out almost $80 million in market cap and reducing the implied premium to Anworth shareholders to approximately 15% based on the closing price the day of announcement. The negative reaction was driven by the issuance of almost 17 million new Ready Capital shares to Anworth investors at approximately 95% of tangible book value, compared to an implied price to tangible book of 0.96x paid for Anworth before consideration of transaction and other friction costs.

This transaction reflects similar sentiment long observed across M&A in the mREIT sector. For Ready Capital shareholders, greater scale and public flotation should facilitate better valuation longer-term, as we detailed in the previous section. However, the unusual pairing from an asset strategy point of view drove skepticism amongst investors around deal motivations as book value dilution is difficult to stomach. For smaller mREITs with limited differentiation in asset strategies, this transaction demonstrates that there are good alternatives to the status quo worthy of serious consideration. Larger players that already have achieved some scale are willing to transfer some wealth to sellers in an effort to continue on an upward trajectory, an outcome that ultimately benefits both sets of shareholders (albeit the more immediate gratification falls in the camp of the acquired).

Recalibration of Investor Expectations

Funding has always been a vulnerability for the mREIT sector. Despite compression in interest rates over the last decade and a much flatter yield curve than persisted in the immediate years following the financial crisis, investors have continued to demand outsized returns. At 1%, the 10-year UST is presently one-half to one-third of what it has been over the last decade. At the same time, the spread between the 2-year and 10-year UST has declined from over 2% in the years immediately following the financial crisis to almost zero over the last few years. Despite that punitive interest rate backdrop for mREITs, the sectors current dividend yield of 10% to 12% is roughly the same as it was 5-years ago. If investors want resilient issuers that don't go out of business once a decade, they'll need to accept lower returns and allow the sector to fund longer-term and with less leverage.

This concession won't come without cost. mREITs will need to work harder to differentiate their business models and prove that their strategies generate real alpha, net of fees and expenses, for investors over the long term. We expect three primary trends: internalization, scale-building and self-asset-sourcing. Internalization has been pursued by several, particularly larger, mREITs and has been met with strong enthusiasm from investors (as evidenced by Annaly Capital Management, Inc. (NYSE:NLY) during 2020). The scale strategy will be limited and is largely set today. There is a place in the market for MBS-focused strategies but not for the number of issuers that are presently pursuing it. Asset sourcing will be a big focal point going forward, as securities strategies fall out of favor for all but the largest players in preference of manufacturing strategies (assuming the alpha makes its way to investors when costs and fees are factored in). In our view, mREITs will be wise to follow one of those paths. **Table 7** highlights some of the asset classes worthy of consideration for capital deployment. We would caution mREITs to be prudent in financing strategies tied to any such extensions of the investment strategy into non-agency asset classes, with reliance on match-funded, term securitization and without the use of repurchase financing on any retained residual interests being most advisable (even if the impact on ROEs must be explained to shareholders).

Table 7: Universe of Investable Alternative Mortgage Assets

Core Non-QM
Fix-and-Flip
Mortgage Servicing Rights
Multifamily
Prime Jumbo
Single Family Rental
Residential Ground-Up Construction

Note: Intended to reflect representative, not comprehensive sampling of investable asset classes.

Specific Board Room Topics for mREITs

As we've previously highlighted, in our opinion this sector more than any in specialty finance has explaining to do to shareholders. Misaligned incentives, poor performance, and too many "bandwagon" strategies leave the space ripe for consolidation and the companies within it in need of a more clearly defined strategic vision. We highlight some key questions every board should be explicitly asking its executive management team in an effort to redefine strategies and make objective decisions around the best way to maximize long-term shareholder value.

Mortgage REIT Board Room Topics and Questions

Capital Structure, Funding and Liquidity Strategies

- Have we explored and/or utilized term funding options to augment short-term, low-cost repurchase financing strategies?
- Can we successfully communicate a funding strategy to the market that may impair current period ROE in the spirit of generating more sustainable long-term returns?

Target Leverage and Return on Equity

- Do we still need to generate double digit ROEs in a zero interest rate and flat yield curve environment?
- How do we manage what is practical with the apparent cost of capital for the space?

