PODCAST TRANSCRIPTION SESSION NO. 219 - DANIEL CHU

Welcome to the Lend Academy Podcast, Episode No. 219, this is your host, Peter Renton, Founder of Lend Academy and Co-Founder of the LendIt Fintech Conference.

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Today's episode is sponsored by LendIt Fintech USA, the world's largest fintech event dedicated to lending and digital banking. It's happening on May 13th and 14th, 2020, at the Javits Center in New York. Lending and banking are converging and LendIt Fintech immerses you in the most important trends of the day. Meet the people who matter, learn from the experts and get business done. LendIt Fintech, lending and banking connected. Go to lendit.com/usa to register.

Peter Renton: Today on the show, I'm delighted to welcome Daniel Chu, he is the CEO and Founder of the Tricolor Auto Group. Now, we're talking auto financing today and a specific niche within that, auto financing for the Hispanic market. So, most of the customers that come to the dealerships of the Tricolor Auto Group, and they have dealerships in Texas and throughout Southern California, most of the people are thin file or no file and yet they approve pretty much everybody who walks in the door.

And we talk about how they're able to do that, the terms of the loans and sort of the state of the auto finance market for the Hispanic population. We also talk about securitization and how they've done many successful securitizations to date. We talk about how they're trying to graduate their customers into the traditional financial system, we talk about a new product they've got going and what their vision is for the future. It was a fascinating interview, I hope you enjoy the show.

Welcome to the podcast, Daniel!

Daniel Chu: Thank you, thank you, Peter.

Peter: So, I like to get these things started by giving the listeners some background. You have an interesting background in that you started off in basketball, not many of my guests start off in sports. So why don’t you give us a little bit of a rundown of the highlights of your background.

Daniel: Sure. So, oddly enough, I do have a background in sports but really I think my experience in basketball really in many ways captured my interest and developed for me a passion in wanting to build something and maybe beyond that building something with really a clear purpose.

Actually, as both a player and a coach, I was involved in two college basketball programs where the sport was reinstated after 10 or 12 years of inactivity. So just being exposed to the process of starting something new where you had to mobilize all of the different constituencies from players, to fans, to media, to all of the different support groups around a vision to create

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something that was going to, hopefully, be successful was really a great experience for me and in many ways was maybe the best preparation for business possible.

It really trained me to understand how to get alignment, to present a clear and compelling vision and get buy in around that vision, very similar to the challenges really of an entrepreneur today.

Peter: So, it's interesting, it seems like you've kind of moved from basketball into the automotive space and you've spent, it seems like, most of your career there. So, tell us a little bit about Tricolor and sort of the founding story. What was the idea that kind of led to it?

Daniel: So I think at the beginning there was a recognition that the Hispanic market was highly underserved, and I think that opportunity led to really the notion that if we could figure out a way to address that segment...it was a differentiated enough segment where there truly was a purpose to providing a better product and a better service that could really be compelling.

My parents were both immigrants and in many respects, Asians and Hispanics share similar cultural values. There's definitely an importance around family, there's definitely a commitment to working hard to build a better future and I think that gave me an appreciation for the Hispanic culture. As I spent time understanding that market, I think there were continued discoveries that led me to believe that there was really great potential in being able to serve that very, again, underserved segment.

One that I often think about is how intensely brand loyal that segment is to the extent you provide them with compelling value, I think you have a customer for life. We've really built our business at Tricolor on providing for that customer superior value to anything that they really could find and access in the marketplace and I think it served to help the company build really a sustainable business.

Peter: Okay, so why don't you just give the listeners a little bit of a description of that business, you know, how it operates because I know you really are in the physical world, more possibly than the digital world. Maybe you can tell us a little bit about that, but sort of explain how the business operates.

Daniel: Sure. So, we do operate in a segment that's known as "buy here, pay here" within retail auto. So, in the continuum of retail auto dealers, you have obviously franchise dealers and independent dealers. We operate in that subset of independent dealers, really, the only subset within the entire continuum that has to finance the sale in order to actually transact it.

That said, we look at our business on a much higher level. The real fundamental mission driving our business genuinely is a desire to enhance the quality of our customers' life and we believe we achieve that by providing them with a vehicle of very high quality and with financing that is affordable and suitable to their specific needs.

Peter: Okay, so just maybe quickly...what percentage of people coming into your dealerships need financing for their vehicle?

