

Home Warranty Industry *Another Warranty Niche*

Investments and M&A activity in the vehicle service contract (VSC) industry continue on a breakneck pace; Colonnade has tracked dozens of transactions over the past three years. With a flood of capital seeking related investment opportunities, we see investor interest expanding into home warranties, a \$2.3 billion market.

In many ways, the home warranty industry today mirrors the VSC market a decade ago, providing an interesting growth thesis. Since the mid-2000's, VSC retail prices have doubled to \$3000 from \$1500 each; new vehicle penetration rates have doubled to more than 40%; and penetration among used vehicles has exploded with the growth of the direct to consumer channel and the use of payment plans to finance these high ticket consumer purchases. Product innovation, marketing, and capital have grown the industry significantly. Low penetration rates characterize the nascent home warranty market, and we expect significant investment in product marketing and innovation over the next decade.

The home warranty market enjoys similar positive industry fundamentals as other warranty segments, especially the VSC market, including strong growth, margins and cash flow. As consolidators provide a logical and ready exit path, we expect to see interest among financial sponsors increase in this industry in the next three to five years. Such interest can provide growth equity and/or liquidity to owners of promising, established home warranty platforms.

OVERVIEW

Home warranties involve service contracts that protect a homeowner against costly repairs or replacement of household systems and appliances. The most commonly covered household items include electrical, plumbing, central heating and air conditioning (HVAC) systems, water heaters, refrigerators, dishwashers and ovens and cook tops. Home warranties include a range of coverages and typically have a term of one year. Home warranties should not be confused with builders' warranties, which cover structural components of a residence.

Most often, home warranties are purchased by the seller of a home and offered to the buyer as part of a real estate transaction. Real estate brokers are the primary sales channel for home warranty companies. Because of the peace of mind and high customer satisfaction rates, home warranties experience significant renewals, often in excess of 50%. American Home Shield (AHS), the largest provider, posts retention

rates in excess of 75%; two-thirds of its revenue is derived from existing contract renewals. In-network service providers also promote home warranties to existing customers and new ones, typically during a repair call, to protect homeowners against future expense. Finally, home warranties are originated online and through direct to consumer call centers.

MARKET SIZE

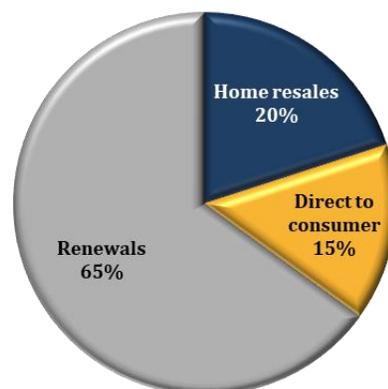
The U.S. home warranty (or home service contract) market is estimated at \$2.3 billion in 2016, involving over four million contracts at an average retail price between \$500 and \$750. The market is estimated to be growing at 5% annually and generally tracks the sales of existing homes in the United States. AHS, the market's largest participant, increased revenue by 5% to 10% annually between 2009 and 2016. Source: *Warranty Week* and SEC filings

The home warranty market is characterized by relatively low household penetration, estimated at less than 10%; although the industry's trade organization, National Home Service Contract Association (NHSCA), claims that penetration in California is considerably higher. ServiceMaster's AHS estimates nearly 30% of home resales include a home warranty. Increasing awareness and penetration among homeowners create significant growth opportunity for providers.

DISTRIBUTION

Home warranties are sold with home resales, direct to consumer, and through renewals.