Differentiation

- Do we offer a sufficiently differentiated value proposition to investors (namely in scale, investment strategy and/or asset sourcing)?

Asset Sourcing

- Are we able to generate risk-adjusted alpha for investors by accessing assets on more of a wholesale basis?
- Should mREITs own or strategically partner with originators and can it be done efficiently?

Consolidation or Internalization

- Could a sale or merger drive better value for shareholders vs. status quo strategic plan?
- Alternatively, would an internal management structure improve value for shareholders?

Subsector: Investor Loan Providers

Investor loan providers service a massive and long-standing marketplace comprised of professional and amateur investors and developers operating in both urban and suburban markets across the United States. Collateral types are largely residential in nature, including single-family homes (1 unit) and other single-family properties (2-4 units) as well as small multi-family properties (generally 5-19 units in larger ticket geographies and up to 50 units in smaller ticket geographies). The market also includes small mixed-use and other commercial properties such as office buildings, strip retail centers and warehouses, among others.

Investment approaches can largely be bifurcated into two primary segments: (i) transactional fix-and-flip and (ii) buy-and-hold rental portfolios. However, there is often overlap between the two, with many investors evolving from flipping single-family homes to more diversified strategies that employ both approaches. For example, many investors buy and rehab properties and then make the decision to sell / flip or hold / rent depending on market conditions and in the context of their own liquidity position and broader portfolio strategy. In addition, flipping strategies can range from low-intensity cosmetic to medium-intensity value add rehabilitation to high-intensity ground-up construction projects. Similarly, rental strategies can range from 1-2 property “mom and pop” investors to sophisticated investors with portfolios ranging from 10 to more than 100 properties.

Despite a wave of institutionalization post-crisis, the financing markets for these investors and properties remain highly fragmented, with the exception of stabilized small commercial and multi-family properties, which are largely dominated by commercial banks and GSE multi-family financing programs. Scaled national nonbank lenders represent only a fraction of the fix-and-flip and rental finance markets, with many investors buying and/or holding properties in cash or relying on local private hard-money lenders. Historically, less than 50% of fix-and-flip and single-family rental properties have been financed with a recorded mortgage at the time of purchase according to data from ATTOM Data Solutions and John Burns Real Estate Consulting, respectively. The actual level of financing is higher due to refinancing activity post-acquisition, but these purchase statistics are telling with respect to the fragmentation of these markets.

Other than Goldman Sachs’ 2018 acquisition of Genesis Capital LLC and one other undisclosed transaction that occurred in December 2020, bank participation in these asset classes has been selective and largely localized with community and regional banks. However, a return to a near zero interest rate environment and the resiliency and performance of these asset classes could spur increased appetite for fix-and-flip and/or rental loans. In addition to mid-to-high single digit yield lending opportunities, professional real estate investors and developers tend to have an attractive customer profile for banks, presenting deposit capture and other cross-sell opportunities.

There is a diverse landscape of nonbank lenders (see **Figure 53**) serving the fix-and-flip and rental finance markets, including a range of origination channels (e.g., direct/retail, correspondent/wholesale and broker) and financing strategies (e.g., bank/warehouse lines, flow sales and securitization).

Figure 53: Investor Real Estate Loan Landscape

Note: Intended to reflect representative, not comprehensive sampling of market participants.

2020 Review

The year started strong with the initial public offering of Velocity Financial Inc. (NYSE:VEL) in mid-January. Velocity's strength and growth profile in single-family rental and small commercial markets were well received by analysts and investors alike, with the IPO pricing above book value and at approximately 8x 2020E earnings. However, Velocity and its balance sheet-based investor loan competitors faced the same warehouse line and securitization liquidity crunch that dislocated the mREITs at the onset of COVID-19.

Moreover, many of the other "capital light" originators relied on the mREIT sector and other private credit managers to purchase new loans on a flow basis in those same warehouse and securitization financing markets, further exacerbating the void of capital in the space. As a result, and combined with general COVID-19 related caution, origination volumes fell dramatically, and in many cases to zero, in March and April. By May, markets had stabilized and platforms with access to capital restarted the origination engine, but with volumes governed by a combination of tightened credit, reduced housing supply turnover and, in many cases, more tepid borrower demand.

