AUTO INSPECTION AND WARRANTY CLAIMS MANAGEMENT

A Sector Worth Investigating

The current pandemic has sent the automotive industry and other large segments of the economy into a period of turmoil and uncertainty. Economic recovery could be slow, and new car sales are forecast to decline by 26% in 2020. Certain services segments of the automotive industry, such as auto inspection and warranty claims management, however, may be insulated from a broad recession. As the economy gets back to work, the frequency of motor vehicle accidents will rise, and mechanical breakdowns will return to pre-crisis levels.

The auto inspection and warranty claims management industry is comprised of four primary segments: accident investigation, warranty inspection and management, pre-purchase vehicle inspection, and floorplan audit. The industry serves insurance companies, lenders, F&I product administrators, dealerships, auction providers, and buyers and sellers in private auto sale transactions. Customers outsource auto inspection and claims management to better manage expenses and improve accuracy and response times.

The auto inspection and warranty claims management industry has favorable dynamics, including the trend toward outsourcing, the increasing severity and cost of accidents and warranty claims, the expansion of the vehicle service contract market, and the increase in sales of private and certified pre-owned vehicles. Companies in this sector generally have high levels of recurring revenue or multi-year contracts. Technology is playing an important role in transforming what was once a cottage industry of local and regional inspectors into a national opportunity of scale.

The auto inspection and warranty claims management sector presents an intriguing opportunity for investors interested in the automotive sector without bearing the weight of the typical macroeconomic trends that impact the new vehicle industry. Numerous companies of size exist, but few acquisitions have occurred in this sector to date. We expect significant M&A activity over the next several years.

INDUSTRY SEGMENTS

Accident Investigation

The accident investigation segment broadly tracks the collision repair market, which is estimated at $33.8 billion in 2018, up from $31.7 billion in 20141.

The number of accident inspections results from the number accidents and the severity. On average, there are 6.7 million car accidents2 per year in the U.S. at a total cost of more than $230 billion. Insurance companies investigate accidents to determine fault, estimate repair expenses and other liabilities in addition to determining if any of the work is covered by the vehicle warranty.

The severity of accidents (the incurred cost per accident) has increased 3.2% compounded annually since 2010, outpacing both wage growth at 2.4% and inflation at 1.7%. The increase in severity is due to the higher cost of vehicles, which is the result of increased technology in the vehicles and the increased number of standard options.

1 U.S. Collision Repair Market Analysis Market Estimates and Trend Analysis to 2025 by Grandview
2 2020 CCC, Time is Money
Severity is driven by the average retail selling price of cars (replacement cost) and the increasing amount of software and electronics embedded in newer vehicles.

The frequency of accidents has also increased, albeit at a lower rate than severity, due to more drivers on the road and miles driven. In January 2020, the U.S. hit a high watermark of 3.3 trillion miles driven over the prior twelve months. The auto accident inspection industry is being affected by COVID 19, as fewer miles are being driven resulting in fewer accidents and mechanical failures. In the last week of March, personal travel dropped by 48% and long haul trucking dropped 20% compared to the same week, prior month3. While miles driven will be lower in 2020 as a result of the pandemic and ensuing lockdowns, we expect miles driven to return to recent historical in the near future as economies open up. An argument can be made that miles may even increase as people avoid public transportation and air travel.

3 Autocare.org
Inspections are also completed after repairs to review the quality of the repairs and the parts used and to identify any potential issues, especially those related to safety.

Accident inspection firms are primarily used by insurance companies as an outsourced service. Rising accident rates and increasing loss ratios have led to higher operational costs. When coupled with insurance clients demands that claims be processed faster and cheaper, insurance companies tend to outsource rather than keep dedicated employees on the payroll. Accident inspection companies with a national footprint are well positioned to sign multi-year contracts with insurance companies.

**Warranty Inspection and Management**

Auto inspection and claims management firms serve the warranty industry across two different sub-segments: independent vehicle service contract (VSC) administrators and dealerships.

