

Vehicle Service Contract Finance

Niche commercial finance industry with limited competition and high margins

The vehicle service contract (VSC) finance industry offers strong returns and a compelling diversification strategy for banks seeking to alleviate their dependence on traditional commercial and industrial (C&I) lending. VSC finance (*aka* warranty finance), like other specialty finance niches, is attractive to banks because of the relatively high yields, low losses and short duration. Private equity firms, too, are attracted to the sector because of the high returns and opportunities to ultimately sell to commercial banks.

The growth of the VSC finance industry tracks the growth rate of the underlying vehicle service contract business, highlighted in Colonnade's recent report "[Vehicle Service Contract Administration](#)". Growth is further dependent on capital availability to the sector, currently nearing a high water mark.

Only a handful of specialty finance companies, most of which are privately held, serve the VSC finance industry; several are off-shoots of insurance premium finance companies that believe VSC finance has a risk profile that is similar to insurance premium finance. The VSC finance industry has matured in recent years, allowing commercial banks to consider entering the sector.

Mergers & acquisitions activity in the VSC finance industry is expected to increase in the next 6-18 months as banks seeking high yielding, low risk commercial finance activities are again looking to specialty finance platforms to bolster growth. Further, private equity firms continue the trend post-financial crisis of buying well-run specialty finance companies in anticipation of banks' renewed interest in asset diversification.

VSC finance industry

Installment plans are instrumental in the sale of vehicle service contracts (VSC) *aka* extended auto warranties, given the relatively high average cost. VSCs can either be financed at the time of the vehicle purchase, typically by a traditional auto lender, or financed separately by a VSC payment plan provider. At the time of purchase of a new or used car, traditional auto lenders may allow customers to include the purchase of a VSC in their financing packages. However, traditional auto lenders do not provide financing for VSCs sold independent of a vehicle purchase. Furthermore, in many cases, traditional auto lenders do not provide sufficient credit to enable customers to finance the purchase of a VSC as part of the auto loan.

VSC finance companies offer an alternative for customers who cannot finance the contract with their vehicle purchase or decide to add a VSC after they have purchased the vehicle. A payment plan is flexible and convenient for the customer as it is "interest-free" and enables the customer to spread the payment over time ranging from six to 24 months depending on the duration of the VSC. In general, the number of installments is no more than half the term of the VSC.

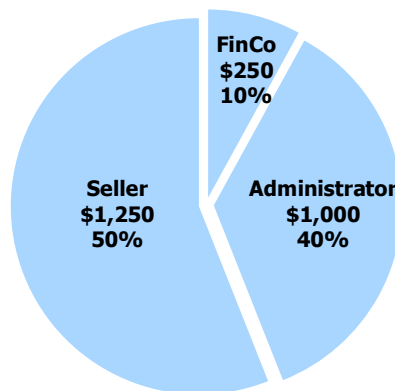
The VSC finance company does not assume consumer credit risk or claims risk under the VSCs. The VSC finance company does not have recourse against the customer for non-payment nor does it owe any refund to the customer in the event of cancellation.

If a customer elects to pay for a VSC through a payment plan, the customer makes a down payment (typically 10%), which is collected by the seller (or dealer) at the time of purchase, and the remainder is financed by a VSC finance company. A receivable for the remaining balance is created, which is acquired by the finance company. The finance company assumes the responsibility to collect monthly payments from the customer.

Upon receiving the first installment payment from the customer, the VSC finance company pays the seller and the administrator their respective portions of the VSC sales price, less the down payment already collected and the finance company's fee. Both the seller and the VSC administrator guarantee the repayment of funds advanced by the VSC finance company, less any payments collected from the customer, in the event a VSC is cancelled.

Typically, sellers do not have the required infrastructure, expertise or personnel to administer payment plans or the ability to advance funds to the administrator upfront. As such, sellers are willing to forfeit a small portion of their commission to a finance company to promote sales.

VSC price breakdown: Sample \$2500 contract



High yielding, short term receivables

A payment plan receivable originates when a buyer of a VSC elects to pay in installments. Pursuant to a contractual agreement, a VSC finance company purchases at a discount the right to receive the payment stream; discounts typically range from 5%-15%. The finance company funds a portion to the administrator and a commission payment to the seller. Disbursements are structured and timed to mitigate risk and increase yield. Yields are also enhanced through reserves, late fees and other service charges and early cancellations. Receivables generate unlevered annualized yields of 15%–20%.