As the industry progressed through the third quarter, financing and housing markets continued to improve, and credit performance remained stable, allowing many originators to begin to return to volumes and/or run rates at or near pre-pandemic levels. It should be noted that, while the current lack of inventory is providing a tailwind to the housing market (and thus collateral values and credit performance for these lenders) amidst these uncertain times, it is also a potential headwind to volumes that may constrain near-term growth above pre-pandemic levels in some markets. According to data from the National Association of Realtors, housing inventory fell to 1.9 months of supply, totaling 1.1 million units, in December 2020; both figures marked new historic lows.

However, there remains a general sense of optimism amongst lenders, a sentiment we share, and the fourth quarter brought signs of meaningful strategic activity in the space. A consortium led by Pretium Partners and Ares Management announced a $2.5 billion take-private acquisition of SFR REIT Front Yard Residential, diversified mortgage lender Finance of America announced its intention to go public via a $1.9 billion SPAC merger with Replay Acquisition Corp., and fix-and-flip lender LendingHome Corporation closed a $75 million growth capital raise from Benefit Street Partners. As we explore in further detail below, we expect strategic activity, particularly as it relates to forming and securing a viable permanent financing strategy, to remain a key theme in fix-and-flip and SFR finance in 2021.

Fix-and-Flip and SFR Are Here to Stay

Despite uncertainty and a general economic slowdown from COVID-19, fix-and-flip and rental properties are permanent and predictable pillars of the $25+ trillion U.S. housing market that will rebound and persist in 2021 and beyond. Since 2000, fix-and-flip has consistently represented approximately 5-7% of U.S. home sales, including through the financial crisis and through 2020 to date, largely driven by an aging housing stock and growing deferred maintenance balance and end-user demand for refurbished or new properties, which many home buyers lack the time and/or resources to pursue (see **Figure 54**). Since 1965, approximately 35% of the U.S. housing stock has been consistently rented, a long-term trend that is buoyed by continued household formation and an increasing propensity among those new households, as well as a desire by many to exit urban areas in a post-pandemic world (see **Figure 55**).

Figure 54: Historical U.S. Fix-and-Flip Volume

Source: ATTOM Data Solutions.

Figure 55: Historical U.S. Rentership Rate

Source: U.S. Census Bureau. Data as of September 30, 2020. Reflects inverse of published U.S. homeownership rate.

Balance Sheets Are Winning

As origination volumes are recovering, many lenders are evaluating strategic alternatives in the wake of the COVID-19 dislocation and continued cost of capital advantages held by a handful of leading balance sheet-based lenders, largely those with access to the growing institutional securitization market. LendingHome is one such lender, and even it strengthened its balance sheet with Benefit Street's support to ensure near- and improve long-term competitiveness with its other institutionally-backed competitors: Anchor Loans (Wafra Capital Partners), Finance of America (Blackstone/SPAC IPO), Genesis (Goldman Sachs), and Toorak Capital Partners (KKR).

While traditional M&A activity is uncommon in this space, expect lenders, particularly those that have historically relied on flow sales to fund volume, to reevaluate their capital footings and long-term financing strategies, including partnering with a competitor or identifying capital partners to establish a balance sheet. As we explored earlier, there is evidence that a flow sale or marketplace model is a viable alternative for funding assets and creating enterprise value in larger, more homogenous markets such as consumer finance, which also has the benefit of generally higher absolute yields. The same is also arguably true for SFR and other longer duration and more homogenous rental assets. For fix-and-flip and other more bespoke investor loan machinations, however, the price compression being driven by the evolution of the securitization market and rise of the larger institutional balance sheet-based lenders is putting significant pressure on the flow sale model, as fix-and-flip loan buyers tend to have minimum absolute yield and dollar return thresholds given the short, generally six- to twelve-month duration of these assets. We acknowledge the presence of more bespoke and often bilateral securitization alternatives available to flow sellers but see little, if any, cost of capital advantage vis-à-vis traditional whole loan sales executed on a pass-through spread basis. As a result, the flow-based lenders have the choice to either (i) find a capital partner or (ii) move into more niche parts of the market and/or experience meaningful compression to gain on sale margins and/or pass-through spreads, neither of which is particularly accretive to enterprise value.

