Medallion Financial: Chicago Loans In Default + Cross-Default + Liquidity Crunch = Imminent Bankruptcy Risk

Nov.15.16 | About: Medallion Financial (MFIN)

ValueSquared

Summary

According to 10Q, a portion of Chicago loan was in default and bank has filed a suit.

If settlement is not reached, this would trigger cross-default on other outstanding loans.

We project just $1m in available cash by end of the year and potentially negative balance during 1Q 2017.

Regulator examining provisioning practice at MB.

Review of 3Q call report for Medallion Bank ("MB") and Melrose Credit Union ("Melrose") continued to suggest deteriorating fundamentals for Medallion Financial (NASDAQ:MFIN). As we argued previously we have been expecting a credit event (i.e. potential default) given the near-term maturity schedule. In addition, we also expected potential suspension of dividend in 3Q since most prudent management teams facing such a dire liquidity situation would attempt to save as much cash as possible. Unsurprisingly MFIN's 3Q earnings release tried to portray business as usual (including no change in dividend and extension of stock buyback program), which led to a brief rally in the stock. However, our review of the 10Q suggests MFIN is already in a serious trouble facing imminent bankruptcy risk due to lack of liquidity.

CHICAGO LOAN DEFAULT:

This was the single most important disclosure in 10Q. Under Subsequent Events, MFIN included the following (emphasis added):

"The Company is finalizing a one year extension of Medallion Chicago's term loans secured by owned Chicago Medallions that are scheduled to mature on November 9, 2016. The Company and its subsidiaries obtain financing under lending facilities extended by various banks and other financial institutions, some of which are secured by loans, taxi medallions and other assets. Where these facilities are extended to its subsidiaries, the Company and others of its subsidiaries may guarantee the obligations of the relevant borrower. Five of its smallest subsidiaries are borrowers under promissory notes extended to them by a bank that total $8.8 million that came due on October 17, 2016. These loans are secured by Chicago taxi medallions owned by the Company's subsidiaries. These notes are guaranteed by Medallion Funding, not by the Company. These subsidiaries have not repaid the amounts due under the notes, and the bank has filed a suit seeking payment of these amounts. This failure to pay would constitute an event of default under other loan agreements under which the Company or its subsidiaries are borrowers, but to the lenders under those agreements have waived the default. The majority of such waivers have been signed but will not be effective until all of the waivers have been received. If judgment is entered against the Company in the suit brought by the bank, or entered and not satisfied within specified periods of time, this event may constitute an additional event of default under these other agreements. The Company not yet asked for waivers from the other lenders of this additional default. If such waivers are required and not granted, it would lead to events of default under other of the Company's financing arrangements. The Company is currently negotiating the renewal of the five loans of its subsidiaries in an effort to reach a mutually beneficial settlement."

In summary, a portion of MFIN's Chicago loans ($8.8m of $23m total) came due on Oct 17, 2016 and MFIN could not repay. If MFIN is unable to reach a settlement, this would trigger cross-default on MFIN's other loans (10Q did not specify which loans will be affected). **Due to insufficient liquidity at the parent (explained in detail below), cross-default would most likely result in immediate bankruptcy for MFIN without additional capital raise**. For such a material event, MFIN didn't even bother to file an 8K at an earlier date (is SEC OK with this?). MFIN filed 10Q on November 10th (a day after Chicago term loan matured) but did not provide any update in terms of what happened post the maturity.

We believe reaching a "mutually beneficial settlement" for all of Chicago loans (since remaining $14m coming due next month) will be extremely challenging. Chicago loans are not entirely non-recourse as $14.2m of the outstanding Chicago loans is guaranteed by MFIN parent (p22 footnote 3). Chicago lenders will try to obtain as much repayment as possible before agreeing to extend the remaining portion. Just like other lenders that have already done so, this is the last opportunity a lender would be able to recover any cash from MFIN. Whatever the portion extended will almost certainly be written off as the collateral value of MFIN will continue to deteriorate.

