

# Tricolor and the Flywheel Effect: Achieving a Defensible Model in Subprime Automotive Finance

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# Introduction

Fundamental competitive advantages are essential for any business model to become defensible and sustainable.

These advantages effectively form “business moats” which set companies apart from their competitors.

Warren Buffet popularized this concept in one of his famous shareholder letters: “We’re trying to find businesses with a wide and long-lasting moat around it.”

This white paper details how Tricolor’s differentiated strategy creates a flywheel effect in which the principal ingredients of Tricolor’s approach construct a defensible and sustainable model.

These fundamentals form the basis for Tricolor’s mission-driven strategy to meet the needs of the underserved consumer using a responsible lending platform that can ultimately help address the systemic problem of economic inequity facing America today.

According to the Consumer Financial Protection Bureau (CFPB), 26 million people in the United States are “credit invisible” and an additional 19 million are “unscorable,” corresponding to a total of 45 million people in the United States whose lack of a credit score translates into limited options in terms of accessing financing for a major purchase such as a motor vehicle.

The Tricolor flywheel helps resolve this scoring issue and creates a path to mainstream credit and finance for low income, underserved customers.

***“The key to investing is to determine the competitive advantage of a given company and above all, the durability of that advantage.”***

**- Warren Buffet**

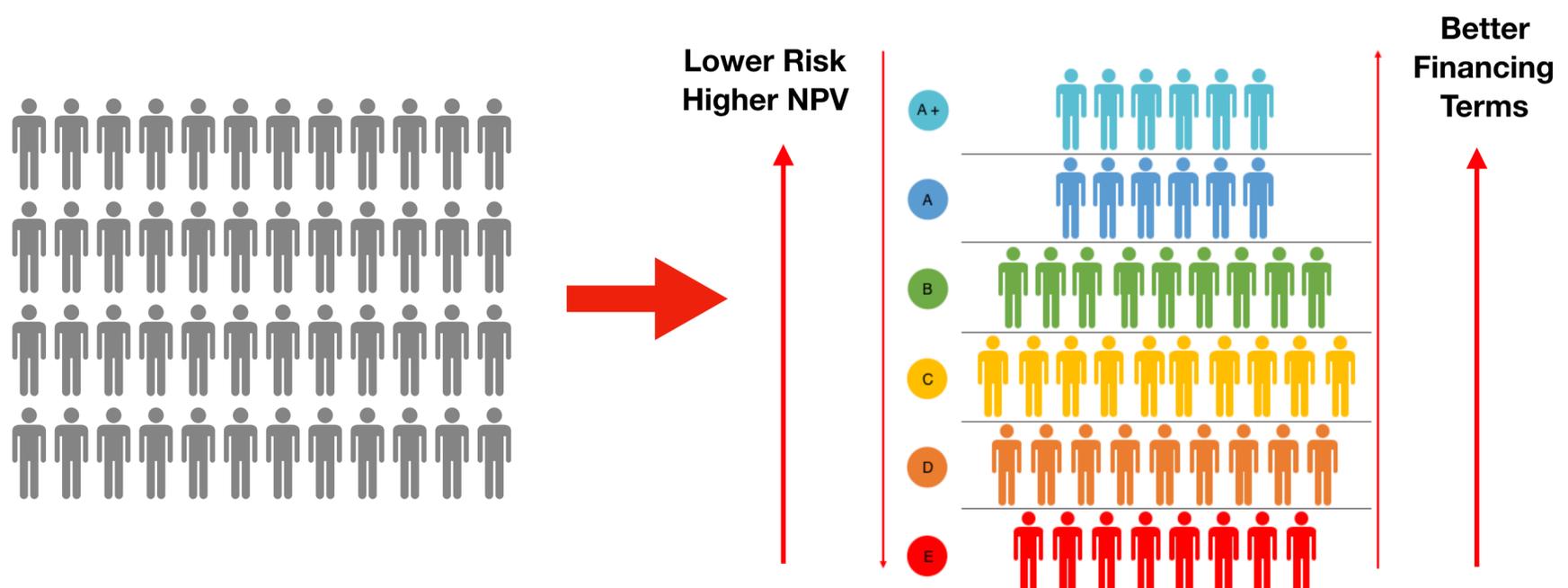
# Understanding Tricolor's Primary Competitive Advantage

Tricolor's fundamental competitive advantage lies in its ability to "score the unscorable."

Over the past decade, Tricolor has gathered data from hundreds of thousands of applicants. In its early versions, Tricolor utilized traditional regression analysis to understand how these application attributes correlated with default, enabling it to grade - or segment - applicants into six distinct grades.

During the past two years, Tricolor has dramatically advanced its risk precision using artificial intelligence to identify "patterns" among over 100 non-traditional attributes and their relationship to default. Given the absence of a FICO score among the credit invisible population, this competency is powerful.

**Tricolor is the only lender in subprime auto ABS to issue an investment grade bond with loans originated to credit invisible borrowers**



# The “Flywheel” Effect

Tricolor’s model puts the customer at the center. Leveraging its proprietary ability to segment risk for credit invisible consumers into a disruptive pricing strategy, Tricolor gains the most powerful competitive advantage as the low-cost provider and most affordable solution for its target consumer.

Tricolor has developed its own bespoke version of a strategy originally described by Jim Collins twenty years ago known as the “flywheel effect,” which preserves the customer-first mindset.

By definition, a **flywheel** is a heavy revolving wheel that is used in a machine to increase momentum and therefore provide greater stability to the machine. Given its weight, the flywheel is difficult to push from a standstill, but once it starts moving, it gradually builds momentum, which eventually enables the wheel to turn by itself and create even more of its own momentum through a self-reinforcing loop.

Amazon’s flywheel is an example of a network effect: the value of a product or service increases according to the number of others using it. In this case, the lower and more competitive the prices are, the more appealing the products are to prospective customers, propelling more third-party sellers and brands to want to sell on the marketplace.

