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Nicholas Financial Inc

NICK (US: NASDAQ)

Update as of November 9th, 2008

Current Price: ~$3.05/share

Company Report Update:

In my original summary of Nicholas Financial Inc, I described a company with a niche focus on auto lending to the lower income client ('subprime'). The company had an owner/founder who was still active in the business and also was a very large shareholder. I described the difficult environment that Nicholas Financial was operating in but how it presented an opportunity for them as they had positioned their business well for a potential downturn.

Well, nearly 18 months later, nothing has changed… except the stock price… which was cut by more than 70%. The founder and CEO is still active in the business, the company is still growing (albeit much slower than I anticipated) and still profitable. No one will argue that Nicholas is doing ***great***, but they are certainly doing ***well*** all things considered. While their profitability has declined, they are still making a decent amount of money. And, although auto industry lending has scaled back drastically as the credit crisis has intensified, and many of their competitors have left the market or gone bankrupt, Nicholas has continued to grow their revenue at 7-8% and fund new loans at very good rates.

My outlook on the company's near term results has declined quite a bit due to the economic weakness, but I believe the company still has a viable business model, and longer term they will have a much larger share of the used car financing market. The company has been experiencing increasing loss rates on their loans and I believe this will continue as unemployment increases. However, the company is very well positioned for even a very bad recession. Their biggest fundamental risk (aside from simply making bad loans… which they have not done) is the credit line provided by Bank of America and a few other banks. If Nicholas fails to meet any of the credit agreements for their credit line, it could be renegotiated or altered. I believe that there is a potential for Nicholas to fail to meet their credit line covenants, but I don't believe there is any fundamental risk to the contract changing materially. The interest rate may increase, but that would be the extent of my expectations as the lenders have a lot of shareholder equity providing them a safe back drop in case Nicholas runs into trouble.

As shareholders, for just over $3/share, you can own a company that has grown equity per share at >15% for nearly 20 year through multiple credit cycles. The company is run by its founder, and his right hand man, who has a lot of skin the game and demonstrates both conservative business practices and conservative accounting. Additionally, for that $3/share, you can buy a company that has net equity of nearly $8/share.

Even given the recent credit difficulties, I believe Nicholas shares hold a true value of much more than $10/share. Given that, the market has disagreed with me for longer than I would like and I will not argue with anyone who says that I should have waited to buy this company until more bad news was priced in. But I believe our initial purchases that were made ~$10 will turn out 'ok'… and the purchases that have been made near the current price and below will be looked back on as 'stupid cheap'.

As Benjamin Graham (Warren Buffett's mentor) said; ***"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."***

Needless to say, I believe my data and reasoning on Nicholas Financial imply a company that is being priced by the market at a substantial discount to its true worth.

(The original investment report on Nicholas Financial Inc is included below in its entirety)

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Nicholas Financial Inc

NICK (US: NASDAQ)
June 31st, 2007

First Purchase: Accumulation began in the low $11.00 range
Last Sale: None
Current Price: ~$10.76/share

Company Background:

Nicholas Financial was a company originally founded by the current CEO (Peter Vosotas) and his wife in 1985. Originally the company focused on accounting software. In 1987, the company was listed on the obscure Canadian Venture Exchange because no other North American stock exchange would accept the listing due to the small price and float of the companies' shares. A few years later in 1990 Nicholas got into the auto lending business which is now the core focus of operations for the company.

Mr. Vosotas owned ~40% of the stock in the company until a 2004 secondary offering occurred in which the CEO sold shares at about 60% of the price they are at today. Now the CEO is a ~16% owner in the business, and while the company is still small and relatively un-followed by Wall Street, it is getting a little more attention these days.

In the past 12 months the company had revenues in excess of $46 Million and profits of $11 Million. The primary area of focus for the company is in the subprime (low credit quality) auto loan segment. The bulk of their business is loans purchased from dealerships (at a discount), but ~7% of their loan business is direct to consumer.

Investment Thesis:

In the lending business, there are always risks. Economic, accounting, and forecasting risks abound. The best strategy for investment in these areas is to partner with honest and ethical management team who has 1) skin in the game, 2) a history of delivering and 3) a history of providing transparent reports to their investors through good times and bad. And as always, the goal is to buy at a very attractive price so we get excellent value for our investment dollars.

In the case of Nicholas Financial, I believe that we have all of the above elements in spades:

1) We have an owner / founder / operator who is a significant stakeholder in the business. (16% owner)
2) The company was founded with $500K in 1987 and has since grown into a $100M+ company. Revenue and Profit growth has been >15% for many years. (See Figure 1 on the next page – Financial Metrics)
3) I've spent many hours reading and researching on the CEO and CFO and I have found them, in many instances spanning several years, to be straight shooters with both honesty and aptitude at what they do.

As for whether Nicholas Financial is a bargain at today's prices, that is always a topic of debate. The auto lending business has always been a difficult one. There is always an enormous incentive to make bad loans and boost volumes (and bonuses) which eventually corrodes the value of the business. Nicholas has survived two credit cycles with their business soundly intact; all the while producing attractive shareholder returns. Their advantage lies in their hands on approach to managing their customers and their credit risk. They actively call customers at the first sign of a missed payment and they work hard to help them get jobs if that is what is needed. They are also very selective up front about which loans they make or buy. In the worst case they also will (if all else fails) work hard to repossess the vehicles that are collateral for their loans so they can minimize losses.