In terms of Chicago collateral value, while we have seen a number of transfers at $60k, we see further downside in Chicago medallion prices. MFIN's lease income from owned Chicago medallions declined **75% sequentially** to $1,300 per medallion (annualized figure) from $5,300 in 2Q. Applying the same cap rate (8.8%) would **imply medallion value of only $15k**, which would value MFIN's 159 medallions at $2.4m (vs $19m reported by MFIN in 3Q).

ZERO LIQUIDITY BY END OF YEAR:

Unfortunately MFIN is rapidly running out of cash. As you can see in the table below (p65), MFIN (called the Company) has $12.6m in cash with no other source of liquidity. However, of the $12.6m, $7.8m is pledge to a lender of an affiliate (unspecified). Since MFIN is continuing to pay dividend, another $1m will be subtracted from the cash balance. Without any dividend from MB, MFIN continues to burn ~$2.5m per quarter. **In sum, MFIN will be left with just ~$1m of available cash by the end of Dec 2016 (assuming no buyback).** This is why we think the possibility of satisfactory settlement for Chicago loans is very low.

(Dollars in thousands)	The Company	MFC	MCI	MBC	FSVC	MB	9/30/2016 Total	12/31/2015
Cash	$ 12,628(1)	$ 584	$ 9,294	$ 34	$ 2,168	$ —	$ 24,708	$ 30,912
Bank loans	72,026	23,028	—	—	248	—	95,302	122,429
Average interest rate	2.99%	3.13%	—	—	6.03%	—	3.04%	2.60%
Maturity	11/16-7/18	10/16-12/20	—	—	1/17-11/18	—	10/16-12/20	2/16-12/20
Preferred securities	33,000	—	—	—	—	—	33,000	33,000
Average interest rate	2.96%	—	—	—	—	—	2.96%	2.58%
Maturity	9/37	—	—	—	—	—	9/37	9/37
Unsecured notes	33,625	—	—	—	—	—	33,625	—
Average interest rate	9.00%						9.00%	—
Maturity	4/21						4/21	—
Bank loans	—	108,284	—	—	—	—	108,284	129,518
Average interest rate	—	2.20%	—	—	—	—	2.20%	2.05%
Maturity	—	12/16	—	—	—	—	12/16	12/16
Margin loans	—	—	—	—	—	—	—	45,108
Average interest rate	— %	—	—	—	—	—	— %	1.48%
Maturity	N/A	—	—	—	—	—	N/A	N/A
SBA debentures	—	—	54,000	—	33,485	—	87,485	77,485
Amounts undisbursed (2)	—	—	5,500(2)	—	—	—	5,500	3,000
Amounts outstanding	—	—	48,500	—	33,485	—	81,985	74,485
Average interest rate	—	—	3.42%	—	3.92%	—	3.63%	3.52%
Maturity	—	—	3/21-3/27	—	3/19-9/23	—	3/19-3/27	3/19-3/26
Total debt outstanding	$ 138,651	$ 131,312	$ 48,500	$—	$ 33,733	$ —	$ 352,196	$ 404,540
Including Medallion Bank								
Cash	—	—	—	—	—	$ 64,565	$ 64,565	$ 23,094
Deposits and other borrowings	—	—	—	—	—	931,612	931,612	908,896
Average interest rate	—	—	—	—	—	1.16%	1.16%	1.04%
Maturity	—	—	—	—	—	10/16-8/21	10/16-8/21	1/16-12/20
Total cash	$ 12,628	$ 584	$ 9,294	$ 34	$ 2,168	$ 64,565	$ 89,273	$ 54,006
Total debt outstanding	$ 138,651	$ 131,312	$ 48,500	$—	$ 33,733	$ 931,612	$ 1,283,808	$ 1,313,436

(1) $7,838 is pledged to a lender of an affiliate.
(2) $4,000 of this requires a $2,000 capital contribution from the Company.

Even if MFIN miraculously manages to extend the Chicago loans by exhausting all available liquidity, how will MFIN fund another quarter of operation when its available cash balance will fall below zero during 1Q 2017? In addition, MFIN faces $108m DZ revolver due December 2016 (although this revolver is supposed to be non-recourse) and another $64m in a various bank debt due over the next 12 months (p62). Companies file for bankruptcy for insolvency and/or lack of liquidity. Of course, you could say MFIN could raise new equity or debt capital to refinance near-term maturity. We think that is unlikely. Debt market is basically shut. In terms of equity market, any prospective buyer of new equity is guaranteed to lose money since MFIN is likely insolvent given our estimation of fair value for medallions. In addition, most prospective buyers would be wary of investing today since regulator is currently questioning the adequacy of provisioning at MB (more detail below), the biggest asset of MFIN, which may materially impact book value of MB.