Part IV

Commercial Finance Review

Introduction

Commercial finance is a broad, multi-trillion dollar annual marketplace within specialty finance and one that has ties across the financial services spectrum: banks, asset management, insurance, and FinTech (see **Figure 63**). As we explore below, a combination of consolidation and competition from these other sectors has created a void of scaled, independent commercial finance companies. Banks have historically and will continue to control the majority of the commercial finance landscape and have driven much of the aforementioned consolidation. BDCs have also traditionally been active participants, and, as of late, more active acquirers. Asset managers are playing an increasing role following a surge of private credit managers with direct lending capabilities to fund BDCs and other investment vehicles (according to data from Preqin, the number of active private debt fund managers in North American has grown to over 1,000 as of December 31, 2020). As previously highlighted in this report, insurance companies are strategically partnering with and providing a significant amount of capital to those credit managers, with Athene and Security Benefit also directly owning large commercial lenders in MidCap and Stonebriar, respectively. FinTech companies have also begun to emerge post-crisis, bringing their underbanked consumer philosophy to underbanked small businesses.

Commercial finance can generally be segmented into secured and quasi-secured financing across asset-based lending, equipment leasing and finance, factoring, cash flow and leveraged lending, securitization and supply chain (purchase order, supplier and inventory) finance sub-verticals (see **Figure 56**). Commercial finance also includes adjacent niche verticals such as venture and life sciences, healthcare and specialty real estate lending, as well as the merchant cash advance and small- and medium-sized business finance niches within the supply chain finance vertical where much of the FinTech activity has centered.

Figure 56: Commercial Finance Market Sizing by Estimated Annual Volume ($B)

Cash Flow & Leveraged Lending	Equipment Leasing & Finance	Supply Chain Finance	Asset-Based Lending	Securitization	Factoring
>$2,000	>$1,000	>$400	>$150	>$125	>$100

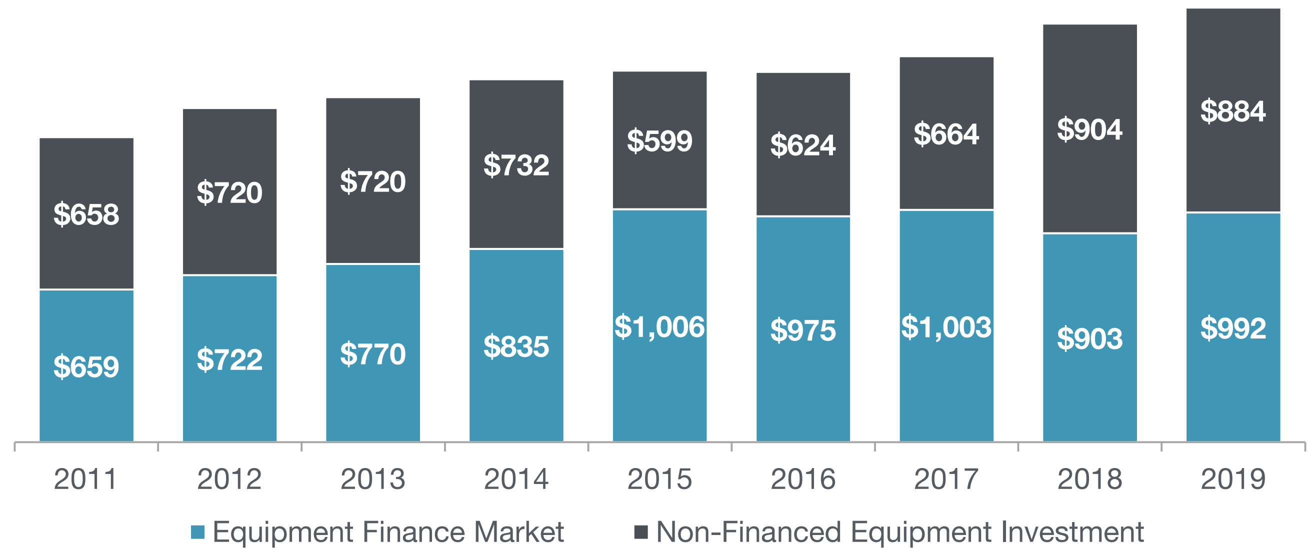
Source: 2019 Secured Finance Market Sizing and Impact Study (Secured Finance Network), Equipment Leasing & Finance Foundation, Refinitiv LPC.