Today it is possible to purchase Nicholas Financial shares at a price of <10x their annual profits. An attractive price to be sure, but the question of growth is always an important one. The company still has many states to expand into and there is an enormous chunk of the market that is still available for them to address in their current states. Growth has recently slowed as Nicholas is currently being very conservative in terms of how they are leveraging their capital to make loans as well. In the past the leverage ratio (assets/equity) that the company employed was greater than 4, and it now sits at a bit less than 2.5. (As an example, a typical bank may be leveraged at perhaps 8:1 or 10:1). As with all business, leverage enhances returns and risk, and Nicholas is taking a more cautious stance for the time being which I believe is the proper choice. (See Figure 2 on the next page – Leverage Ratios)

Figure 1

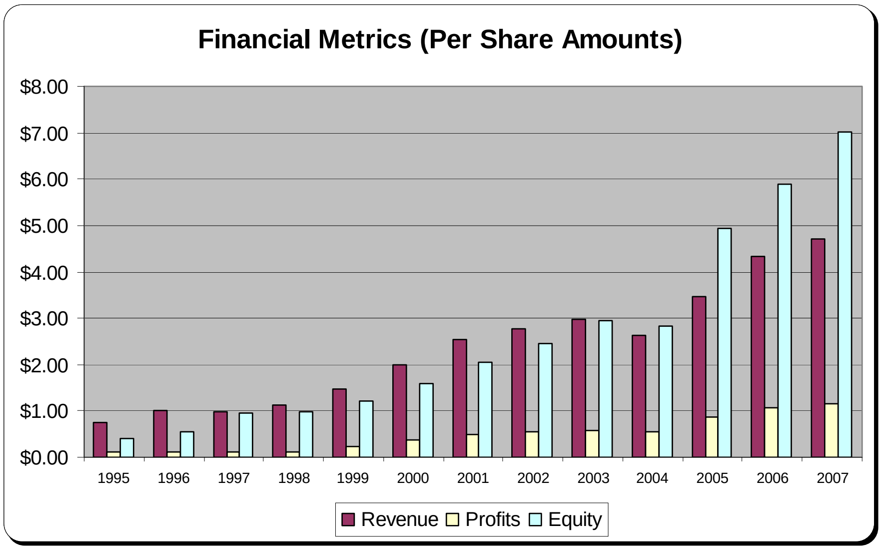
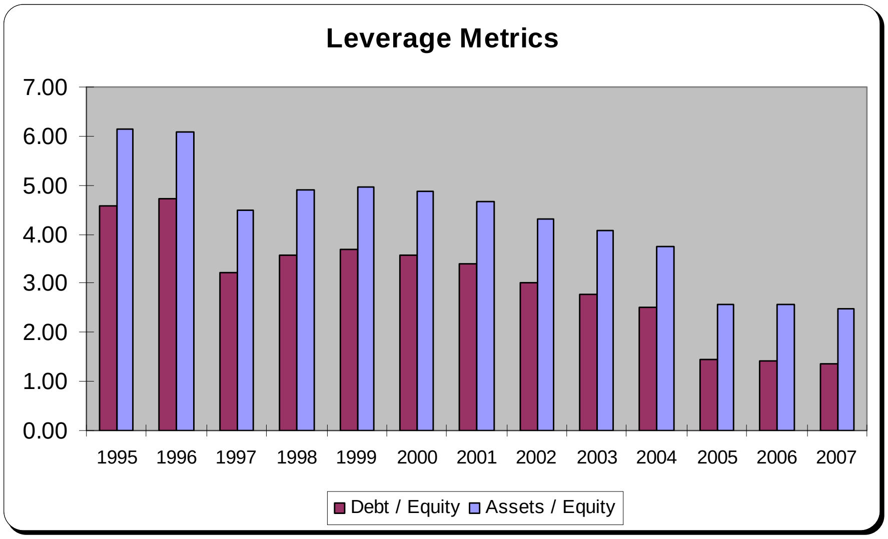


Figure 2



Conclusion:

The basic investment thesis in Nicholas Financial is fairly straightforward. I acknowledge that there will always be inherent risks the subprime auto lending business will face. Their subprime status makes people nervous with respect to Nicholas as they tend to deal with lower income customers, the current housing market makes people nervous, and the threat of an economic recession makes folks a bit twitchy as well. In the end, recessions and crises will come and go, and perhaps some (or many) events may have a negative impact on the Companies' business operations in the short term. However, by purchasing companies like Nicholas that trade at attractive valuations, and have honest and qualified managers, I believe we have an excellent chance of generating good returns with time and to weather any storms that come our way.

Today the stock market is offering us an attractive price on the shares of Nicholas Financial because of general market worries about the economy. The fact that NICK is an under followed company, too tiny for Wall Street to care about, is what gives us the opportunity to acquire the shares at a bargain. At less than 10x earnings and with lots of growth ahead, I strongly believe our investment in Nicholas Financial will prove to be a sound one.