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Medallion Financial Corp. Loses Its Largest Institutional Investor

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Disclosure: The author is short TAXI. **(More...)**The author wrote this article themselves, and it expresses their own opinions. The author is not receiving compensation for it. The author has no business relationship with any company whose stock is mentioned in this article.

Summary

- Largest institutional investor sells 5% stake.
- Confusion over Dimensional Fund Advisors, LP 13G filing.
- Risk reward in TAXI shares points to significant further downside.

Medallion Financial Corporation's (NASDAQ: TAXI) largest institutional investor, Dimensional Fund Advisors, LP (DFA) sold its entire position, a 5% stake, according to a 13G filed on Thursday, February 5, 2015. There has been confusion among interested parties about the 13G Amendment filing by DFA. A 13D and its abbreviated version 13G are SEC filings instantly recognized by many as the documents through which funds disclose accumulation of at least 5% of the outstanding shares of a security. But the same filings are required when a fund crosses the 5% ownership threshold on the SALE of shares. The LATTER occurred in this case, with DFA having fully sold out of its 5% position in Medallion Financial Corp. as of December 31, 2014. DFA had been the largest institutional holder of TAXI shares.

DFA's Investment Approach

Dimensional takes the approach of eliminating human emotion from investment decision-making, never seeking to market-time, eschewing the pervasive practice among mutual funds and professional money managers of relative performance benchmarking - misaligns the interests of fund managers and investors during periods of high systemic risk and subsequent market drawdowns, in our opinion - by ignoring commercial indexes. Dimensional rates thousands of securities on the basis of multiple metrics, or "dimensions," it believes to be highly correlated with long-term security performance based on academic research. Securities screening favorably across their dimensional matrix for a given strategy, are included in that portfolio. TAXI had been in four separate portfolios managed by DFA. DFA has been in business since 1981 and manages $380 billion.

For more information on the DFA investment process go to website. Here are some instructive quotations:

Prudent investing is a rational process. It involves deciding how much risk to take, then choosing asset classes to match an investor's preferred risk-return tradeoff. We manage a broad range of strategies to meet the needs of investors with diverse investment goals.
Dimensional manages strategies with these core beliefs in mind: Securities are fairly priced in liquid and competitive markets, diversification is essential, and investing involves trading off risks and costs with expected returns. These time-tested principles have guided our approach for more than three decades. By focusing on what matters, Dimensional focuses your efforts.
A scientific priority runs deep through Dimensional. We have a high regard for research, process, and time-tested data. A time line of innovation offers proof that Dimensional has always looked forward, ready for change, eager to go where the evidence leads.

The Problem for Medallion Owners and Implications for Medallion Lenders

In our December 19, 2014 article and in follow up articles on January 9, 2015 and January 15, we laid out the thesis that the end of taxi medallion monopolies across major U.S. cities - supply caps imposed and enforced by regulators for the last several decades meeting unconstrained new supply - precipitated by the entry of ride share networks, would cause billions of dollars in losses for medallion owners and financing enterprises with significant exposure to the asset class, including Medallion Financial Corporation, in particular, Signature Bank (NASDAQ:SBNY) and a large number of non-public credit unions and other specialty lenders.

Across medallion markets, lower-priced, higher-quality, more convenient and safer (for drivers and customers) transportation options, have been made available to riders for the first time in decades. Consumers have rapidly adopted the app-hail option. As aggregate dollars spent on taxi-equivalent-price-point rides gets disbursed over the much larger supply of vehicles, the lower cash flow per medallion directly impacts the value of medallions. At the same time, the market's historical perception of a lengthy competitive advantage period - the number of years/decades over which positive medallion-based cash flows are discounted for valuation purposes - for government-protected medallions is giving way to recognition that there is probably no competitive advantage whatsoever remaining for medallions. As medallion owners come to realize that their lost equity is not coming back - why would buyers continue to pay a secondary market premium for a permit that no longer confers any *exclusive* commercial rights? - and the declining cash returns associated with medallion ownership no longer cover the cost associated with that ownership, borrowers will default in greater numbers. For fleet owners the cost of capital is measured by both the interest paid on borrowed funds to purchase fleet medallions and the risk/return profile of alternative uses of cash. For medallion owner-drivers it is measured by their cash earnings including the cost of paying interest and principle on medallion loans.

