

## **Vehicle Service Contract Administration**

### ***Fragmented industry with strong margins and accelerating acquisition activity***

A rebounding automotive sector and a modest recovery of the U.S. economy have driven significant growth in the market for vehicle service contracts (*aka* extended warranties).

- The vehicle service contract (VSC) industry in the U.S. is sizable, \$14.7 billion at retail in 2012.
- The sale of VSCs is an important contributor to dealer profitability, which otherwise is under pressure from greater transparency of pricing of autos due to Internet resources.
- Revenue to VSC administrators was an estimated \$8.5 billion at wholesale in 2012. VSC administration is fragmented with dozens of regional players.
- VSC administration involves program design, pricing, underwriting, billing and claims administration (including reserving for potential losses). Administrators maintain reserves to pay claims, provide ongoing actuarial analysis of their programs, and manage program loss ratios. A well-managed VSC administrator can generate EBITDA margins in excess of 20%.

M&A activity in the VSC administration sector has accelerated in the last year. VSC administrators are selling at robust values because strong demand exists among financial and strategic buyers for high growth, high margin services businesses.

Since early 2012, six companies in the VSC administration sector have changed ownership. Each exit generated robust returns for its investors. This strong performance demonstrates the resilience of companies in this sector; many suffered early in the financial crisis and recession.

We anticipate further consolidation over the next few years as more entrepreneurs decide to exit as they approach retirement, more private equity firms seek to harvest the value of their VSC investments, and insurance companies that underwrite VSCs decide to vertically integrate.

### **Vehicle service contracts**

A vehicle service contract (*aka* extended auto warranty) is an agreement between an administrator and a vehicle owner whereby the administrator agrees to pay for the replacement or repair, for a specific coverage period, of vehicle parts in the event of a mechanical breakdown. VSCs supplement manufacturers' original warranties and provide a broad array of coverage options. Many contracts include emergency roadside assistance and rental car benefits. VSCs are marketed to drivers who (i) anticipate owning the vehicle longer than the term of the original warranty, (ii) anticipate "driving through" the original warranty by exceeding the mileage limitations, or (iii) are seeking enhanced coverage.

Consumer demand for VSCs is driven by fear of unexpected, costly automobile repairs. The purchase price of a VSC is often "rolled into" the loan that the consumer uses to buy the vehicle, or the VSC can be financed on a stand-alone basis by finance companies that offer payment plans for these products.

Vehicle service contracts are typically marketed at three points in the life cycle of an automobile: (i) at original sale, (ii) near or after expiration of factory warranty via direct-to-consumer sales, and (iii) at resale through a dealer of used vehicles.

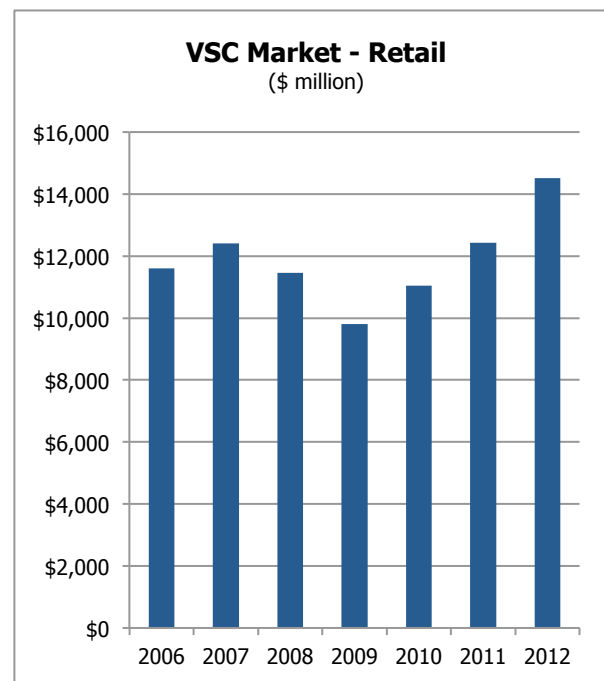
U.S. consumers spent \$14.7 billion in 2012 on service contracts for their motor vehicles. According to a recent study by *Warranty Week*, VSC companies not affiliated with automotive OEMs accounted for about 66% of VSCs sold in the U.S. at the time of vehicle purchase. Approximately 29% of VSCs were sold by an administrative/underwriting team owned or backed

by an automotive OEM, typically through franchised automotive dealers. The remaining 5% of VSCs were sold after the car was purchased, mainly through the Internet, mail or phone.