Below we explore equipment leasing and finance and asset-based lending, two large and discrete markets most closely aligned with traditional balance sheet specialty finance companies.

Equipment Leasing and Finance

At $1 trillion in annual volume according to the Equipment Leasing and Finance Association, equipment leasing and finance is one of the largest and most notable sub-verticals within the U.S. commercial finance landscape. Equipment finance solutions are valuable components of business' overall financing strategies, allowing them to finance investments to preserve capital and/or debt capacity on ABL and other commercial facilities. As such, equipment finance volumes are generally aligned with equipment and software investment by businesses and thus GDP growth and the health of the broader economy, with the propensity to finance also influenced by interest rates.

Figure 57: Equipment Finance Annual Market Size ($B)



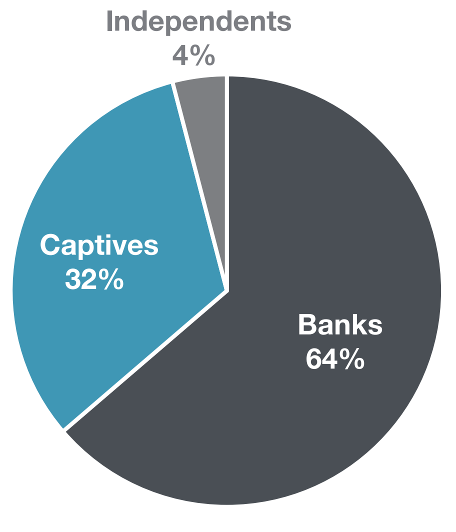
Source: Equipment Leasing & Finance Foundation, Keybridge LLC, U.S. Bureau of Economic Analysis.

When excluding "large-ticket" leasing for aircraft, container and rail assets, equipment finance can be viewed into two primary transaction sizing segments: (i) "small-ticket" transactions of less than $250,000, including "micro-ticket" below $25,000, and (ii) "middle-ticket" transactions between $250,000 and $5,000,000. Small-ticket transactions include computers, copiers, fax machines, network hardware and other office and technology equipment. Middle-ticket transactions include "yellow iron" construction equipment, transportation assets (e.g., buses and motor coaches, trucks, trailers, etc.) and waste equipment, among other asset classes, serving a wide range of end-users and sectors across the economy. Together, the small- and middle-ticket segments represent approximately 80% of equipment finance activity according to data from the ELFA.

Market participants can similarly be segmented into three primary lessor types: (i) banks, (ii) captives and (iii) independents. Large banks such as Bank of America and Wells Fargo have an inherent cost of funds advantage and tighter, regulatory-driven credit standards that naturally orient them towards larger transactions and larger and higher credit quality customers through direct and vendor channels, whereas select community and regional banks such as Huntington Bancshares Inc. (NASDAQ:HBAN), Regions, Sterling Bancorp (NYSE:STL) and Umpqua Holdings Corp. (NASDAQ:UMPQ) have proven more nimble down ticket sizes and customer profiles, including acquiring independents in search of

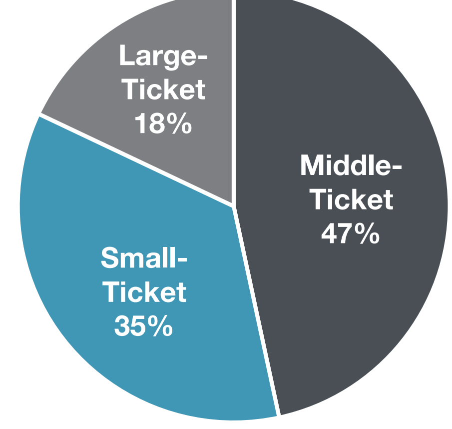
higher yields post-crisis. Captives such as John Deere Financial, Caterpillar Financial and IBM Global Financing are financing affiliates of original equipment manufacturers that primarily bundle equipment and financing at the point-of-sale and benefit from their parents' competitive funding cost allocations and intrinsic knowledge of the collateral when setting residual values and overall lease terms. The remaining independents, such as Commercial Credit Group and GreatAmerica, are themselves and as a whole smaller than banks and captives but are generally more dynamic models with an ability to serve a wider range of customers and channels, including brokers, and compete on flexibility and service versus pricing.

