

Medallion Financial 10-Q: Asset Valuation Keys Q2 Earnings

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Disclosure: I am/we are short TAXI. (More...)

Summary

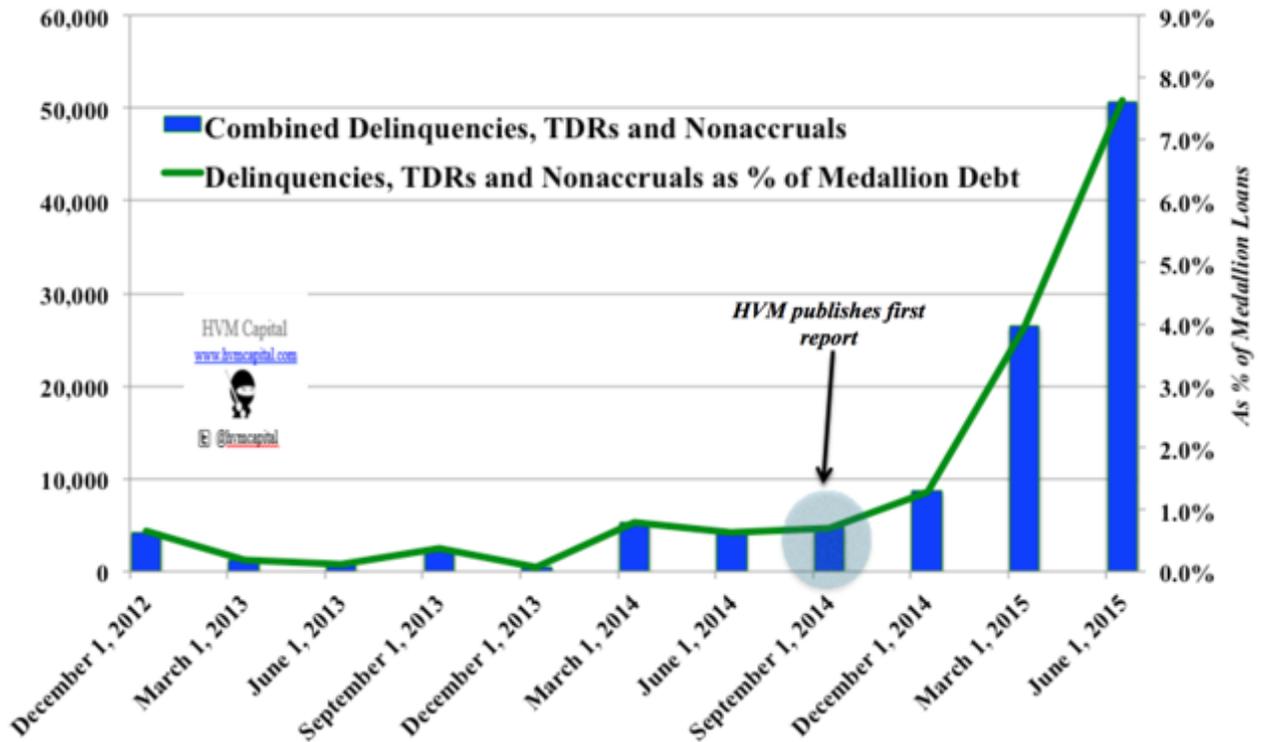
- Parent medallion loan delinquencies nearly double in 3 months.
- Combined total delinquencies, TDRs and nonaccruals reach 7.6% of outstanding medallion loans from 1.3% in Q4 and 3.9% in Q1.
- Company wrote-up Medallion Bank value based on oblique reference to “external interest” – adding \$0.43 per share in noncash gains in the quarter.

In our [initial analysis](#) of Medallion Financial's (NASDAQ: [TAXI](#)) second quarter earnings, we noted the limited press release disclosure was unduly optimistic, and investors would again have to wait for the 10-Q to know critical "numbers behind the numbers." As predicted, the 10-Q shows worsening deterioration in medallion loan quality and offers a curious explanation of a \$10.6 million (\$0.43 per share) non-cash write-up we previously highlighted.