The popularity of vehicle service contracts has been growing at the dealer level, as dealers are relying more on their F&I operations to offset margin pressure on car sales from consumers armed with research on vehicle prices from the Internet. VSCs are highly profitable to dealers. Selling a VSC can hike a dealer’s total profit on the sale of a used car materially. In addition, VSCs promote customer loyalty, require no inventory, increase customer retention and involve little, if any, marketing. VSCs also encourage customers to return to the dealership for routine servicing.

**The U.S. vehicle service contract market is large and growing**

- We estimate vehicle service contract sales totaled \$14.7 billion in 2012, an increase of nearly 15%. Related revenues for administrators were an estimated \$8.5 billion.
- VSC sales have grown at a compound annual rate of 13.5% since the trough in 2009.
- Over 100 VSC administrators and 30 VSC underwriters compete.
- The top 25 administrators account for nearly 75% of industry revenues, and the top 10 administrators account for nearly half of industry revenues.
- VSC sales fluctuate with automobile sales, consumer confidence and the general economy. Sales are rebounding.
- The VSC market can be divided into integrated providers (sellers/ administrators that underwrite the contracts) and independent administrators (sellers/ administrators that place coverage with third parties).
- In the used vehicle segment, in particular, lenders often encourage customers to purchase VSCs; and the purchases are typically rolled into the auto loan.



Sources: *Warranty Week* and Colonnade estimates

**Improving the image of the industry**

The VSC industry has taken action to repair the damage wrought by the highly-visible failure in 2009 of U.S. Fidelis, a direct marketer of VSCs. Attorneys general of 42 states joined forces in an investigation of U.S. Fidelis and its affiliates. U.S. Fidelis used deceptive and misleading direct mail and telemarketing campaigns to mislead customers into thinking they were talking to auto dealers or manufacturers, and receiving a more comprehensive warranty than they actually were, according to court documents. In 2008, an industry trade group, the Vehicle Protection Association (“VPA”), was established to promote and ensure integrity in the industry. The VPA’s certification program for VSC firms has established standards of conduct and regulatory compliance.

## Four groups participate in the VSC market

<b>Customers</b>	<ul style="list-style-type: none"><li>• New and used vehicle owners purchase VSCs for a specific coverage during a defined period</li><li>• Customers seek coverage for a term after original car manufacturer's warranty expires or to enhance factory warranty</li></ul>
<b>Sellers</b>	<ul style="list-style-type: none"><li>• Market and sell contracts on behalf of administrators and carriers and earn a commission</li><li>• Participants include franchised dealers, independent dealers and direct marketers; some sellers are captives of administrators</li></ul>
<b>Administrators</b>	<ul style="list-style-type: none"><li>• Responsible for program design, pricing, underwriting, and billing and claims administration</li><li>• Maintain reserves to pay claims, provide ongoing actuarial analysis of claims and refunds, and manage program loss ratios</li><li>• Administrators include<ul style="list-style-type: none"><li>– Captives of insurance carriers</li><li>– Captives of vehicle manufacturers</li><li>– Third parties that manage insurance carriers' programs</li></ul></li></ul>
<b>Insurance Carriers</b>	<ul style="list-style-type: none"><li>• Receive a premium from administrators for VSCs sold and provide an insurance policy to consumers to cover payment of claims and refunds in the event that aggregate losses exceed reserves</li></ul>

## The VSC market has three major segments

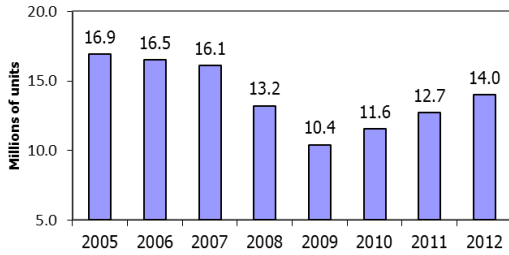
<b>New vehicle sales</b>	<ul style="list-style-type: none"><li>• New vehicles are sold through 18,400 franchised dealers in the U.S. These dealers sell VSCs to supplement the OEM's warranty.</li><li>• New car sales grew to 14.0 million units in 2012, the highest level since 2008 and a 10% year-over-year increase.</li><li>• VSC income accounted for 15% of total dealer profits in recent years.</li></ul>
<b>End of warranty sales</b>	<ul style="list-style-type: none"><li>• Median age of passenger cars was 8.3 years in 1999 and grew steadily to exceed 10.5 years in 2012. Over 20% of light vehicles in the U.S. are at least 15 years old</li><li>• Buyers of new cars typically "drive through" the mileage limit on a 3 year warranty in 2.5 years and within 4 years on a 5 year warranty</li><li>• Both auto dealers and direct marketers sell VSCs in the aftermarket.</li></ul>
<b>Used vehicle sales</b>	<ul style="list-style-type: none"><li>• U.S. used vehicle sales approached 40.5 million units in 2012, the strongest level in four years. The market for used vehicles is three times the size of the new vehicle market on a unit basis</li><li>• Used vehicles are sold through 36,400 independent and franchised dealers. Private sales accounted for about 11.5 million units in 2012</li><li>• VSCs are sold by dealers and direct marketers to buyers of used automobiles.</li></ul>

**Favorable industry trends are driving VSC sales growth**

Fear of a huge automobile repair bill motivates consumers to purchase VSCs. The rebound in vehicle sales, combined with a significant increase in the median age of automobiles owned by consumers, is driving the sales of extended vehicle service contracts.