3Q FINANCIAL AND OTHER UPDATES:

Since most readers are already familiar with the operating trend of the company, we will include only a brief update on the key financial metrics.

As was the case in 2Q, holdco did not receive any dividend from MB in 3Q. According to call report, MB had $1m net loss in 3Q due to a large increase in provision related to medallion loans. Total delinquency for medallion portfolio rose to 23% from 16% in 2Q. Tier 1 leverage ratio remained unchanged at 15.6%, slightly above minimum 15%.

For the second quarter in a row, MFIN holdco reported pre-tax loss. However, holdco was able to report nearly $5m of GAAP net income due to sizeable net realized and unrealized gains, which was almost entirely driven by huge unrealized gains in its stake in MB. Here is the rationale from 10Q:

"In the second quarter of 2015, the Company first became aware of external interest in Medallion Bank and its portfolio assets at values in excess of their book value. Expression of interest in Medallion Bank from both investment bankers and interested parties has continued through 2016. The Company incorporated these new factors in the Medallion Bank's fair value analysis and the Board of Directors determined that Medallion Bank had a fair value in excess of book value. In addition, in the third quarter of 2016 there was a court ruling involving a marketplace lender that the Company believes heightens the interest of marketplace lenders to acquire or merge with Utah industrial banks. The Company also engaged a valuation specialist to assist the Board of Directors in their determination of Medallion Bank's fair value, and this appreciation of $15,500,000 was thereby recorded in 2015, and additional appreciation of $28,600,000 was recorded in 2016 as a component of unrealized appreciation (depreciation) on investments, in addition to Medallion Bank's actual results of operations for the quarter"

As of 3Q MFIN is valuing its investment in MB at $194m, 29.4% premium to book value because there has been "expression of interest" and management "believes" the recent court ruling increases possibility of potential acquisition. This is why MFIN's reported book value per share actually increased in 3Q sequentially!

Similar to MB, holdco also saw medallion delinquency rise in 3Q sequentially from 26% to 29%. While holdco slightly marked down its holdings in medallion loans, holdco is still marking them at only 4% discount to principal outstanding, which is hugely inadequate compared to nearly 30% delinquency. As a data point, **Melrose wrote off almost $191m of medallion loans during 3Q with $0 recovery.** When the largest lender and MFIN's closest peer is experiencing effectively 100% loss on default loans, MFIN's determination of provision appears extremely questionable. No wonder regulator has finally taken notice. MFIN included the following for the first time in the third quarter 10Q (emphasis added),

"As a regulated entity, Medallion Bank is subject to periodic routine examination from its regulators. Medallion Bank is currently undergoing such an examination, and while the final results of the examination are unknown at this time, it is possible that the regulators could require additional loan loss reserves or other financial adjustments at the Bank. While this would be, if it occurs at all, a subsequent event to our current regulatory filings, it is possible that the regulators could require the Bank to record any adjustment as a restatement of the Bank's previously filed regulatory reports, resulting in certain of the supplemental Medallion Bank disclosures in this Form 10Q to differ from the adjusted numbers. The Company would assess as appropriate any such restatement to the Bank's regulatory reports and its effect, if any, on the carrying value of Medallion Bank, and if there is no material change on the carrying value there would be no change required in the Form 10Q"

If this is a routine examination, how come we haven't seen similar disclosure in prior Qs and Ks? While we do not know the exact nature of this examination, we welcome regulator's decision to examine MFIN's provision methodology. It is incredible that MFIN decided to mark up its holding in MB while MB is subject to examination by regulator, which may have material impact on the stated book value of MB.

Disclosure: I am/we are short MFIN.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Editor's Note: This article covers one or more stocks trading at less than $1 per share and/or with less than a $100 million market cap. Please be aware of the risks associated with these stocks.