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Daniel: Over 99% of the sales that we transact are financed by us and so, clearly, we're positioned in the market as a lender and as a retailer who can meet the specific needs of a consumer who really has a very, very low ceiling in the types of financial services they can access.

They're really excluded from anything that would be considered mainstream, but at the same time, it's a segment of consumer that we've been able to observe as being not only appreciative of the opportunity to get financing, but works very hard to meet their obligation to the extent they're extended credit.

Peter: So, then who are you kind of...let's just maybe step back and talk about the Hispanic market. They're going out to buy a car today, and they don't have the capital to do that, what are their options?

Daniel: Generally, their options would be with a dealer that would be operating in this "buy here, pay here" category and really we would say we're the only operator serving that specific segment at scale. You will find...you know, virtually in any of the geographies that we operate in, you will find operators that have had positive experiences and have been able to accommodate a Hispanic consumer that may or may not exist in the credit bureau.

We are really the only lender that has been able to address that segment at scale and we believe we have a platform that leverages technology that enables us to do that better than anybody else with more affordable terms and really an opportunity beyond that to build credit and ultimately break through that ceiling that enables those customers to ultimately access traditional financing.

Peter: Right, right. So then maybe you could help us just give a little profile of your typical customer. Are these people...you know, are they thin file, or they have no file, are they really in the cash-based economy, do they have bank accounts, maybe just give us a little bit of a profile.

Daniel: Sure, so the majority of our customers would fall into the category of being no file, or thin file so either they have no bureau data, or they have such limited bureau data that they become effectively unscorable. That said, the average borrower that we finance, even though they are thin file, or no file, have resided in the United States for over 15 years and that's really consistent with the research that we see in the market.

There's a very good resource called the Pew Research Center and Pew says that 60% of the undocumented immigrants in America have resided in America for in excess of ten years. That's very congruent with what we're seeing in the marketplace. So, even though these customers that we are financing or these consumers do not necessarily exist in the bureau, they are established in the ecosystem in the US.

In Texas, we average over 15 years in the US; in California, actually 18 years. In fact, a reasonably high percentage of our borrowers in California actually own their own business, even though they may be undocumented residents.

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Peter: Interesting. So, they have thin file and no file, how do you underwrite these people? I mean, obviously it's a secured loan, you have the car as the asset securing the loan, but you obviously don't want to have to go and repossess it. So, tell us a little bit about how you go about underwriting when there is such little information formally on these people?

Daniel: Sure. So, our underwriting process both utilizes alternative data, bureau data as well as what we would call application data. Even on no file/thin file consumers, there are a number of alternative data sources that we use that provide us with insights that we can utilize in the underwriting process for those no file/thin file consumers. At the same time, we do rely on application data which are data points that we are collecting from the customer face-to-face with them when they are in one of our retail dealerships.

We're collecting, Peter, probably a hundred different data points from that customer in the application process and what we've been able to do and what has really been augmented very effectively with the use of artificial intelligence is we've been able to identify patterns in both the application data we collect as well as the alternative data and bureau data that give us the ability to segment this consumer even though they may have no credit score that we can rely on.

Peter: Do they need to have a bank account to take out this loan?

Daniel: So, we don't require a bank account. It would surprise most people that about 80% of our borrowers do have a bank account so even though they are a no file/thin file, or in some cases undocumented, there are several banks, two major banks, Wells Fargo and Bank of America, that will provide that profile with a checking account.

So, the majority of our customers do have bank accounts and actually, we rely on an alternative data source called DecisionLogic which verifies that banking information and that's an integral part of our process. For us, at the end of the day, with our underwriting model, we're measuring stability and there is a correlation between a consumer that has been able to secure and maintain a checking account and their overall stability.

Peter: Sure, so then during the application process....this is happening face-to-face in one of your dealerships, is this a paper-based experience, or is it digital, or is it some sort of combination?

Daniel: So, the information is gathered face-to face. It is entered during that interaction with the customer, it is entered into an interface that we've built which then feeds our credit decisioning engine. So, once all of that information is actually gathered, collected and input, the process from there becomes purely digital. It's an automated underwriting process that's going to feed back to the dealership a grade and we grade in six different tiers, A+, A, B, C, D and the lowest tier, E. And so, the process, again, once we input that data into our, call it "decisioning engine" is fully automated.

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Peter: Okay, so then what percentage of the people pass the underwriting, and what percentage do you turn away?