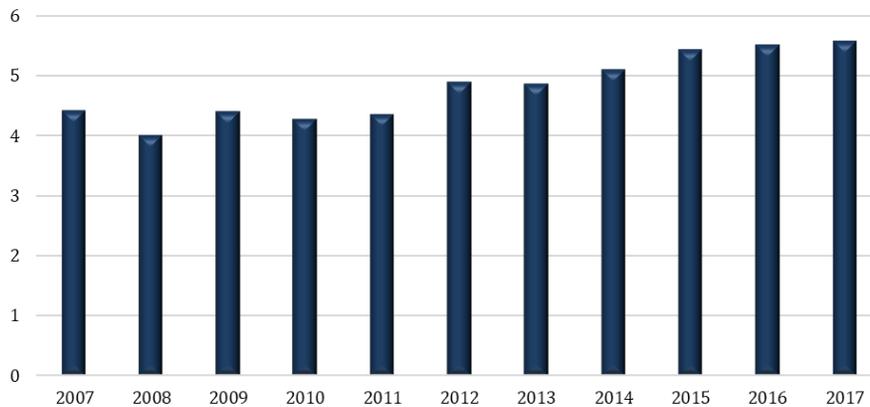
REVENUE BY CHANNEL



Source: AHS

Home warranties are sold through real estate brokers at the time of a home sale and are purchased by the seller. According to the National Association of Realtors, existing home resales, as measured in units, increased by approximately 3% in 2016.

US EXISTING HOME SALES (*units in millions*)



Source: National Association of Realtors

While home warranty sales typically follow the housing market, warranty sales are expected to increase as appliances become more complicated and difficult to repair, making a home warranty an increasingly attractive product. Home warranties provide buyers peace of mind. The reliability of a home warranty’s professional repair network, with pre-negotiated rates, also increases the value proposition of the warranty to the consumer and spurs use of the product.

Direct-to-consumer (DTC) sales of home warranties are marketed as financial protection and convenience products. DTC sales are independent of a real estate transaction and benefit from the opportunity to finance the product. DTC sales are generally available to customers through multiple channels (*e.g.*, phone, web, email, mobile, social media). The NHSCA claims that industry-wide direct sales to consumers now account for approximately one-third of all home service contract sales. In the DTC segment, AHS estimates less than 5% market penetration.

CATEGORY DYNAMICS



Source: ServiceMaster

While many home warranties are originated by realtors, most of the revenue stream comes from existing warranty holders renewing their product. Renewals are typically offered near the end of the term via direct mail, phone call, or email.

HIGH RENEWAL RATES

The home warranty industry is characterized by a high level of customer interaction and service requirements. Home warranty providers generally partner with a preferred network of pre-approved contractors to enhance distribution and increase consumer satisfaction. This combination of a high-touch/high-service business model and the peace of mind the service contract delivers to the customer has led to high renewal rates in the home warranty industry. AHS boasts a 75% renewal rate, and nearly two-thirds of its revenue comes from renewals.

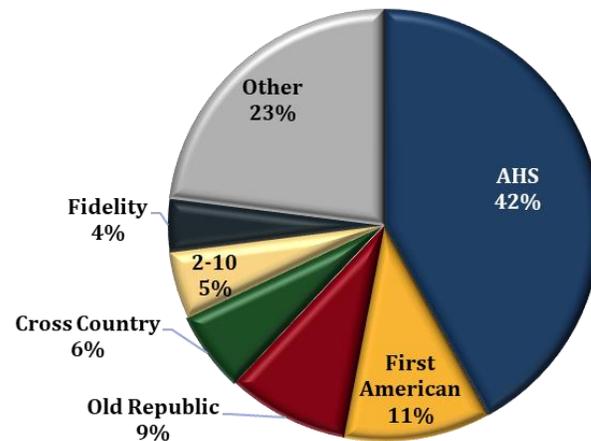
FINANCING

Home warranties, like vehicle service contracts, sold through the DTC channel can be financed over a term up to half the length of the warranty. Financing or payment plans can meaningfully increase sales of home warranty products. Some of the direct to consumer sellers are providing financing in-house, and a few third-party payment plan companies have nascent programs.

INDUSTRY STRUCTURE

The home warranty market is highly concentrated, with the top four providers commanding nearly two-thirds of the estimated \$2.3 billion market. American Home Shield, a unit of ServiceMaster, posted over \$1 billion of revenue in 2016, estimated at nearly four times the size of its next competitor, First American Home Warranty.