Amazon refers to this as the “virtuous cycle” and focused its model around price value. With the growth and massive scale that accompanies this rich customer experience comes the ability to lower cost structures and simultaneously offer customers lower prices and reinvest capital into new initiatives, which in turn, drive more growth.

***“There are two kinds of companies – those that work to raise their prices and those that work to lower them”***

**-Jeff Bezos**



**The Amazon Flywheel**

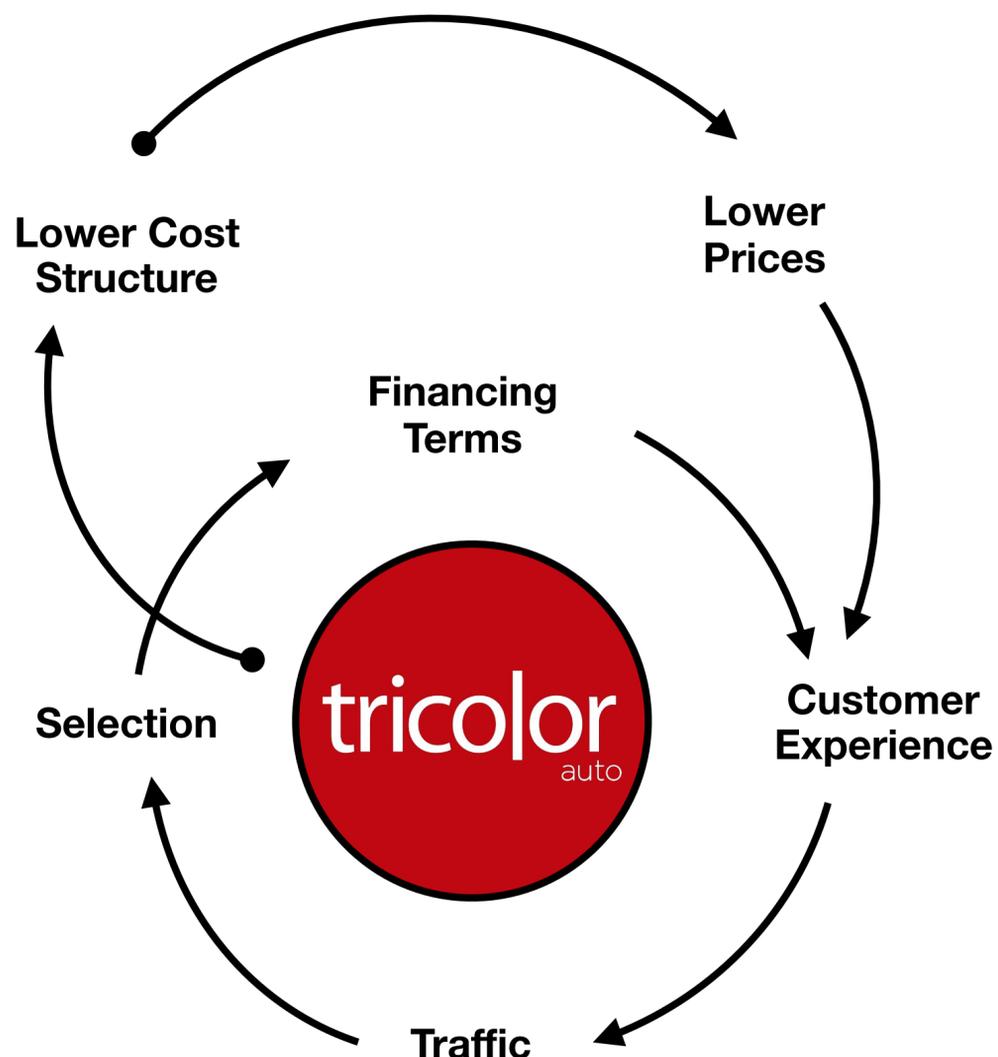
# The “Flywheel” Effect (continued)

Tricolor’s pricing strategy creates a classic flywheel effect.

Price value is the single most important factor for any consumer. So as Tricolor lowers prices by reducing the gross margin on its vehicle inventory, it attracts more customers. Then, by leveraging its proprietary risk model and segmenting the customers into six distinct grades, it offers the higher-grade applicants more favorable financing terms, optimizing conversions of these borrowers.

As sales volume grows, Tricolor continues to lower its prices by improving its financing terms, resulting in increasing conversion of the “good” borrowers and greater market share. Conversely, this pricing strategy creates adverse selection for its competitors.

**Tricolor has gradually lowered its gross margins over the last four years to a level which is roughly 50% less than the national average for the industry.**



*A description of Tricolor’s pricing strategy can be found in the Appendix. For a more detailed explanation, please read the [Company’s white paper on pricing strategy](#) or [watch this video](#).*