Medallion Loan Quality Deteriorating Rapidly

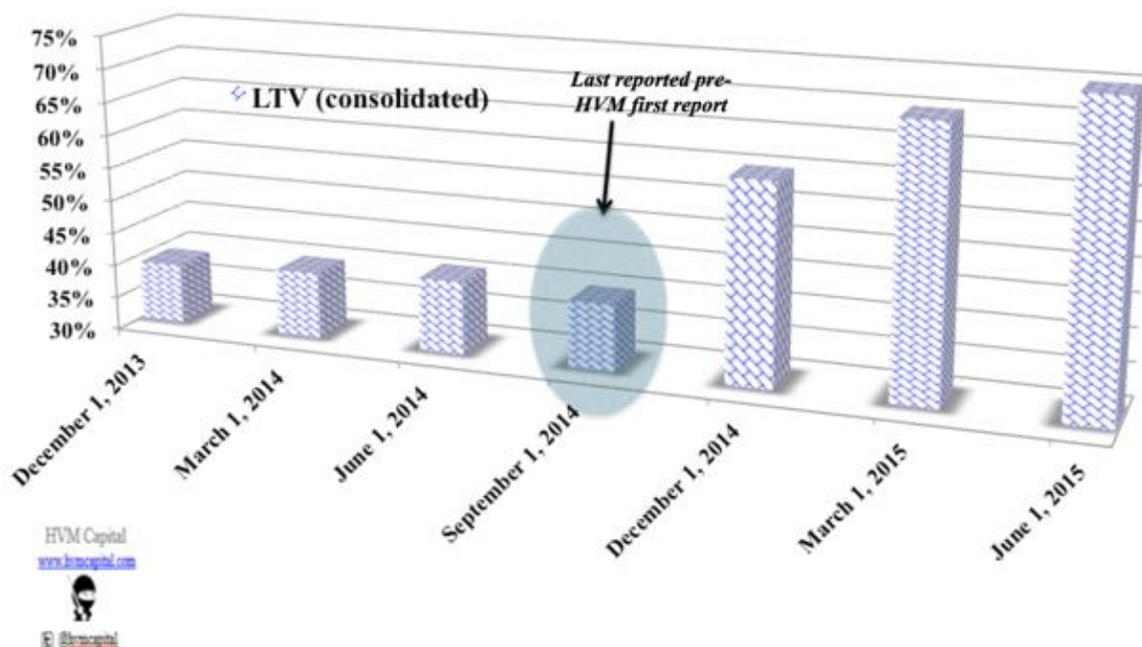
Total medallion loan delinquencies (31 days or greater past due) increased 85% in the last three months to \$23.4 million (parent-only, excluding nonaccrual status loans of \$14.7 million in the quarter - up \$4.6 million from Q1 and likely mostly related to medallion loans, but lumped together with Commercial Loans). On a combined basis, the sum of delinquencies, troubled debt restructured (TDRs) just in the quarter, and nonaccruals (Medallion Bank only) as a percentage of managed medallion loans went from 1.3% to 3.9% to 7.6% in the last two quarters (see Chart below), an accelerating trend of deteriorating loan quality while taxi medallion cash flows continue to decline in major markets. The consolidated LTV ratio stands at 75%, up from 40% in September 2014 (see second Chart below).

Medallion Financial Combined Medallion Loan Performance Metrics



Source: Medallion Financial Corp. SEC filings and Medallion Bank FDIC Call Reports.
 Note: Medallion Bank "Loan Loss Provisions" and parent "Nonaccruals" not included because neither broken out for medallion loans.

Medallion Financial Consolidated Medallion Loan LTV Ratio



Valuations of Medallion Bank and Chicago Medallions Salvage Earnings

During the quarter, TAXI valued Chicago taxi medallions at \$248,000 (a \$0.19 per share write-down), a price level only observed for medallion sales in which 100% or near-100% financing was offered to fleet-owning buyers. For already heavily leveraged fleet owners, 100% financing, even at those prices, resembles a free call option on the recovery of Chicago medallions. Ignored were clear market signals that fair-market-value remains at [\\$150,000](#) (an additional \$0.64 per share write-down), a price at which medallions continue to be offered but not financed, and [the price](#) of the only medallion sold in July.