US MARKET SIZE: \$2.3 billion



Source: SERV, Warranty Week

The largest ten players account for nearly 80% of industry revenue, creating a significant barrier to entry. After the top four, the landscape is littered with roughly a hundred small companies operating on a local or regional basis. Larger players typically look to acquire promising providers that reach scale to cement local and/or regional coverage. Some of the larger players include:

- American Home Shield, a unit of ServiceMaster (NYSE: SERV), claims to be the founder of the home warranty nearly 50 years ago, offers warranties on a national basis, and serves over 1.9 million customers. AHS commands over 40% of the national market, as measured by revenue. AHS reports that it completes more than three million service requests per year. In 2016, it reported revenue of \$1.0 billion and EBITDA margins in excess of 20%. AHS boasts that it has paid over \$3 billion in claims. AHS estimates that its share of the new sales market for contracts written in connection with existing home resales and direct-to-consumer sales in 2016 was 30% and 55%, respectively.
- First American Home Warranty, a unit of the specialty insurance segment of First American Financial Corporation (NYSE: FAF), operates in 39 states and the District of Columbia and posted an estimated \$300 million of revenue in 2016.
- Old Republic Home Protection operates as a unit of the general insurance group of Old Republic International Corp (NYSE: ORI). Founded in 1974, the company operated primarily in California until launching its national expansion plan in 1995.

- Cross Country Home Services, a member of the Cross Country Group (Private), sells home warranties and maintenance plans nationally through the real estate broker channel, direct to consumers in the aftermarket, and through other financial services partners. CCHS launched in the 1980s.
- 2-10 Home Buyers Warranty (2-10 HBW), based in Denver, CO, was acquired by Brera Capital Partners in 2002. 2-10 offers both structural warranties on new homes and systems and appliances services agreements (home warranties). 2-10 HBW's structural warranties are generally 10-year policies purchased by builders of new homes. 2-10 HBW's Resale Warranty Division sells primarily through real estate brokers across the country.
- Fidelity National Home Warranty is a unit of Fidelity National Financial (NYSE: FNF). Fidelity's home warranty operation results from the combination of Alliance Home Warranty (formed in 1995) and Chicago Home Warranty (acquired in 2000 with FNF's acquisition of Chicago Title). Fidelity National Home Warranty operates in California, Arizona, Nevada, Texas, Colorado, Washington and Oregon.

Several water and electrical utilities sell protection plans that cover appliance repairs. For instance, Dominion Products and Services (a unit of Dominion Energy, focused on the Mid-Atlantic and Northeast U.S.) and American Water Resources (a unit of American Water) offer various home appliance and related protection plans.

Source: NHSCA, *Warranty Week*, and SEC filings

RECENT TRANSACTIONS

Significant recent transactions are listed below.

| DATE | BUYER | SELLER |
|------|---------------------------|--|
| 2017 | Kingsway Financial / 1347 | Professional Warranty Service Corp (new home warranties) |
| 2016 | American Home Shield | Landmark Home Warranty |
| 2016 | American Home Shield | OneGuard Home Warranties |
| 2015 | Fidelity National | BPG Home Warranty |
| 2014 | American Home Shield | HSA Home Warranty |
| 2013 | NRG Energy | Allied Warranty |
| 2012 | Direct Energy | Home Warranty of America |
| 2002 | Brera Capital Partners | 2-10 Home Buyers Warranty |
| 2000 | Fidelity National | Chicago Title / Chicago Home Warranty |
| 1998 | Fidelity National | Alliance Home Warranty |

M&A OUTLOOK

Consolidation is accelerating in the home warranty industry, as the largest players continue to acquire well-performing, high quality local and regional players. We expect financial sponsor interest in the broader service contract industry, particularly the vehicle service contract industry, to spill over to the home warranty segment. The home warranty industry enjoys compelling industry fundamentals, including strong growth, margins, and cash flows. Combined with obvious exit alternatives, the home warranty segment seems like a natural market to attract institutional investor interest.

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