# Data Network Effect

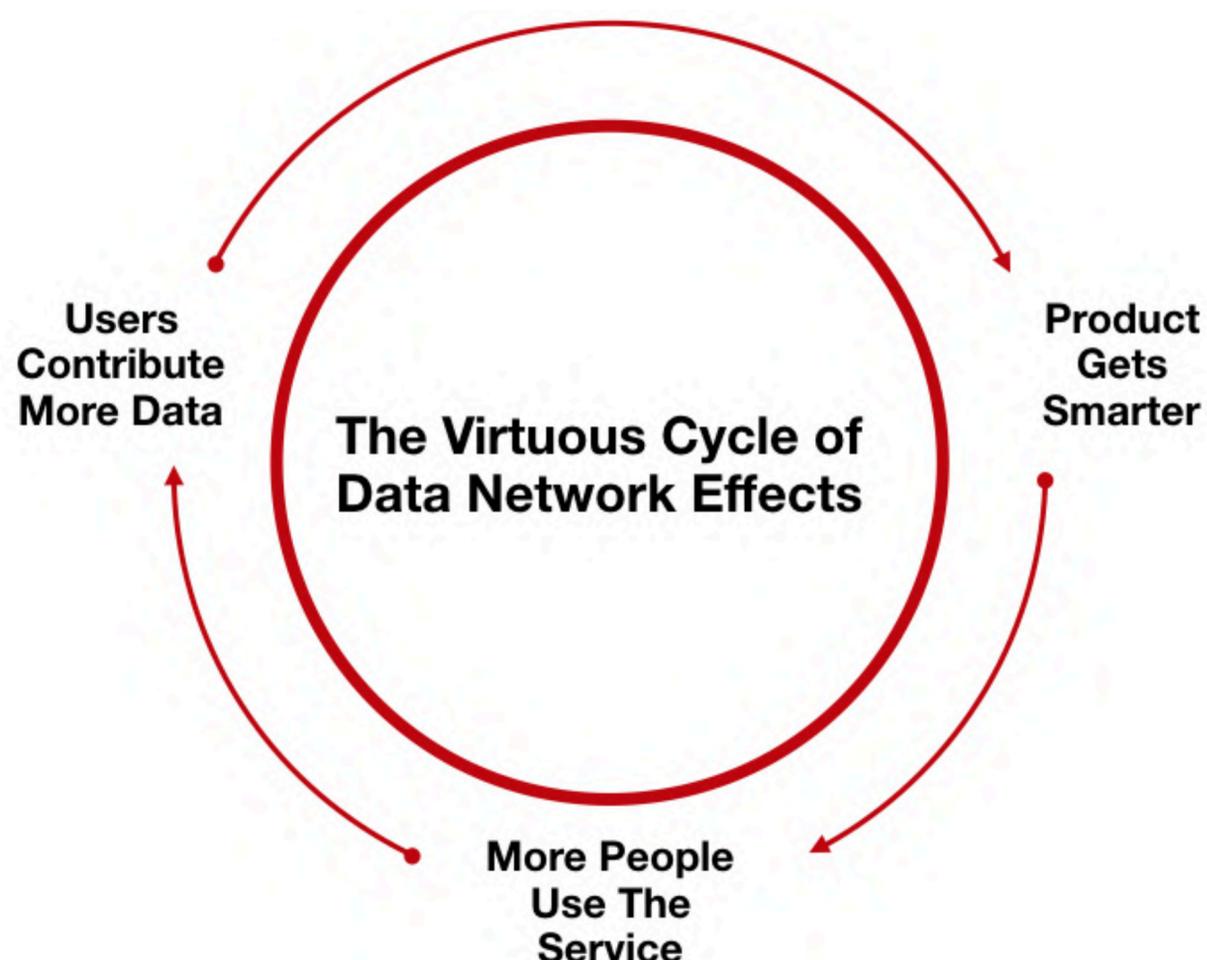
A data network effect exists when a product's value increases with more data and when additional use of that product yields more data.

Over a twelve-year period, Tricolor has gathered data from hundreds of thousands of applications from its targeted niche of underserved Hispanic consumers. More data means better algorithm, thereby continually improving the value of Tricolor's proprietary segmentation model. This growing data set enables it to capitalize on its use of unconventional data at scale.

With Tricolor's introduction of deep learning two years ago, the data network effect is even more profound. The company's ability to segment is constantly improving as the system learns and optimizes in response to daily loan level payment and delinquency data.