Figure 58: Equipment Finance Market: Net Business Volume By Lessor Type



Source: ELFA 2020 Survey of Equipment Finance Activity. Reflects composition of net business volume, based on data submitted by survey participants, by lessor type for the year ended December 31, 2019.

Figure 59: Equipment Finance Market: Net Business Volume By Market Segment



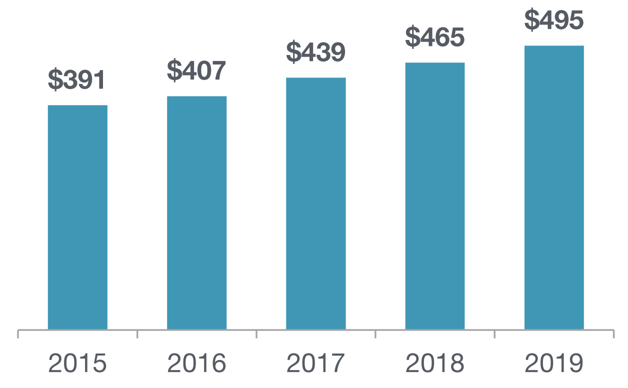
Source: ELFA 2020 Survey of Equipment Finance Activity. Reflects composition of net business volume, based on data submitted by survey participants, by market segment for the year ended December 31, 2019.

Asset-Based Lending

ABL has historically been a lesser accepted form of commercial financing and somewhat associated with distressed, non-cash flow generating borrowers, but has matured and grown into an almost $500 billion market in the U.S. according to the Secured Finance Network. ABL revolvers are primarily secured by receivables and/or inventory and have become increasingly utilized by businesses, particularly in the middle market, to fund not only working capital but also organic and inorganic growth as well as a refinancing alternative for other debt. Given its defensive structure and independence from current period cash flow generation, ABL is a full-cycle product that represents approximately 10% of leveraged lending across cycles and as high as almost 20% as the market rotates towards security in periods of distress according to data from Refinitiv LPC.

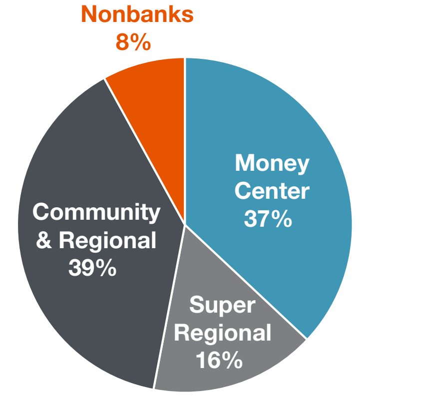
The ABL market is largely controlled by Bank of America, JPMorgan Chase and Wells Fargo, as well as super regional banks such as PNC Financial Services Group Inc. (NYSE:PNC), Truist Financial Corp. (NYSE:TFC) and U.S. Bancorp (NYSE:USB), which dominate the largely syndicated upper end of the market at or above $25-50 million facility sizes. Nonbanks, however, remain a vital component of the middle market segment and overall ABL market at almost $40 billion or approximately 8% of commitments. Nonbank participants include BDCs, many of which operate via distinct portfolio companies such as Solar Senior Capital Ltd. (NASDAQ:SUNS) via North Mill Capital and Owl Rock Capital Corp. (NYSE:ORCC) via Wingspire Capital, as well as other independent finance companies. Many of these other nonbanks have similar institutional backing, including BDC affiliations, from prominent credit managers. Examples include Ares Commercial Finance backed by Ares Management Corp. (NYSE:ARES) and its BDC affiliate Ares Capital Corp. (NASDAQ:ARCC) and MidCap Financial backed by Apollo Global Management, Inc. (NYSE:APO) and its BDC and insurance affiliates Apollo Investment Corp. (NASDAQ:AINV) and Athene, respectively. Similar to equipment finance, there is also a select group of community and regional banks, including Cadence Bancorp. (NYSE:CADE), Sterling and UMB Financial Corp. (NASDAQ:UMBF), that have built and/or acquired more nimble nonbank-like ABL platforms within their commercial bank infrastructure to compete more directly with nonbanks in the ABL middle market.

