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Carvana: Well-Received ABS Securitization Includes Unorthodox Calculation of Expected Deal Proceeds; Gross Profit Calculation Heavily Reliant upon Securities not Offered for Sale as Part of Deal

In a March 26 press release, Carvana (CVNA) disclosed that its $350 million ABS sale—placed through a 144(a) private offering to certain accredited investors—constituted "an exciting development for Carvana's financing platform" and "was well-received by investors . . .mark[ing] a significant step toward achieving [Carvana's] long-term financing profitability goals."

But a closer look at details from a private offering memorandum reviewed by *The Capitol Forum* raises questions about the nature of the nearly $15 million "gross profit" expected by Carvana on this securitization and its ability to continue generating such profit from future financings.

Carvana representatives did not respond to numerous requests for comment regarding this financing.

Carvana's March 26 press release foreshadows a $15 million gain on sale for Q1 2019. Per Carvana's disclosure to equity holders, Carvana priced and was expected to sell $350 million (face value) in auto loans into the ABS facility in exchange for $338.8 million in expected proceeds from the note sale, in addition to $31 million in proceeds from the sale of "Certificates, Class XS Notes and other."

Because Carvana's total "proceeds" of $365.4 million (before fees and expenses, but net of a $4.4 million reserve account established for credit enhancement) exceeded the $350 million face value of the loans contributed by Carvana, investors should expect Carvana to recognize nearly $15 million in gross profit on the ABS deal, or roughly $792 per car sold (less fees), which would represent roughly 37 percent of the overall "gross profit per unit" reported by Carvana in Q4 2018.

Carvana Q1 2019 Securitization Expected Proceeds (in millions)

	Q1 2019 Securitization
Principal balance sold	$350.0
Rated notes	$338.8
Certificates, Class XS notes, and other	$31.0
Reserve account funding	($4.4)
Total proceeds before fees and expenses	$365.4

Source: Carvana March 26, 2019 Press Release

Indeed, a recent report by Wedbush analyst Seth Basham acknowledged that CVNA shares had "jumped in recent weeks" on the back of investor excitement about its first ABS deal, estimating that the deal would generate roughly $702 in finance-driven gross profit per vehicle sold (net of expenses), slightly lower than the $839/vehicle reported in the prior quarter but still comprising an important 32 percent of Wedbush's projected $2188 in total gross profit per vehicle for FY2019.

Certificates, Class XS notes, and other. The bulk of the proceeds from the sale of notes were expected to be realized when the deal closed on March 29. However, there is little transparency into the $31 million expected from "Certificates, Class XS notes, and other."

The press release likens the Class XS notes to "strips seen in the mortgage securitization market" and describes the certificates as an equity-like tranche, which "entitle the holders to residual cash flows after required payments are made to the rated notes, the servicer, other service providers and trustees, and the Class XS noteholders. Importantly, the press release states that "[t]he certificates and Class XS notes are expected *to be sold* to multiple third-party investors who are new to the Carvana platform."

A review of a Preliminary Offering Memorandum for the ABS notes—made within a Rule 144a private offering prospectus that typically is unavailable to equity investors or sell-side analysts—does not provide any more clarity into the timing or magnitude of the "proceeds" being estimated by Carvana. The Offering Memorandum states that "[t]he certificates will be sold by the depositor [Carvana] in one or more private placements or initially retained by the depositor or one or more majority-owned affiliates of the sponsor and are not being offered under this confidential offering memorandum." Similarly, the Memorandum states that the Class XS Notes "will be retained by the depositor on the closing date."

This manner of computing expected "deal proceeds"—where a sponsor includes a class of securities with no stated principal value and whose value is unsupported by arms-length sales to unaffiliated third parties because they are retained by the sponsor—is highly atypical, according to Professor Bruce Markell, a professor of bankruptcy law and practice at Northwestern Pritzker School of Law and expert on bankruptcy and securitizations.

A review of several recent ABS offerings suggests that Carvana's peers do not include such securities within their computation of "proceeds" when the entire class of securities is neither marketed nor sold to third parties. A copy of the prospectus for Carmax's recent $1.5 billion ABS securitization can be found here.

Equity-like tranches. Carvana's Class XS Notes and certificates, unlike the other $338 million in notes comprising the rest of the loan package, are not entitled to principal or interest payments.

They are effectively an "equity tranche reminiscent of the riskiest mortgage strips seen in mortgage backed securitizations that went bust during the last credit crisis and are unlikely to return much value at all," according to Professor Markell.

Also unlike the other $338 million of notes that were marketed in the Carvana securitization, the Class XS Notes and certificates bear no face value and are not rated by the ratings agencies. It's unclear if Carvana has tried to have these securities rated by Moody's or Kroll, both of whom were paid by Carvana to rate the facility's notes. It's possible they would have difficulty obtaining a rating because "there's little or no demand or market for such subprime paper that has no stated principal value and whose entitlements to residual cash flows are unclear," said Professor Markell.