But TAXI owners should not despair. As taxi medallion skies grow darker, like manna from heaven, according to [the 10-Q](#):

... the Company became aware of external interest in Medallion Bank and its portfolio's assets at values in excess of their carrying amount. 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. 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 \$10,600,000.

Wow. After years of unwittingly low-balling themselves on the value of Medallion Bank, "external interest" alerted the Board in time to book a \$0.43 per share non-cash gain in the second quarter, more than offsetting the Chicago medallion write-downs and delivering an "upside earnings surprise." (See the income statement at the end of the document.) The "external interest" was purportedly prompted by the July 2013 expiration of the Dodd-Frank moratorium "... on the acquisition of control of an industrial bank by a 'commercial firm'."

Apparently, this externally interested party was a very patient tire-kicker as well as a hopeless optimist, as there is zero chance TAXI parts ways with the franchise golden goose short of a silly offer, also unlikely, in our estimation.

Medallion Bank has been the primary source of NII and growth for TAXI as well as the singular reason critical third party capital has been available to sustain the BDC/RIC structure during multiple years of operating cash shortfalls. In 2015 (6 months), 2014, 2013 and 2012, the Medallion Bank cash dividend accounted for the following percentages of NII, respectively: 108%, 99%, 98% and 120%. It has averaged between 71% and 91% of reported net income in that period. TAXI would be a relative shell of itself if Medallion Bank were sold, and hard pressed to redeploy as profitably whatever it fetched.

Medallion Bank is an asset categorically not-for-sale. Moreover, Medallion Bank purchases its deposits through brokers, having no retail presence. There is also that little taxi medallion loan problem. In the last six months, medallion loan (plus minimal contributions from Commercial Loan) delinquencies, troubled debt restructured and nonaccruals held by the Bank have increased from 0.5% to 6.8% of total outstanding loans. Medallion loans represent 37% of total investments and 233% of Bank equity. Multiple banking sources have indicated that Medallion Bank fetching a meaningful premium to book value is unlikely even if TAXI were so inclined.

This is an aggressive pair of calls by a Board exercising the good faith discretion required to value company assets. Together, they represent over a \$1.00 per share swing in reported earnings and tangible book value in a single quarter, on the basis of Boardroom valuation decisions.

No Commentary on Debt Covenants

TAXI has a \$150 million revolving line of credit with DZ Bank (\$120.7 million outstanding at June 30). It would appear that regulatory changes in Illinois and those pending in Massachusetts may place TAXI in breach of Section 6.01 (E) of [Omnibus Amendment No. 3](#) to the *Loan and Security Agreement and Amendment No. 1 to Medallion Loan Sale and Contribution Agreement and each Affiliated Loan Sale Agreement*, (see Exhibit below).

DZ Bank Omnibus Loan Agreement Articles of Default

From [Omnibus Loan Agreement](#) with DZ Bank. 8K filed December 12, 2013

Section 6.01. Events of Default. If any of the following events (each an “*Event of Default*”) shall occur:

(e) (i) the introduction of or any change in or in the interpretation by any Governmental Authority of any law or regulation applicable to Medallions or Medallion Loans or (ii) the compliance by the Borrower with any directive or request from any Governmental Authority (whether or not having the force of law) imposed after the date hereof, shall adversely affect the value of the Medallion Loans or any Medallion Loan Collateral, as determined by the Agent in good faith; or

Illinois and Massachusetts implement regs allowing ride sharing:

Gov. Baker of MA [proposes ride sharing regs](#) after [federal judge rejected taxi advocates’](#) attempts to block new regulations allowing [Uber](#) and [Lyft](#).

Chicago [Mayor Emanuel approved ride share permits](#) and [Governor Quinn vetoes HB 4075](#) to overturn regulations in August 2014.