Figure 60: Asset-Based Lending Market Size: Total Asset-Based Lending Commitments ($B)



Source: Refinitiv LPC, Secured Finance Network.

Figure 61: Asset-Based Lending Market Composition: Commitments by Lender Type



Source: Refinitiv LPC, Secured Finance Network. Money center banks include banks with total assets greater than $500 billion. Super regional banks include banks with total assets between $250 and $500 billion. Community and regional banks include banks with total assets less than $250 billion.

Year-End Review

The equipment finance market was robust in the first quarter of 2020, with new business volume, as measured by the ELFA's Monthly Leasing and Finance Index, growing 17% from the first quarter of 2019, and Regions announcing its acquisition of leading independent lessor Ascentium Capital in late February. By the second quarter, Regions had closed the Ascentium transaction, but the effects of COVID-19 had significantly diminished economic growth and new equipment and software investment, with ELFA data indicating new volumes down 14% from the second quarter of 2019. As we moved into the back half of the year, equipment and software investment experienced an unprecedented rebound in-line with the broader recovery and, through November, ELFA data indicates year-to-date volumes down only 6% Y/Y. November also saw a return of meaningful strategic activity with BDC Solar Capital Ltd. (NASDAQ:SLRC) announcing an approximately $216 million investment to acquire a majority stake in Kingsbridge Holdings LLC, a leading independent lessor of information technology, industrial, healthcare and commercial essential-use equipment.

Conversely, originations of new credit commitments in the ABL market, as measured by the Secured Finance Network's Quarterly Asset-Based Lending Indices, were and continue to be more suppressed by COVID-19's impact on the economy, particularly given continued weakness in the retail trade and wholesale trade sectors that traditionally account for a significant portion of overall ABL activity. Through the third quarter, new commitments are down almost 30% Y/Y. Total committed credit lines, however, have grown steadily over the course of the year and are up approximately 5% Y/Y, and credit line utilization spiked to over 50% in the first quarter according to the same dataset, highlighting the resilience and value of ABL facilities to borrowers in time of stress. While utilization rates fell in the second and third quarters, we attribute this to the same conservatism that has led U.S. companies to hold historic cash levels and expect a rise in new commitments and utilization rates as most companies grow with a recovering economy and others turn to the ABL market as a viable alternative in restructuring and turnaround situations.

Equipment and ABL Tailwinds

The commercial finance sector has historically ebbed and flowed between cash flow-based structures (e.g., traditional C&I and leverage lending) and collateral-based structures (e.g., equipment finance and ABL) as preferences and/or financial conditions evolve. We believe we are seeing and will continue to see such a rotation as companies continue to utilize and/or turn to equipment finance and ABL structures amidst the fallout of the COVID-19 pandemic. Companies will continue to borrow given the low interest rate environment and these structures are tailor made to balance growth and investment with a prudent desire to maintain liquidity and avoid cash flow-based covenant packages in recovering but still uncertain times.

Whereas the ABL market will benefit more so from companies most adversely impacted by COVID-19, the equipment finance market should benefit from a generally reemerging economy with positive overall GDP growth and investment trends following a sharp recovery in the third quarter of 2020. Equipment and software investment growth outpaced overall GDP growth in 2020 as companies evolved and invested in response to COVID-19 and is projected to remain positive in 2021, with notable momentum around construction as demand for single-family homes surges, technology as the workforce shifts remote and transportation assets with the substantial rise in online sales. Widespread adoption of a

vaccine should further these tailwinds and provide much needed relief to other industries such as travel, retail and restaurants.

