Specialty Finance M&A: Market Update

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While activity in the traditional bank M&A market remained tepid, transactions involving nonbank specialty finance companies attracted strong interest from the private equity community and strategic buyers alike in 2014. Specialty finance encompasses a broad range of nonbank financial and credit-related businesses, including consumer lenders in various industries and asset classes — such as mortgages, auto finance, personal loans, student loans, credit cards and payday lending — as well as commercial finance businesses such as asset-based lending and leasing. Deals in the industry include both acquisitions and divestitures of whole companies and divisions, as well as asset portfolio and platform transactions.

Market activity involving nonbank consumer finance companies in particular remained robust in 2014, as private equity and other investors focused on opportunities in the space. The underlying drivers for this activity have been the increasingly complex and active regulatory and enforcement environment and the availability of more attractive financing alternatives for these businesses.

Federally regulated banking institutions generally have found the politicized and evolving regulatory and enforcement environment associated with these businesses to be increasingly challenging and risky, resulting in a number of them choosing to divest themselves of these concerns. Meanwhile, nonbank buyers and investors have benefited from continued improvement in the debt and equity financing markets, including the securitization market. Citigroup's widely publicized renewed effort to divest its interest in its OneMain Financial subsidiary — either through a public equity offering or a possible sale of the business — and the expected interest from private equity funds and other strategic buyers is the latest example of this trend.

Financing Market Developments. The existential question for nonbank buyers of consumer finance businesses is the availability and terms of the funding for the business on an ongoing basis. While banking institutions are able to fund these businesses through their deposit-taking operations, independent nonbank consumer finance companies must secure adequate and ongoing financing from various potential sources, including warehouse and other bank credit markets, public and private debt markets, and the securitization market.

During 2014, the funding environment for these businesses generally was attractive, and financing availability was excellent. Warehouse financing terms have become much more competitive, and securitization financing has become available for many more asset classes. However, given that conditions in the debt markets are subject to change on a cyclical basis, a prudent buyer of a specialty finance business needs to assess whether the amount of financing in place is adequate for its growth plan and sufficiently locked in to manage through potential adverse developments in the financing markets, and whether the duration of the financing is appropriate for its investment horizon.

Regulatory and Enforcement Risk. Since its creation with the passage of the Dodd-Frank Act, the Consumer Financial Protection Bureau (CFPB) has played an increasingly active role in the consumer finance industry through rulemaking and guidance documents as well as investigations and enforcement actions. In the nonbank lending space, the CFPB has focused

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in particular on short-term, small-dollar lending and nonbank auto finance companies. In 2014 alone, the CFPB initiated dozens of enforcement actions or investigations, most of which relied on the bureau's authority to enforce the Dodd-Frank prohibition of "Unfair, Deceptive, or Abusive Acts or Practices." (See "CFPB Defines 'Unfair,' 'Deceptive' and 'Abusive' Practices Through Enforcement Activity.") In addition, a number of industry regulators at the state level, such as New York's Superintendent of Financial Services Benjamin Lawsky, have adopted a more aggressive regulatory approach, challenging to some extent the consumer protection enforcement role traditionally played by state attorneys general.

With these risks in mind, it is important that buyers and investors familiarize themselves with the political and regulatory environment surrounding the asset class that is the subject of the proposed transaction. This analysis should include an evaluation of the level of scrutiny to which the industry will be subjected and whether regulators and others will seek to impose further burdens or restrictions on the types of products and services offered by the business to be acquired. Issues that require scrutiny include the business' products and practices with respect to overall compliance management, fair lending, advertising, complaint activity, ancillary product offerings and training. A review of these matters sheds light on, among other things, potential contingent liabilities, the risk that certain products and services could subject the business to greater regulatory scrutiny going forward, and the possibility that the buyer will need to incur expense following the closing to enhance the compliance function of the acquired business (including by hiring additional personnel).

We expect specialty finance businesses, particularly consumer finance, to continue to attract significant amounts of interest and capital during 2015, in light of regulatory pressures on traditional banking institutions and rapid financial industry change. As a result, specialty finance M&A activity should remain robust.