***"Innovation is the only way to win."***

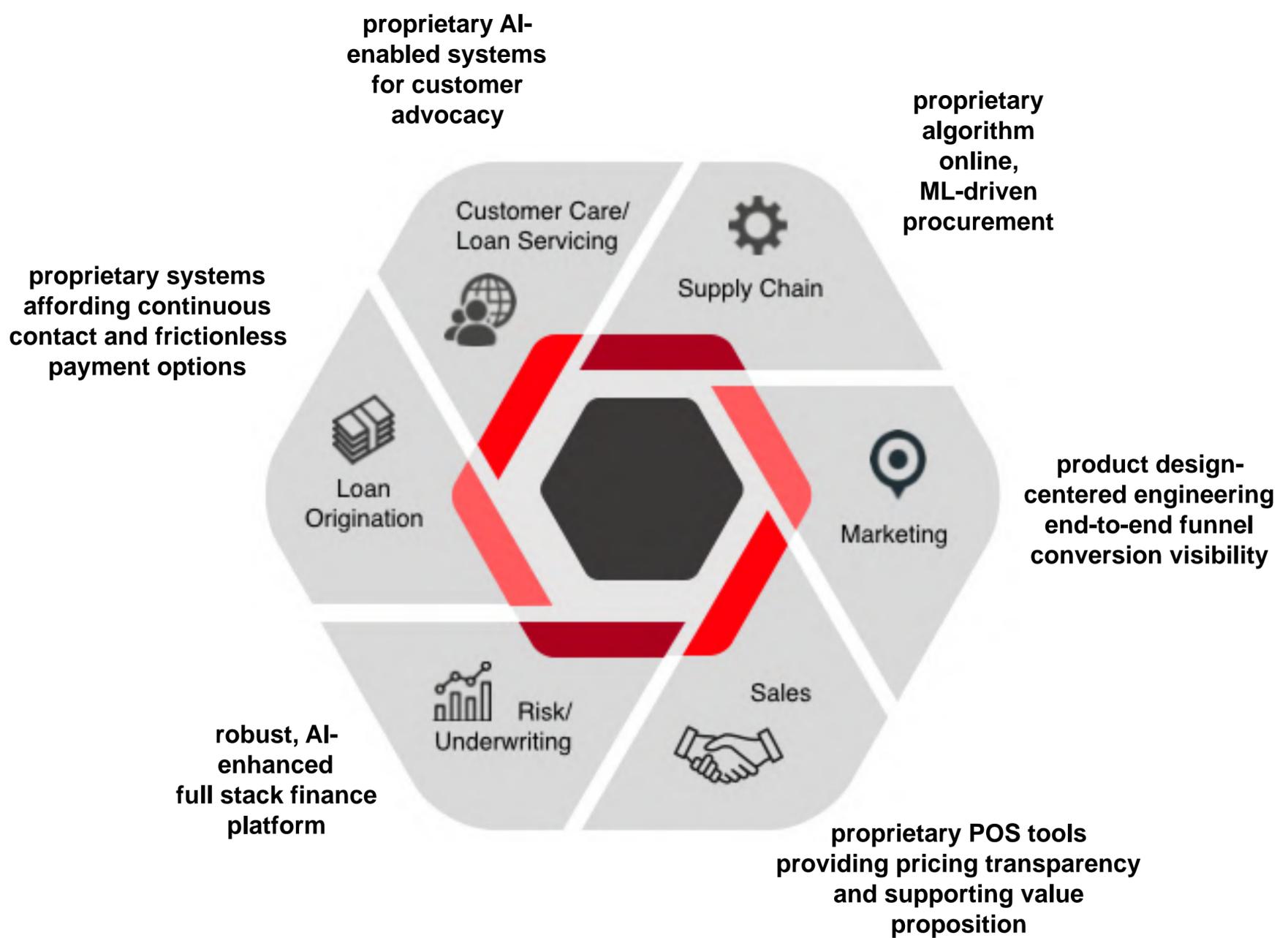
**- Steve Jobs**



# Technology Investment

Tricolor's data network effect is supported by a substantial investment in technology, which manifests as a proprietary, end-to-end analytical platform.

Tricolor now applies deep learning across all of its processes. Integrated with millions of data points and proprietary data analytic processes, our solutions can provide new levels of insight and control, empowering us to make the most profitable business decisions across the entire customer lifecycle by informing decisions from marketing and lead generation to loan servicing.



# Constructing a “wider and longer lasting” moat

There are a number of additional features of the Tricolor model that serve as competitive advantages accelerating the flywheel effect:

**Direct to consumer approach.** Unlike its indirect peers in subprime auto, Tricolor owns a direct relationship with the consumer, allowing it to gather data in order to gain behavioral insights and shape a personalized customer journey. This integrated retail auto-finance model creates complete alignment between marketing, risk, and underwriting.

**Strong, recognizable brand supported by distinct value proposition.** Over twelve years of investment in the brand through an omni-channel marketing approach has created a strong emotional connection with consumers rooted in Tricolor’s aspirational messaging.

**Digital engagement.** Targeted lead generation strategy based on design thinking approach and mobile-first, AI-enabled customer experience.

**Robust, centralized infrastructure.** Strategic footprint of 39 dealerships and 8 state-of-the-art reconditioning facilities across Texas, California, and Nevada (opening September 2020) with shared services center in Guadalajara, Mexico provide a scalable and cost-effective back office.

**Capital markets access.** One of only five Buy Here Pay Here (BHPH) operators that have capital markets access and the only issuer in all of subprime auto ABS with loans originated to credit invisible borrowers.

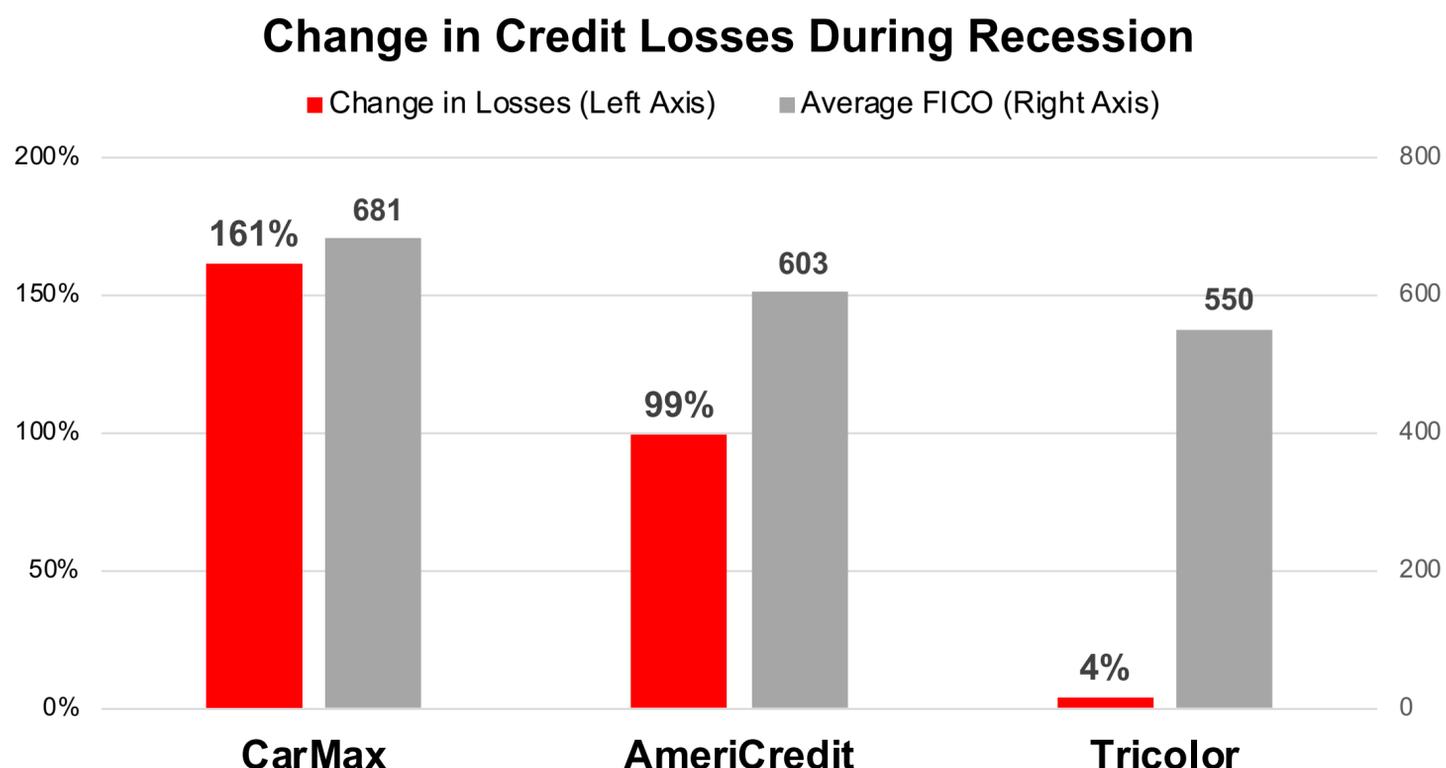
*“If you don’t have a competitive advantage, don’t compete.”*