Customers who elect to pay in installments agree to make a down payment (typically 10%) and a series of fixed monthly payments for a period of time generally ranging from six to 24 months depending on the term of the underlying coverage. VSC finance receivables typically have an average life of 6-12 months.

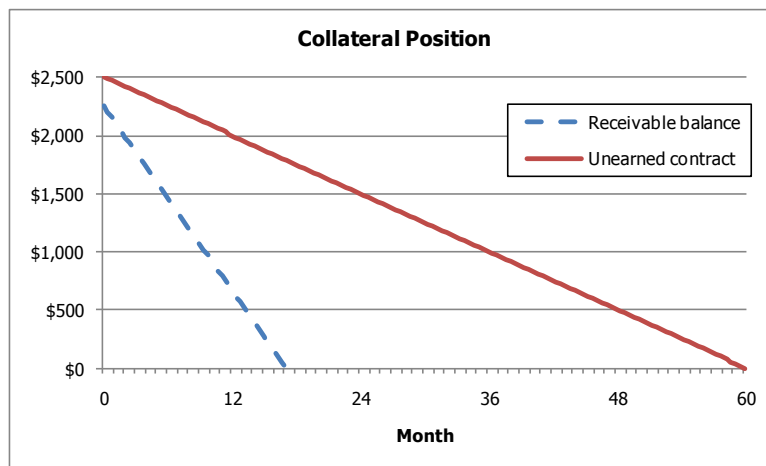
Strong collateral

VSC administrators are financially responsible for any VSC claims that arise as well as administering those claims. In most states, the administrator is required to purchase a contractual liability insurance policy (CLIP) from an insurance company that guarantees performance of the service contract to the customer in the event the administrator fails to perform the service contract. The payment plan provider does not assume consumer credit risk or claims risk under the VSCs.

Customers are allowed to voluntarily cancel the service contract at any time and are generally entitled to receive a refund from the administrator and/or seller of the unearned portion of the service contract at the time of cancellation. If a customer exercises the right to cancel the service contract or stops making payments on a payment plan, the seller and administrator are jointly obligated to refund to the payment plan provider the unearned portion of the service contract previously funded. Further, the insurer that issued the CLIP for the service contract often guarantees all or a portion of the refund.

As a result, a VSC finance company does not evaluate the creditworthiness of the individual customer but instead relies on the financial strength of its counterparties. The VSC finance company does not have recourse against the customer for non-payment of a payment plan nor does it owe any refund to the customer in the event of cancellation.

In structuring a VSC payment plan, the down payment, number of installments and timing of the disbursements are set such that in the event of cancellation, the unearned portion of the VSC returned by the administrator and the seller is sufficient to cover the payment plan provider's receivable balance and any other charges. As the graph below illustrates, a properly structured VSC payment plan receivable is always collateralized in excess of the finance company's exposure.



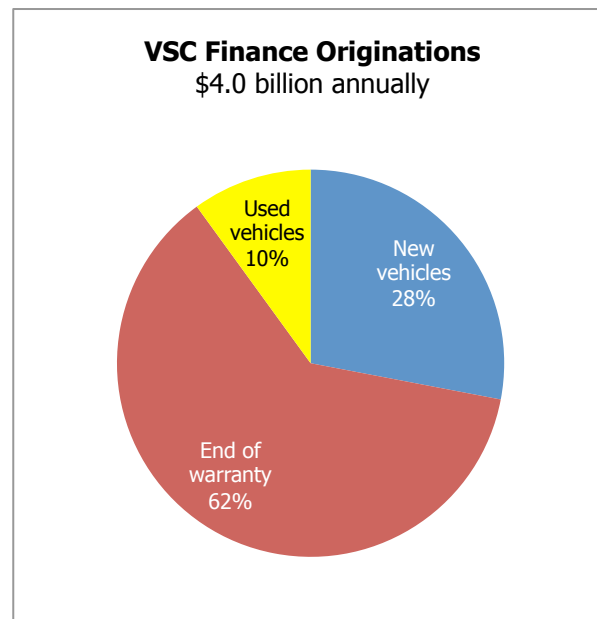
Sizeable market opportunity; limited competition

U.S. consumers spent \$14.7 billion in 2012 on service contracts for their motor vehicles, an annual increase of nearly 15%. 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.

In the end-of-warranty segment, in particular, sellers use payment plans as a powerful sales incentive. Payment plans are critical to the sale of VSCs due to the relatively high purchase price of the coverage. An estimated 95% of end-of-warranty sales utilize payment plans.