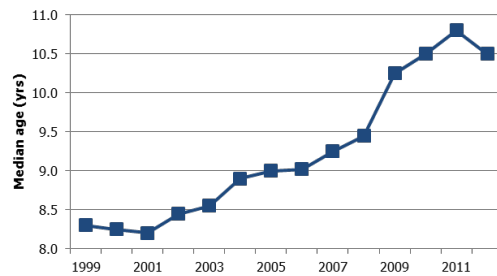
**Rebound in new vehicle sales**

New light-duty vehicle sales



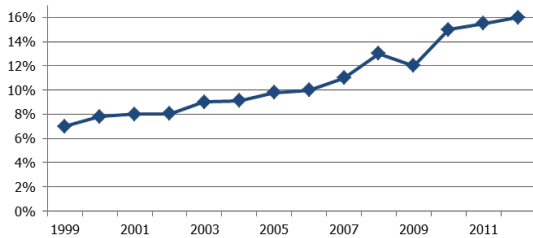
**Extended vehicle ownership**

Passenger vehicle median age



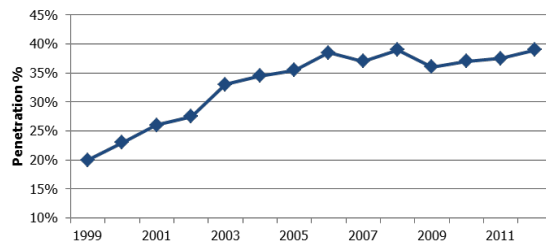
**Continued focus on F&I income**

VSC Share of Total Dealership Profits



**Proliferation of VSCs**

New vehicle contract penetration rates

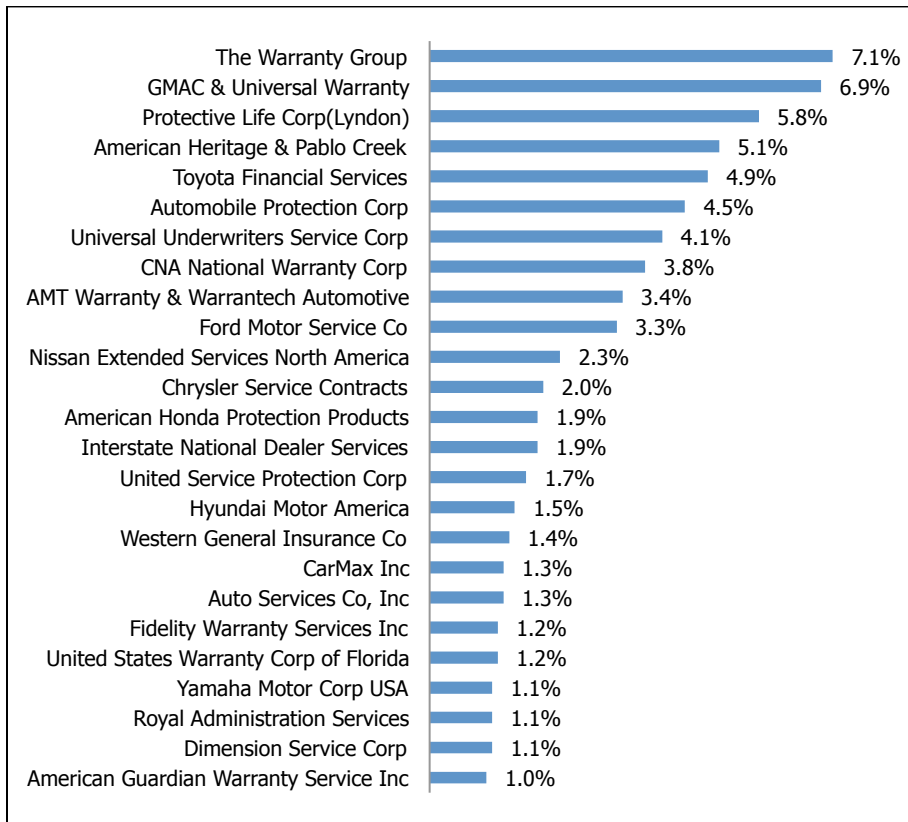


Source: NADA, NIADA, Colonnade estimates

**VSC administration industry is fragmented**

- Top five players accounted for less than 30% of total volume in 2012
- Top 25 players exceed 70% of total volume in 2012
- Largest participants in VSC administration industry are integrated firms such as The Warranty Group (Onex), Universal Warranty (Ally Financial) and Protective Life Corp. (Lyndon)
- OEM's are also major participants in the industry, both as integrated firms and as administrators that place the warranty risk with third-party underwriters