**-Jack Welch**

# Countercyclical Effect

Tricolor, like much of the BHPH segment, is positioned to flourish in a recessionary environment. This is due to a number of key industry drivers:

**Integrated model.** BHPH operators have two levers that can mitigate potential increases in credit losses: the retail margin on the vehicle sale and the financing margin, or interest rate, on the loan amount. For a traditional operator in the BHPH space, both margins are wide and consequently, can accommodate more volatility. In Tricolor's case, given that its pricing strategy constrains its latitude to vary margins, it relies on deep learning to optimize pricing. In comparison, a lender such as CarMax or AmeriCredit has much narrower margins, so an incremental increase in losses can correspond to a large percentage increase (please see chart below) and an unacceptable level of risk.

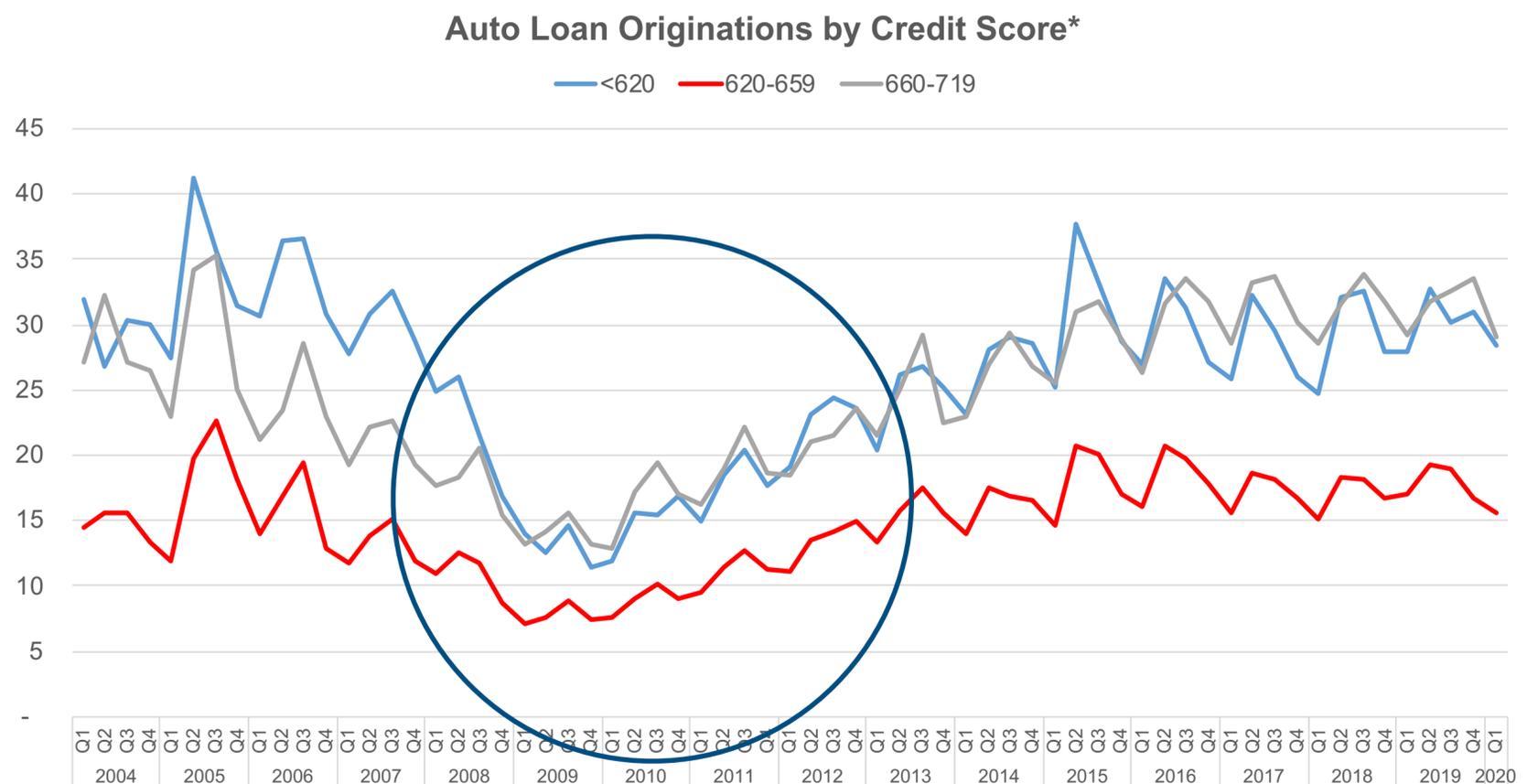


Change in Credit Losses is measured the annualized net losses on managed portfolio from pre-recession through to recession peak.

# Countercyclical Effect

**Positive selection.** Most indirect lenders withdraw in a pronounced way from the market during periods of economic uncertainty. Through the end of May 2020, subprime auto loan originations declined by nearly 70% from pre-pandemic levels, according to Equifax. This is consistent with the trend in the last recession (please see chart below) in which originations for borrowers in the lowest tier of subprime (<620 FICO) dropped by 65%. Subprime auto originations did not resume pre-recession levels for two years.