From the [SEC Guidance](#) Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Section IV C:

- ... companies should consider whether discussion and analysis of material covenants related to their outstanding debt (or covenants applicable to the companies or third parties in respect of guarantees or other contingent obligations)⁵⁵ may be required.⁵⁶
- ... companies that are, or are reasonably likely to be, in breach of such covenants⁵⁷ must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:
- the steps that the company is taking to avoid the breach;
- the steps that the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding.

TAXI made no mention of this subject in the MD&A or anywhere else in the 10-Q, despite SEC guidelines that seem to call for such commentary.

Conclusion

Let's review the highlights for the quarter:

- \$2 million accounting shift from "net change in unrealized appreciation in Medallion Bank" to Net Investment Income.
- \$0.19 per share write-down of Chicago taxi medallions when market intelligence suggests a write-down in excess of \$0.80 per share was probably warranted (a mark to \$150,000).
- \$0.43 per share write-up of Medallion Bank after a change in the Board's long-held valuation philosophy for the Bank.
- Nearly a doubling of medallion loan delinquencies, TDRs and Bank-level nonaccruals to 7.6% of total outstandings,
- Another increase in LTV ratio to 75% despite the modest Chicago write-down and certainly not using a NYC medallion value anywhere near the [\\$603,000](#) independent medallion transfer in July.
- Another 10-Q published with no commentary on ride sharing nor covenant questions regarding DZ Bank in the MD&A.

Some might say management "managed earnings" in the second quarter, while others might explain it less euphemistically. One thing is certain, earnings quality was weak and the headlines claiming Medallion Financial [beat](#) second quarter earnings expectations were a little premature.

Medallion Financial Quarterly Earnings Trends

Medallion Financial Corp.

Selected Consolidated Statement of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Q2 2015	Q1 2015	Q4 2014	Q3 2014	Q2 2014
	Three Months Ended June 30	Three Months Ended March 31	Three Months Ended December 31	Three Months Ended September 30	Three Months Ended June 30
Interest income on investments	\$ 5,462	\$ 5,583	\$ 5,132	\$ 6,933	\$ 6,434
Dividends and interest income on short-term investments	5,014	5,902	5,224	4,015	3,010
Medallion lease income	362	346	423	431	431
Total investment income	\$10,838	\$11,831	\$10,779	\$11,379	\$9,875
Total interest expense	2,343	2,212	2,261	2,222	2,085
Net interest income	\$ 8,495	\$ 9,619	\$ 8,518	\$ 9,157	\$ 7,790
Total noninterest income	110	56	74	136	108
Salaries and benefits	2,975	3,343	4,372	2,906	2,965
Professional fees	367	412	571	70	294
Occupancy expense	219	230	210	207	189
Other operating expenses	714	786	774	882	647
Total operating expenses	4,275	4,771	5,927	4,065	4,095
Net investment income before income taxes	4,330	4,904	2,665	5,228	3,803
Income tax (provision) benefit	-	-	-	-	-
Net investment income after income taxes	4,330	4,904	2,665	5,228	3,803
Net realized gains (losses) on investments	324	7,899	(4,556)	(193)	(685)
Net change in unrealized appreciation (depreciation) on investments	(5,634)	(3,309)	3,491	(1,723)	681
Net change in unrealized appreciation on other controlled subsidiaries ex-Medallion Bank	(433)	(4,125)	3,988	700	(223)
Net change in unrealized appreciation on Medallion Bank (FDIC Call Reports)	9,499	1,699	2,540	2,682	3,529
Net unrealized appreciation on investments	3,432	(5,735)	10,019	1,659	3,987
Net realized/unrealized gains on investments	3,756	2,164	5,463	1,466	3,302
Net increase in net assets resulting from operations	\$ 8,086	\$ 7,068	\$ 8,128	\$ 6,694	\$ 7,105
Net increase in net assets resulting from operations per diluted common share	\$ 0.33	\$ 0.29	\$ 0.33	\$ 0.27	\$ 0.28
Cash earnings per diluted share	\$ 0.19	\$ 0.52	\$ 0.11	\$ 0.21	\$ 0.15
Distributions declared per share	\$ 0.25	\$ 0.25	\$ 0.24	\$ 0.24	\$ 0.24