The addressable market for third party VSC payment plans was \$4.0 billion in 2012. Market demand for third party financing of VSCs has been adversely impacted by 0% financing offered by OEMs and the low interest rate environment and correspondingly strong leasing market. In general, strong consumer credit availability also trims demand for VSC finance companies, as more VSCs get rolled into the auto financing. Demand has been bolstered by strong fundamentals for VSCs; sales of VSCs grew 15% in 2012.

- VSC finance was once a cottage industry but has since evolved and matured
- Third party marketer sector exploded during mid-2000's as access to capital fueled growth of direct marketers
- OEM segment has increased modestly with improved penetration rates and continued dealer focus on F&I income
- Average VSC prices have increased considerably in recent years
- Receivables duration has increased modestly as payment plan terms have extended
- Regulatory issues of mid-2000's are largely resolved to the benefit of consumers and responsible industry participants
- Senior financing continues to be available for well-run independents
- Only a handful of independent players of size exist; others are generally affiliates of VSC administrators



Source: NADA, NIADA, Colonnade estimates

Rationale for bank ownership

VSC finance is a well-established, high margin, high growth commercial lending activity for banks.

Positive fundamentals for banks

<ul style="list-style-type: none">• <i>Short duration assets</i>	<ul style="list-style-type: none">• Receivables typically have an 18-month term and an average life of 6-12 months
<ul style="list-style-type: none">• <i>Minimal credit losses</i>	<ul style="list-style-type: none">• VSC finance companies rely on the strength of the insurance carrier backing the underlying policy or other. Net losses typically average less than 25bps of originations
<ul style="list-style-type: none">• <i>Attractive yields</i>	<ul style="list-style-type: none">• Receivables are purchased at a discount of 5%-15%, generating effective yields of 15%-20%. Delayed funding mitigates costs of no-pay defaults and enhances yields
<ul style="list-style-type: none">• <i>Granular, homogenous underlying assets</i>	<ul style="list-style-type: none">• Standard contract terms and small contract size well-suited to efficient transaction processing and securitizations
<ul style="list-style-type: none">• <i>Diversification of earnings</i>	<ul style="list-style-type: none">• VSC finance assets allow banks to diversify commercial loan categories
<ul style="list-style-type: none">• <i>Banks' access to capital and low cost of funds offers competitive advantage</i>	<ul style="list-style-type: none">• Bank-owned VSC finance companies maintain a competitive funding advantage relative to independent operators
<ul style="list-style-type: none">• <i>Opportunity to efficiently deploy capital in a high margin lending business</i>	<ul style="list-style-type: none">• VSC finance companies generally contribute 4% to 6% pretax return on average assets, well above traditional commercial lending activities

Most leading VSC finance companies are privately held and funded through bank syndicates. Commercial banks are currently lending aggressively to the VSC finance space, given the high quality, short duration, and granular nature of the assets.

Comparisons to the insurance premium finance industry

VSC finance and insurance premium finance are similar; and comparisons are meaningful in an M&A context.

- Market size and growth rates
- Origination strategy and competition
- Loan sizes, yields and durations
- Collateral
- Credit risk, fraud risk and charge offs
- Transaction processing intensity
- Ancillary income

Specific challenges of the VSC finance industry include:

- Credit exposure to administrators and sellers
- Concentration of administrators and sellers
- High cancellation rates
- Transaction processing intensity
- Specialized servicing knowledge
- Perceived consumer protection risk

Conclusion

Mergers & acquisitions activity in both the VSC finance and insurance premium finance sectors is expected to increase in the next 6-18 months as banks seeking high yielding, low risk commercial finance activities are again looking to specialty finance platforms to bolster growth. Further, private equity firms continue the trend post-financial crisis of buying well-run specialty finance companies in anticipation of banks' renewed interest in asset diversification.

Representative transactions



DE Shaw & Co
has sold



PayLink
Payment Plans LLC

to an investment group led by



OXFORD
FINANCIAL GROUP, LTD

The undersigned acted as exclusive financial advisor to
D.E. Shaw & Co. and PayLink Payment Plans, LLC

Colonnade Securities LLC



**MEPCO**
insurance premium financing

has been acquired by

Independent Bank Corporation
(NASDAQ: IBCP)

The undersigned acted as exclusive financial advisor to
Mepco Insurance Premium Financing, Inc.

Colonnade Advisors LLC

Colonnade has advised the sellers of two VSC finance companies in their successful sales to new owners. Colonnade has also served as financial advisor in several buy-side situations regarding VSC finance companies. In addition, Colonnade has advised on fifteen successful transactions in the insurance premium finance industry, a related asset class.

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