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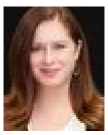
2022 should be even busier year for F&I agency M&A

2021 was a big year for finance and insurance agency mergers and acquisitions. Based on current trends, 2022 will likely be an even hotter M&A market than 2021.



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CEO of Colonnade Advisors, an investment bank

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Last year was a big one for finance and insurance agency mergers and acquisitions. Based on current trends, 2022 likely will be an even hotter M&A market than 2021.

Mergers and acquisitions in the F&I industry mirror significant trends across all sectors. Through the third quarter of 2021, an estimated 12,855 deals had been completed for the year across all U.S. and Canadian industries for a total transaction value of $1.86 trillion.

Private equity firms are driving the current frenzy with their desire to take advantage of the booming economic growth and capitalize on the low interest-rate environment. Notably, many firms are looking to deploy capital quickly to raise additional funds when limited partner investors into their funds are allocating more capital to the private equity sector. The resulting competition for deals creates a seller's market resulting in higher valuations.

However, there are headwinds to M&A, including high-valuation multiples, inflation and labor shortage concerns.

Dealership consolidation

As consolidation of F&I agencies has continued, the independent agencies can find themselves in a weak competitive position.

Dealership consolidation is the single biggest threat to an F&I agency without a highly diversified book of business. Dealership M&A activity was at a record high level in 2021, with an estimated 350 dealerships changing ownership. Many small agencies have built their books on a few dealership groups, which results in a lack of client diversification. Client concentration leaves the agency vulnerable to the vagaries of dealership owners' actions and the consolidation of dealerships themselves.

To compete, agencies need scale to produce the breadth of products and geographic footprint to be the winning agency. This competitive dynamic has been the motivating factor for some selling agencies.

Private equity

The elevated deal multiples coupled with inflation will have a long-term impact on returns for private equity firms.

Many firms are likely underwriting current investments for zero future multiple expansion, if not contraction. To improve returns, many private equity firms deploy buy-and-build strategies. Private equity firms will invest in a platform and acquire smaller firms as add-on acquisitions.

Private equity firms are effectively using the buy-and-build strategy in the F&I industry. For example, Lovell Minnick acquired National Auto Care in 2018, and the new subsidiary has since made numerous acquisitions over the past two years, primarily of agencies.

Great Resignation

Millions of workers quit their jobs in 2021 as part of what is being called the Great Resignation. Workers are leaving for higher wages, better conditions or just a change.

The automotive industry is not immune to the challenges of retaining, let alone increasing, the number of employees in this incredibly tight labor market. And leadership within the automotive F&I ecosystem is likely disproportionately impacted because of their average age.

The F&I industry is a human capital-intensive sector, and employment is critical. To mitigate the employment problem, some companies will be using M&A as a near-term solution.

Deal timing

In real estate, the adage is "location, location, location." In mergers and acquisitions, it is "timing."

The availability of capital is one of the primary drivers of deal activity, and investors had been bracing for tighter liquidity before the Federal Reserve increased the federal funds rate to 0.25 to 0.5 percent on March 16. Expectations of future rate increases may prompt acquirers that rely on debt financing to make deals sooner rather than later.

It takes roughly six months to close a deal from the time an adviser is hired. However, deals in the F&I industry tend to have complex due diligence because of reinsurance positions and the idiosyncratic effects of the pandemic on business.

The due diligence processes will primarily focus on dealerships, employees and financials. Buyers will evaluate the client base for concentration, strength of relationships, performance through the pandemic and dealership market position — i.e., is it an acquirer or a target? In reviewing the financials, buyers will hire an accounting firm to conduct a quality of earnings review, which will take approximately six weeks.

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M&As to continue

The F&I industry is all about relationships, and agents are the critical element in the dealership ecosystem.

Mergers and acquisitions in the F&I sector will continue into the foreseeable future because private equity firms have record levels of dry powder, add-on acquisitions will be utilized to bolster existing platform investments, and importantly, companies need to remain on the offensive with the competition. However, higher interest rates and exogenous variables can negatively impact valuations.

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