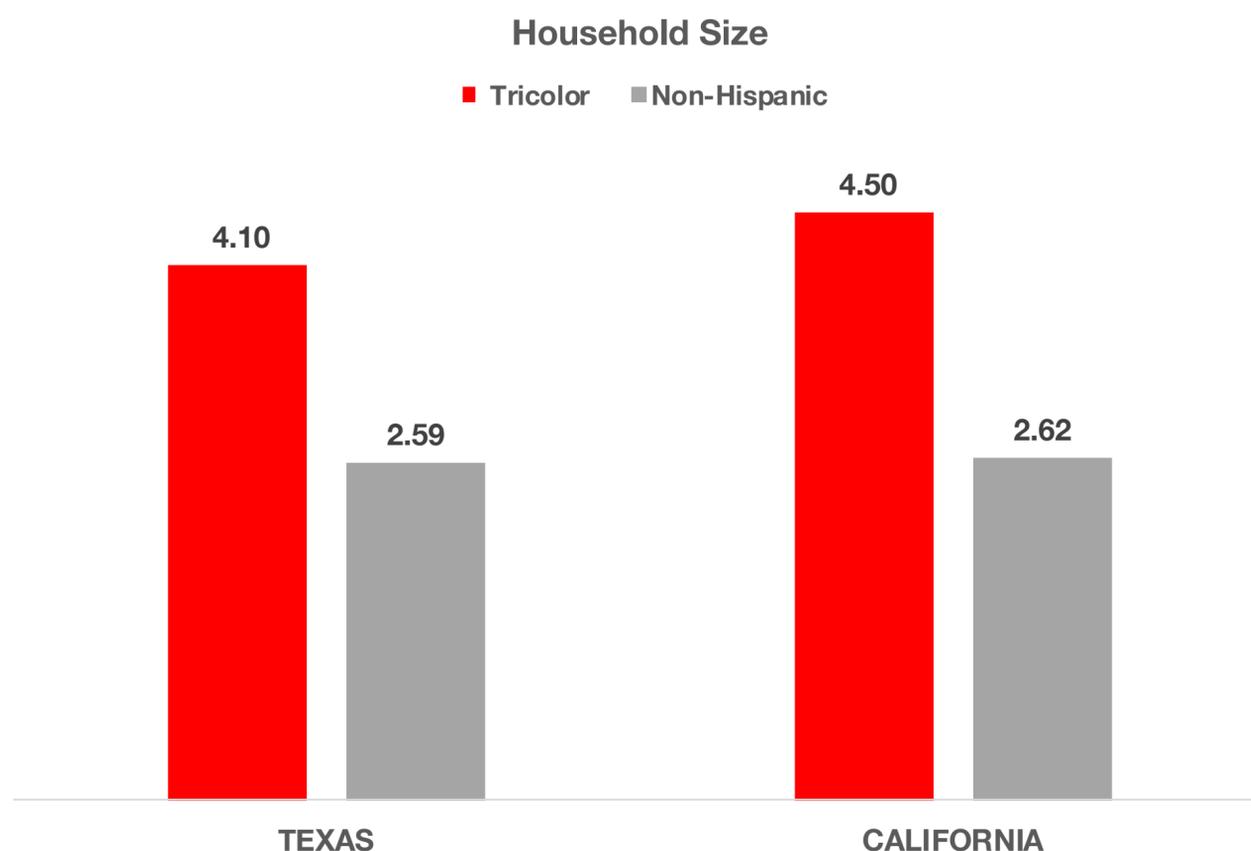
Consequently, the addressable market expands for the operators at the bottom of the credit spectrum, such as the BHPH segment. As beneficiaries of increased demand, BHPH operators can experience positive selection and subsequently lower credit losses in these vintages of loan originations.