Investors might question why Carvana elected to include $31 million in "proceeds" from these Class XS Notes and certificates that are of questionable value and have never been sold to third parties. First, the prospectus contains no explanation for Carvana's basis for pegging the valuation at $31 million.

In many cases, the lowest-priority tranche in such securitizations is valued based upon models—presumably approved by the sponsor's bankers or accountants—that rely upon assumptions about the loan pool's expected loss ratios, prepayment levels, recoveries and other factors used to approximate future cash flows. But such models typically are imprecise, subjective, and highly dependent upon credit market conditions that appear to have weakened in recent weeks, according to Professor Markell.

Second, even if the securities' $31 million valuation were justified by reasonable assumptions related to the trust's expected performance, is it proper for Carvana to include in "proceeds" its estimated valuation of an entire class of securities for which it never received any actual cash proceeds because they were retained entirely by the sponsor?

Carvana's March 26, 2019 press release seemingly anticipates this problem and attempts to counter potential investor concerns by providing that "the certificates and Class XS Notes are expected to be sold to multiple third-party investors who are new to the Carvana platform." But even this disclosure to investors strikes a curiously defensive tone and is highly unusual in the context of a sponsor's public announcement regarding its financings, according to Professor Markell.

As investors await additional disclosure regarding whether Carvana can realize its "expectations" of selling these notes to unaffiliated investors, they may scrutinize the quality of the financing-driven "gross profit" that Carvana ultimately reports from this ABS securitization. Without a market-based pricing mechanism, says Professor Markell, the actual value of securities like Carvana's Class XS Notes and certificates is inherently difficult to determine, and in any event, will not become apparent for at least several quarters as the loans within that pool season by developing a payment history.

If the value ultimately realized by Carvana for these Class XS Notes and certificates (either through sale or receipt of residual cash flows) turns out to be $16 million, for example, Carvana's entire "gain on sale" from this securitization would be wiped out. If the Class XS Notes and certificates were initially booked as a $31 million asset and ultimately proved worthless, Carvana would be forced to potentially absorb a $31 million impairment rather than any gain at all, according to Markell.

In short, any "gross profit" ultimately booked by Carvana from this ABS deal is wholly dependent upon the stated valuation of the Class XS Notes and certificates.

A Closer Look at the Class XS Notes and Certificates

As noted, the prospectus reveals important details that are absent from the press release—namely that the Class XS Notes and certificates are not being marketed for as part of the overall ABS offering. Although the press release lumps them together in one line, the prospectus shines more light on their differences and how they might be valued.

The Class XS Notes. The loans contained within the offering will be serviced by Bridgecrest Credit Company, LLC, which is an affiliate of Carvana. In exchange for servicing the loans, Bridgecrest will receive, on a monthly basis, a fee "set forth in the servicing agreement that will not exceed an amount equal to the product of (i) 2% of the pool balance … times (ii) a fraction equal to 1/12 … (the "Servicing Fee")."

The Servicing Fee is payable from the "Servicing Strip Amount," with the prospectus calculates each month as "an amount equal to the product of (i) 2% of the pool … times (ii) a fraction equal to 1/12."

Finally, the prospectus states "[t]o the extent that the Servicing Strip Amount exceeds the fees owed to the servicer, or successor servicer, as applicable, such amount (the "Excess Servicing Strip Amount") will be paid to the holders of the Class XS Notes.

A reader of the prospectus can see that residual cash flows to which holders of Class XS Notes are entitled is extremely dependent on the Servicing Fee set forth in a servicing agreement, which is not made clear to the reader. If the servicing agreement permitted Bridgecrest to collect only 1 percent of an average loan pool of roughly $320 million loan pool in the first year, for example, the Class XS Notes would then be entitled to cash flows of roughly $3.2 million for that year.

However, if the servicing agreement calls for a 2 percent annual servicing fee, the Class XS Notes would receive nothing. There is nothing in the prospectus to suggest that Bridgecrest would lack incentive to maximize its servicing fees, leaving open the possibility that there is little, or even no, money left for the Class XS Notes.

To the extent Bridgecrest theoretically might have incentive not to maximize its servicing fee income—i.e., to permit Carvana, as sole holder of the notes, to enhance its finance-driven income in any given period—such incentive would be undermined to the extent the Class XS Notes are ultimately sold to an unaffiliated third party.

The certificates. The certificates come at the bottom of the cashflow waterfall. The holders of certificates are entitled to any remaining amounts only after all other parties—the Servicer, the XS Noteholders, the Class A-E noteholders—have been paid and a reserve account and overcollateralization pool are sufficiently capitalized.