Since September, the most well protected medallion market of them all, New York City, has witnessed seven foreclosures, after years without any. There have been four medallion foreclosures in Boston in the last several weeks (we attended the public auctions in which lenders took back the medallions for lack of interest at prices above loan par values) and street asking prices of $350,000 versus $700,000 transfers last spring are not attracting buyers. Chicago, the most vulnerable market of them all, is likely to experience massive defaults the soonest (transfer in January at $150,000, the current street "asking" price, compared to peak prices of almost $360,000 less than a year ago).

Medallion Financial's Exposure to Medallions

Medallion Financial has $1.14 per share (on pace to earn roughly that amount in 2014 pending Q4 report) of earnings exposure to taxi medallions, and balance sheet exposure of $480 million, including $49 million of owned Chicago medallions currently on the books at twice the $150,000 transfer-low observed in January (implying $0.95 per share of write down vulnerability, some portion of which should at least be acknowledged imminently, lest Board directors open themselves up to SEC wrath over BDC valuation or shareholder litigation, though management has a good deal of discretion as to valuing assets and the attendant timing of marking-to-market) on tangible book value of $273 million.

In addition, before any consideration of the deteriorating fundamentals in medallion markets, Medallion Financial has been coping with a misalignment of operating cash flows versus cash obligations since at least 2011, owing to its Business Development Corporation and Regulated Investment Company status. Having to pay out 90% of income defined under the regulations, including non-cash, unrealized earnings, is largely the source of the cash flow imbalance, and has compelled the company to engage in suboptimal, in our opinion, cash-raising activities to fund the mandatory distributions (dividends and share repurchases) including:

- Potentially-premature asset sales and unproductive borrowing. From the 2013 10K: "We are authorized to borrow funds and to sell assets in order to satisfy distribution requirements."
- Equity issuance of $83 million in two separate offerings in the last three years, at a cost of $5.3 million in fees ($0.22 per share).
- Aggressive expansion into higher risk Consumer Lending (up 35% from September 2013 to September 2014). From 2013 10K "By its nature, lending to consumers that have blemishes on their credit reportes carries with it a higher risk of loss."

Management has indicated it has engaged third party counsel on the advisability of maintaining the existing structure, and warned of the potential fallout associated with ceasing to be a pass-through investment entity and paying federal income taxes. From the 2013 10K:

- We may materially change our corporate structure and the nature of our business.
- We are very much affected by the legal, regulatory, tax and accounting regimes under which we operate. We are evaluating whether those regimes and our existing corporate structure are the optimum means for the operation and capitalization of our business.
- As a result of these evaluations, we may decide to proceed with structural and organizational changes ... which could result in material dispositions of various assets, changes in our corporate form, termination of our election to be regulated as a BDC, our conversion from an investment company to an operating company or other fundamental changes. If we were no longer an investment company, our accounting practices would change and, for example, lead to the consolidation of certain majority owned companies with which we do not now consolidate as an investment company.
- Additionally, if we were no longer an investment company, our shareholders would not benefit from the investor protections provided by the 1940 Act.

Conclusion

In short, TAXI shares present an uncompelling risk profile, despite the significant share price decline over the last year. As we have stated, we believe the stock is likely to decline significantly from current levels as the operating headwinds begin to impact TAXI's medallion loan portfolio during 2015, despite historically conservative lending practices in the asset class.

The competitive landscape for taxi medallions has absorbed *demand* shocks in the past without missing a beat precisely because supply caps have always ensured a supply shortfall protecting the markets from transitory declines in ridership. But never, in the multi-decade history of medallion monopolies, has the industry had to deal with a *supply* shock at, or in this case below the taxi price point, of the *magnitude* posed by the introduction of ride share networks. The regulatory response has overwhelmingly been to *"accept and regulate"* rather than "*eliminate*" ride share networks, and only the latter will stop the bleeding for the medallion owners. Otherwise the economic course is set and demonstrated in other cities where supply caps were eliminated and secondary market premiums of medallions/capped licenses dropped to zero - e.g., Minneapolis, Milwaukee and San Diego. We believe DFA's is the first in what will eventually be widespread divestiture among TAXI's institutional holders, except for its investment banking partners.

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It is interesting that SBNY, with an $800 million medallion loan portfolio, is rated a buy by most analysts, and is trading at a P/E of 21. Regardless of your view on TAXI, it is interesting how differently these two stocks are trading. Note that SBNY just made strongly positive comments about it medallion loans on its call the other week.