Source: New York Fed Consumer Credit Panel/Equifax

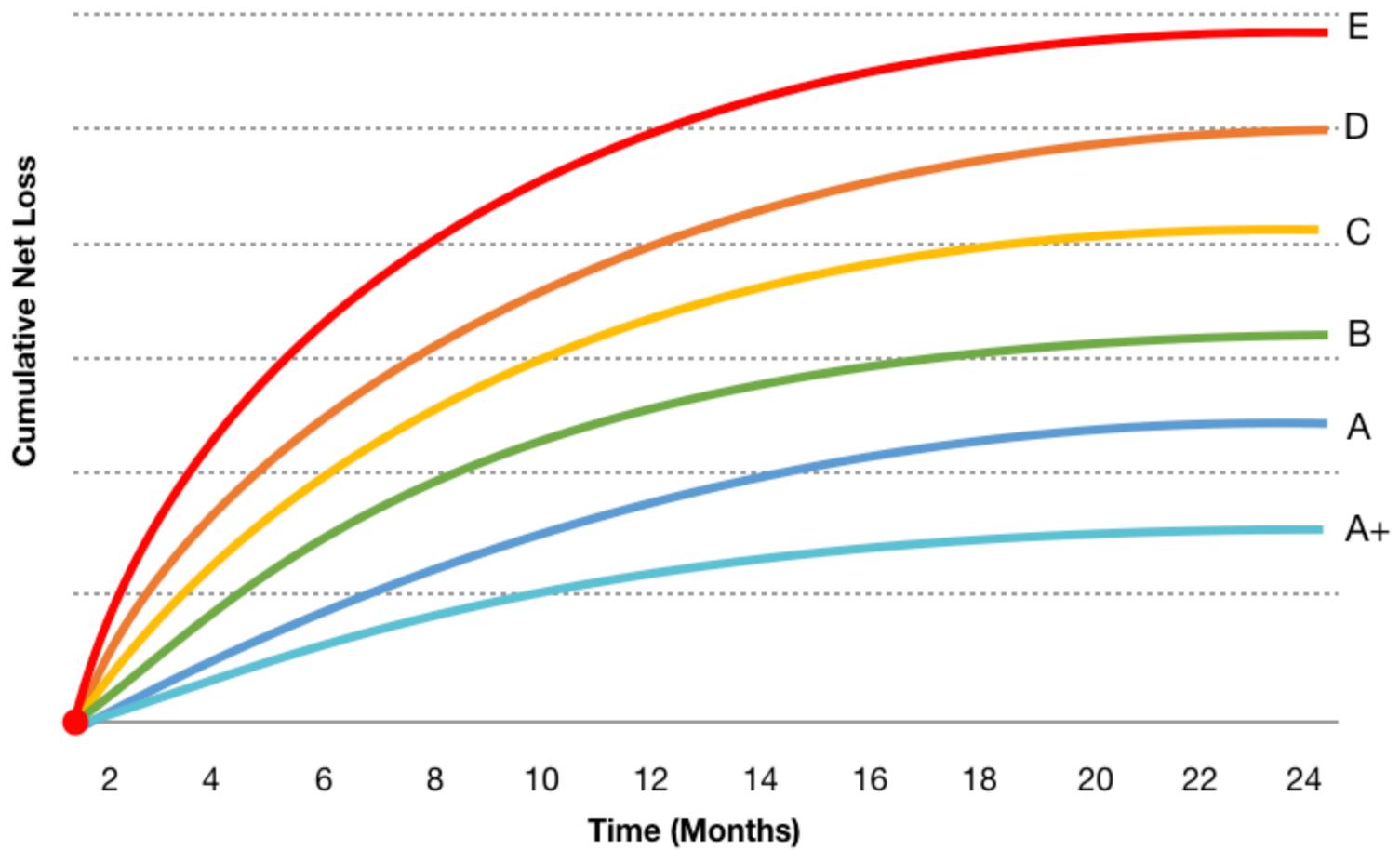
# Countercyclical Effect

**Loyal and resilient customer base.** A number of cultural qualities of the Hispanic population favorably impact businesses, and in particular lenders, that serve this fastest growing segment of the US population. Hispanics immigrate to the United States in search of a better life for their families and work tirelessly to pursue their own American dream. In general, Hispanics are hardworking, determined, and value the opportunity to live in America. They appreciate the opportunity to secure financing on quality transportation and reciprocate with responsibility and commitment, as well as brand loyalty. Hispanics place tremendous emphasis on the family, which typically includes multiple generations, as well as extended family, living in the same household. Consequently, the obligation on an auto loan is shared by multiple individuals and supported by multiple incomes, mitigating the risk associated with a single borrower experiencing a loss of employment.

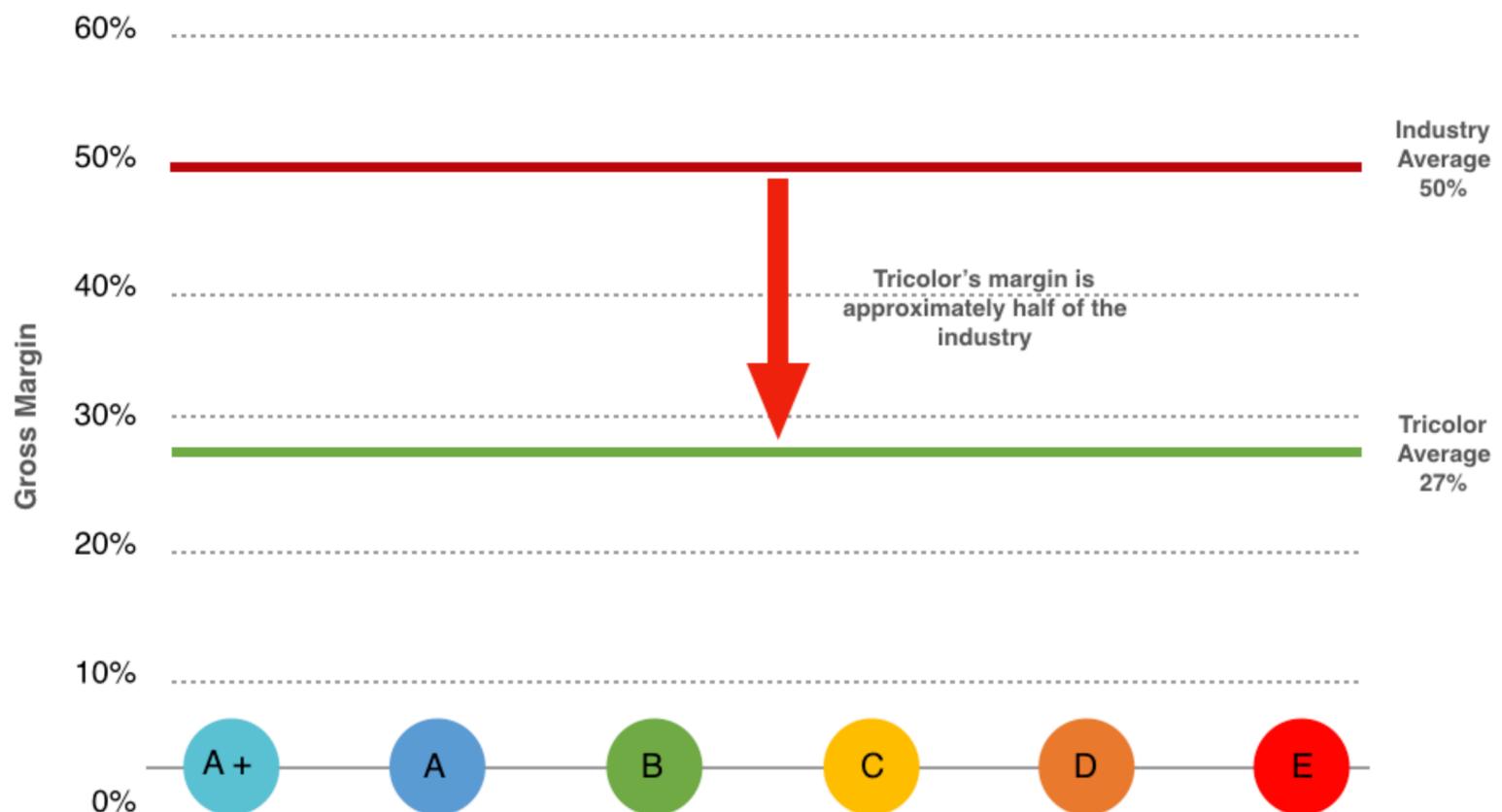


# Appendix: Pricing Strategy

Tricolor's pricing strategy leverages its proprietary, technology-driven risk model which segments credit invisible borrowers into six distinct grades.