Figure 62: Equipment Finance Drivers: GDP Growth and E&S Investment

Source: Equipment Leasing & Finance Foundation, Keybridge LLC, U.S. Bureau of Economic Analysis. Seasonally adjusted annualized rates.

Competition Driving Consolidation and Evolution

Banks generally remain in pole position across the commercial finance landscape but have been forced to rethink and adapt their appetite and approach to the sector amidst heightened regulation and the well-publicized proliferation of nonbank platforms backed by BDCs and credit managers over the past decade, which have been further enabled by a robust ABS financing market. We believe these factors had banks at a critical turning point and nonbanks poised to take more share even prior to the onset of COVID-19 and the resulting need for more flexible capital amidst uncertain times. We could see banks pursue a number of paths ranging from a pull back or outright exit, to partnership or joint venture models where they serve a bank customer with a nonbank's capital, to further acquisitions of banks and/or nonbanks with differentiated asset generation capabilities. Regardless, we see opportunity and change ahead for banks and nonbanks alike, with nonbanks potentially further consolidating to fill voids left by banks and a potential return of the capital and independent platform formation cycle experienced amidst the exodus of bank talent and leadership through and following the financial crisis.

Disappearance of the C-Corp Commercial Finance Company

The previously mentioned post-crisis cycle had temporarily helped to fill a void that has grown amidst the consolidation and evolution of the past two plus decades: a lack of scaled independent commercial finance companies. In the late 1990s and early 2000s, the landscape included large commercial finance companies such as Associates First Capital Corp., CIT Group Inc., GE Capital Corporation, Heller Financial, Inc. and Newcourt Credit Group, Inc., all of which were eventually absorbed by or into the banking system. The crisis and post-crisis eras saw the rise and consolidation of smaller, yet still notable

platforms such as Ascentium, Commercial Credit Group (CCG), Financial Federal Corp., Financial Pacific Leasing LLC, GreatAmerica, LEAF Commercial Capital, Inc., Marlin Business Services Corp. (NASDAQ:MRLN), MidCap, Navitas Credit Corp., NewStar Financial, Inc., NXT Capital, LLC, Oxford Finance LLC and Tygris Commercial Finance Group, Inc., among others, and in Canada, Element Financial Corporation and then its successor entities Element Fleet Management Corp. (TSX:EFN) and ECN Capital Corp. (TSX:ECN).

At the time of this report, however, only CCG, GreatAmerica, Marlin, Oxford and the Element companies remain independent. The others identified above, in addition to countless more, were again absorbed by the banking system or caught in the wave of BDC and other nonbank capital entering the space in recent years. Using ELFA equipment finance data as a means of quantifying this trend, independents' share of annual new business volume fell from over 50% in 1999 to approximately 20% in 2009 to less than 5% by 2019.

Moreover, Marlin now primarily operates via its ILC Marlin Business Bank and GreatAmerica has a pending ILC application to form its own bank. A bank owner or structure brings obvious advantages, but, as previously discussed, also a highly regulated credit box that could struggle to compete with nonbanks. Similarly, BDCs and credit managers bring ready access to capital, but BDCs have leverage and other 1940 Investment Act limitations and credit managers have higher return thresholds.

CCG, GreatAmerica (for now) and Oxford have created efficient capital structures and become respected leaders in their niche markets without the freedoms and limitations of a bank, BDC or massive fund complex. It remains to be seen whether any platforms will grow or be formed and achieve similar success or whether the new reality is simply that regional banks and BDC portfolio companies are today's version of the commercial finance companies of the past. We also expect the life insurance sector to be an interesting part of this evolution, as they represent perhaps one of the most logical long-term owners of these businesses as evidenced by Athene-MidCap and Security Benefit-Stonebriar.

Figure 63: Commercial Finance Landscape

Banks

Large Cap

Community and Regional

Nonbanks

Asset-Based Lending

Equipment Finance

Cash Flow

MCA / SMB

Specialty

Note: Intended to reflect representative, not comprehensive sampling of market participants. For nonbanks, note that many platforms participate in two or more of the sub-verticals identified above.

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