Daniel: There are a couple of conditions that would lead to an automatic disqualification, but for the most part, every customer that applies is going to be approved at some level. They're going to be graded somewhere on that continuum between an A+ and an E.

What we're going to do is use that grade to drive the financing terms that we would offer the customer so we're going to offer the highly stable, high grade customers very attractive financing terms, low down payments, longer terms, lower installment payments and conversely, we're going to offer the lower grade customers...we're going to require from those lower grade customers higher down payments, we're going to finance less over a shorter term.

Peter: Okay, so let's talk about the loans themselves. Give us a sense of the terms of these loans, the interest rates, the duration, that kind of thing.

Daniel: Sure. I think it might be helpful to provide some context first.

Peter: Okay.

Daniel: Within the "buy here, pay here" industry when we look at the industry, we think about it being comprised of roughly 10,000 pure play operators generally concentrated in Texas and the southeastern United States. If you look at that segment overall, that group is originating loans with an average interest rate of between 22% and 26% with LTV's of somewhere between 170% and 250% at terms between 36 and probably 60 months.

There are a couple of "buy here, pay here" firms that have been active in the capital markets, DriveTime being the most prominent, and they are originating loans to borrowers with FICO scores in the mid-500 range. And there have been two capital markets transactions from two other "buy here, pay here" firms in the southeastern United States with average FICO scores closer to 500. By contrast, what we've been able to do really by applying and leveraging our risk model is originate much lower LTV loans.

Our LTV's average around 125%. We believe our financing terms are more affordable so our average interest rates are around 16% ranging from 9.9%, a very high grade borrower up to about 19% or 20% for our lowest grade borrowers and we're financing those customers over a term of between 48 and about 55 months.

If you look at how that translates into performance, I would say among all the "buy here, pay here" operators that currently enjoy capital markets access, our net credit losses are significantly lower, really going hand-in-hand with FICO scores so to the extent our customer has a FICO score...it's probably averaging around 580 so we're seeing net credit losses being incrementally or correspondingly lower across, you know, our industry group.

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Peter: Okay. So, speaking of the capital markets, I know that you've sort of been active in securitization with...I think the last deal that you did was rated and obviously sub-prime auto is not...hasn't got a great reputation, in some ways that's been deserved, but just tell us a little bit about your approach to the capital markets.

Daniel: Sure. So, we probably would say first and foremost that our ability to access the capital markets is a pretty strong validation of our ability to actually segment risk with a borrower who, again, is a no file, or thin file and so has very little bureau data that we can rely on.

What we've been able to do, and we've done now 5 term securitizations, the last one was a rated one that Credit Suisse underwrote...what we've been able to do, I believe, is prove that not only can we fairly precisely segment this no file/thin file borrower, but we can fairly precisely predict their loan performance. And so, as a result, I think through 5 term securitizations, we've always been comfortably under those loss assumptions and we've seen continued success in terms of increasing the advance rates and the execution in those term deals.

Peter: Okay, so then I presume that you are submitting these payments to the credit bureaus and so I imagine that this 580 FICO that your customers applied with...I presume and maybe you can correct me, but I presume that continues to grow, their FICO score keeps going up as they're now becoming less of a thin file when they have a payment track record with you. I know you mentioned this earlier on, are you trying to move these people, I think you said into the mainstream, into mainstream finance, maybe talk a little bit about how you're trying to do that.

Daniel: Sure. So we absolutely are trying to graduate this customer. When we started our business, we made it very obvious that our intention was to ultimately provide a path for this consumer to access traditional financing. A lot of people were critical of that approach saying that not engaging in the practice of really trying to build a repeat customer in our portfolio was ultimately going to impair our ability to grow.

We actually believed in the contrary. We believe that to the extent we could provide a customer with affordable financing that allowed them to be successful and ultimately graduate to a lower cost of funds and more mainstream financing, we believe that that would ultimately enable us to attract more and more customers and I think that's been the case.

So, when a customer builds credit for us, and his friends and family see that he has been able to...on his next purchase, perhaps acquire a new pickup truck that is beyond anything he ever imagined he could access, purchase and finance, we believe that business comes back to us really in a multiple and I think that's been our observation.

Peter: Sure, so I presume the vehicles that you're dealing with...I mean, these are all primarily used cars, I imagine. Maybe you could tell us about the average selling price and hence the average loans for these cars.