*VSC Administrator Market Share*



Source: *Warranty Week 2010*

### **Investment case for the VSC administration sector**

- Opportunity for organic growth through higher penetration.
  - Over 30% of cars and light trucks are sold with a VSC (including dealer incentives and excluding private auto sales).
  - Auto dealers are under pressure to improve profitability, as Internet-based comparison shopping compresses the profit margin on vehicle sales.
  - Warranties are highly profitable for auto dealers.
  - Financing for warranties is increasingly available, both separately and bundled with vehicle financing.
  - Many VSC administrators have under-invested in educating dealers.
  - As more VSC companies become professionally managed, payment of claims increases and consumer confidence in the product rises.
- Cyclical growth opportunities remain.
  - Job growth is rising slowly in the U.S.
  - Unemployment rate of 7.6% leaves substantial room for improvement.
  - Auto sales have rebounded in the first half 2013, though still below 2005-2006 levels.
- Opportunity for growth through acquisition.
  - Market share is fragmented nationally, though less so regionally.
  - No dominant national player exists – yet.
  - Many VSC administrators have under-invested in systems and marketing.
- Barriers to entry.
  - Relationship of VSC administrators with dealers is similar to insurance brokers with commercial clients. Differentiated marketing strategies are key.
  - Licensing requirements in many states.
- Multiple dimensions for competitive differentiation and extension.
  - Target franchise dealers or independent dealers indirectly, or drivers directly.
  - Focus on used vehicles or extended warranties on new vehicles.
  - Distribute through agents, direct sales force, and/or telemarketing.
  - Breadth of coverage (exclusionary or explicit coverage).
  - Depth of coverage (make/model, mileage).
  - Length of coverage.
  - Ancillary products (GAP, anti-theft, tire & wheel, windshield, financing).
  - Adjacent vehicle markets (power sports, truck, motorcycle).
- Scalable models.
  - Larger scale players should dominate the sector eventually due to the nature of the business: (a) many small contracts that can be delivered in real time over the Internet; (b) actuarial risk; (c) large amounts of data available to manage; (d) financial strength important to the sale of the product.
  - Larger scale should drive efficiencies in systems and marketing, resulting in higher margins.
  - Larger size should help drive multiple expansion upon exit.

**M&A activity in the sector is accelerating**

M&A activity in the VSC administration sector has increased recently, with five significant transactions in the past six months. Both financial and strategic buyers are demonstrating strong interest in the VSC administration sector.

<b>Date</b>	<b>Target</b>	<b>Buyer / Investor</b>	<b>Seller</b>
Jun-13	Preferred Warranties	KAR Auction Services (NYSE: KAR)	Harbert Private Equity, NorthStar Capital and management
Feb-13	GWC Warranty	Stone Point Capital	CIVC Partners
Dec-12	Portfolio Group	Frontenac Company	Acquired majority position from founder who remains CEO
Dec-12	Safe-Guard Products International	Goldman Sachs Capital Partners	H.I.G. Capital
Dec-12	National Auto Care (NAC)	Trivest Partners	Founders
Dec-11	Innovative Aftermarket Systems (IAS)	Genstar Capital	CIVC Partners
Aug-10	Warrantech	AmTrust Financial Services (NASDAQ: AFSI)	H.I.G Capital. AmTrust bought the 73% of Warrantech it didn't already own.

***Colonnade advised Harbert Management and NorthStar Capital on the sale of Preferred Warranties to KAR Auction Services***

KAR Auction Services Inc. (NYSE:KAR) acquired Preferred Warranties, Inc. ("PWI"), a vehicle service contract administration company, from Harbert Private Equity Fund II, LLC, Northstar Mezzanine Partners IV L.P. and management in June 2013.

PWI markets vehicle service contracts through independent dealers of used vehicles in 2,200 locations in fifteen Mid-Atlantic, Midwestern and Southern states.

KAR, a leading provider of floor plan financing and auto auction services, believes the acquisition of PWI will strengthen its offering to independent dealers and that PWI's products will be enhanced as a result of being backed by KAR's financial strength and stability.



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