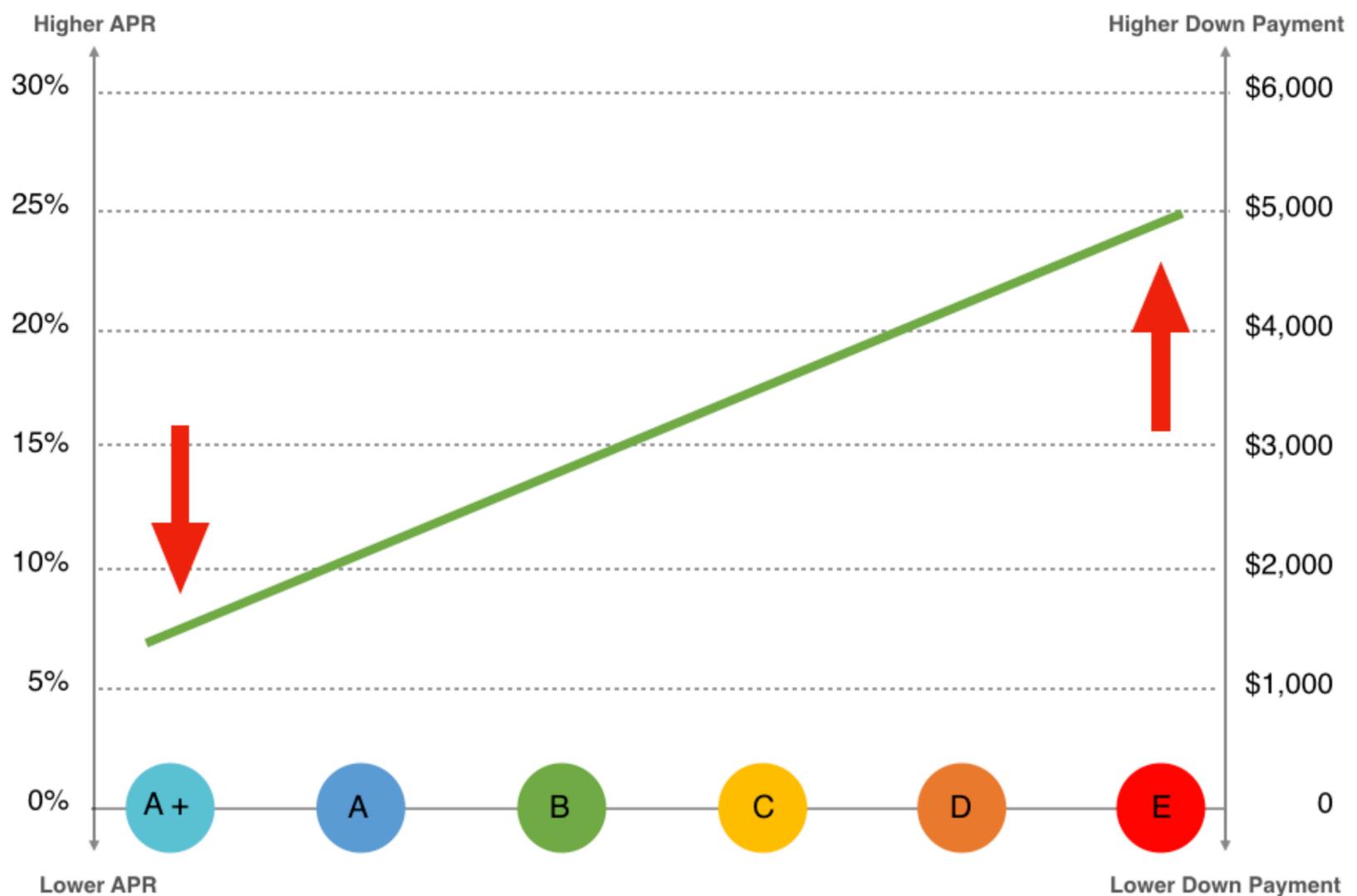


First, Tricolor lowers its margin across all grades.



## Pricing Strategy (continued)

Next, Tricolor “slopes” its financing terms sharply across all six grades. It offers highly attractive terms---low interest rates, low down payments, and longer terms---to the high-grade applicants, resulting in high conversion. Conversely, sloping results in poor conversion of low grade applicants, ultimately creating adverse selection for the competition.





## About Tricolor Holdings

Daniel Chu is the founder and CEO of Tricolor Holdings, which owns Tricolor Auto Group and Ganas Auto Group.

Tricolor is a Community Development Financial Institution (CDFI) and mission-driven company which sells and finances high quality, certified used motor vehicles through its premium brands, Tricolor Auto Group in Texas and Ganas Auto Group in California, utilizing advanced data analytics and technology to advance financial inclusion to a highly underserved market and offer responsible, affordable, credit-building auto loans to individuals with no or limited credit history.

Headquartered in Dallas, Tricolor and its affiliate Ganas Auto Group operate 38 retail dealerships across 15 markets in Texas and California, as well as a shared services center in Guadalajara, Mexico. On a combined basis, Tricolor and Ganas have served over 60,000 customers and disbursed over \$1 billion in affordable auto loans by using its proprietary model to segment risk.

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