Daniel: Sure. So, our average sale price is right at $20,000. Most of the expensive vehicles we sell are large trucks and SUV’s which in Texas are, by and large, the preference of the customer

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we serve. We're trying to sell across the board a much higher quality vehicle than what we're seeing overall, particularly in the "buy here, pay here" segment. We're selling a passenger car that is a one or two-year old vehicle and then a large truck or SUV that's maybe a five or six-year old vehicle. But, on the average we're financing between $16,000 and $17,000, again, at an interest rate of approximately 16% and a loan term of around 54 to 55 months on the average.

Peter: Right, okay. Can you give us some sense of the scale? You mentioned Texas and California, how many locations do you have, what sort of volume are you guys doing?

Daniel: Sure. So, we currently operate 36 dealerships, 28 of them are in Texas where we really started the business. We've been in California for three years now and operate eight dealerships in Southern California. The California dealerships are a little larger scale than the Texas ones simply because the magnitude of the market in Southern California is so vast and so enormous, we believe there is a tremendous market opportunity there so we try to serve that market with larger locations.

But, we currently are originating around $250 million loans a year and we would anticipate growing about a little over 20% year over year. I think if you look at the last six or seven years, we've grown at an average compounded annual growth rate of a little over 20% and we anticipate most of our growth to be in California going forward.

Our value proposition in California is very distinct, there aren't a lot of opportunities for our customer to secure financing that's affordable on a vehicle that's reliable, dependable and sound. And so, we really believe that our value proposition in the platform we've built that allows these customers to secure financing has become very compelling in that part of the country.

We are opening in Las Vegas at the end of this year and we will probably fill in gradually through the western part of the United States. Certainly, Arizona is a market that has some appeal, New Mexico, Colorado, and so as we continue to fill out in Southern California and potentially migrate through the Central Valley up to the northern part of the state, San Jose, Oakland, the Bay Area. We also will probably fill in between Texas and California into markets like Phoenix and Tucson and potentially Albuquerque and Denver.

Peter: Okay, so we're almost out of time, but a couple of more things I really want to get to here. Firstly is, you very recently launched an auto insurance product which I just read about recently so maybe you could tell us a little bit about that product and why branch out into something...obviously, it's quite a different product to a loan.

Daniel: Sure. So, in many respects, we saw auto insurance as it's marketed to our customers to be very similar to our observations in the "buy here, pay here" industry. We saw pricing that lacked transparency that was inundated with high fees and really did not provide the customer with the value that we believe they deserved.

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And so, we did some research in the industry, we hired a couple of veterans of the agency business that served the segment of the population that resembled our consumer and we really concluded there was an opportunity to build an insurance business that relied on transparency and its pricing and that eliminated all of the brokerage origination fees that really made insurance so costly for our consumer.

So we just actually launched this strategy this year in Texas, we're getting ready to roll it out across all the markets in Texas as well as California and we really believe that it will be an opportunity again to leverage our platform, to leverage our customer base, our brand, a lot of the infrastructure we've built and offer service to the customer that has, again, really compelling value.

Peter: Okay, so final question then, what about other lending products like beyond car loan? Have you thought about it, are you thinking about expanding in the other areas?

Daniel: So, we have done our share of research into other products that we believe would allow us to offer a broader platform of services to our customers. We've looked at unsecured loan products, we've looked at really all the opportunities across the continuum. We really believe, right now, that our biggest opportunity is to continue to evolve our core business and then compliment that with insurance.

That's going to be our focus, but we have a bigger picture vision that I think, ultimately as we scale, will become much more efficient for us to leverage the existing infrastructure and add on to and we certainly are optimistic that we'll be able to do that.

Peter: Okay, we'll have to leave it there, Daniel. Good luck, I really appreciate you coming on the show today.

Daniel: I appreciate the opportunity, Peter, thank you.

Peter: Okay, see you.

You know, I love hearing these stories of companies operating on the periphery of the traditional financial markets and doing so in an honorable and respectable way and helping their customers not just getting a loan and being able to, you know, really provide them with a vehicle that can probably really help their livelihood considerably, but doing it in a way that actually helps them in the future, helps them graduate into more mainstream products. I think that is an honorable mission and something that I think is going to really help bring...expand the sort of middle class of America.

Anyway on that note, I will sign off. I very much appreciate you listening and I'll catch you next time. Bye.

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