New vehicles typically carry a two to five-year warranty from the OEM. Many drivers purchase additional or supplemental coverage through an independent VSC administrator. A VSC is an agreement between an administrator and a vehicle owner under which the administrator agrees to replace or repair, for a specific coverage period, designated vehicle parts in the event of a mechanical breakdown. Non-OEM VSCs supplement manufacturers’ original warranties and provide a broad array of coverage options. VSC administrators often use independent investigators to inspect claims over a threshold dollar amount, typically $900-$1100.

An estimated 23.0 million VSCs are sold annually, of which 22.2 million are sold through dealerships and 1.1 million are sold direct-to-consumer. The direct-to-consumer market for VSCs grew 14%, compounded annually, over the last five years and is the fastest growing segment of the industry.
Direct-to-consumer VSC administrators use third-party inspectors more frequently than VSC administrators that focus on dealer-originated VSCs. Consumers who buy VSCs through dealerships usually take the vehicle back to the dealership for claims; and since the dealer’s and administrator’s interests are typically aligned through reinsurance participation, third-party warranty inspections are unnecessary.

Mechanical breakdown inspections are a tool to minimize the claim costs and prevent fraud. VSCs typically experience a claims rate typically of 40%-60% over the term of the VSC. Industry insiders estimate 10%-30% of those claims will be investigated. Direct-to-consumer VSC administrators depend on third-party warranty inspectors because they typically sell contracts nationally, and it is unprofitable for them to have an inspector on the payroll in all geographies.

On new car sales, manufacturers typically provide a two to five-year warranty. When a new car owner has a claim, they return to the dealership or certified repair facility for the repair work and the store submits the claim to the manufacturer for reimbursement. This sounds simple, but it is not. The relationship between dealerships and OEMs can be David and Goliath-esque. Dealerships and repair facilities need pre-authorization from the OEM. Each OEM, and sometimes each brand, has different warranty coverage. Reimbursement for claim work can be difficult to track. And, of course, OEMs periodically audit claims departments.

Outsourced warranty management companies process a higher volume of claims than individual dealerships and repair facilities. Thus, they have the ability to better manage OEM red tape, identify claims trends and provide informative reporting with benchmarking. Most importantly, outsourced warranty management companies typically charge on a per-claim basis, thereby shifting the dealership from a fixed cost to a variable cost structure.

There are an estimated 150 million vehicles under OEM warranty. This number has grown as the number of new car sales has grown.
Pre-Purchase Vehicle Inspection

Vehicle inspections are used to facilitate transactions among private party sales, leases at maturity, certified pre-owned sales and wholesale used vehicles at auctions.

- **Person-to-person sales**: When financing a private sale, lenders typically inspect the car to confirm loan-to-value. Individual buyers use inspectors to independently verify vehicle quality in private transactions.
- **End-of-lease**: Inspectors are used for damage assessments regarding excessive wear and tear and general operating condition.
- **Certified pre-owned**: CPO vehicles generally include an extension of the original vehicle warranty. The inspection confirms the vehicle complies with the OEM guidelines for CPO status.
- **Auctions**: Inspections are completed after wholesale used vehicle auctions to protect dealers against unexpected repair costs, which can cut into profits and cause delays in turning inventory.

Each segment listed above is increasing and relying more on independent providers to maintain costs and consistency.

**PRIVATE PARTY SALES (in millions)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>11.0</td>
</tr>
<tr>
<td>2016</td>
<td>11.1</td>
</tr>
<tr>
<td>2017</td>
<td>11.2</td>
</tr>
<tr>
<td>2018</td>
<td>10.9</td>
</tr>
<tr>
<td>2019</td>
<td>11.9</td>
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</table>

Source: NIADA Used Car Industry Report
**Floorplan Audit**

Floorplan financing is commonly used by car dealerships to purchase inventory. Dealers borrow against the cars in inventory, structured so that the debt is repaid from the sale of the vehicle. Dealers must sell vehicles before the collateral depreciates to a liquidation value that is below the loan amount. The loans are made against specific pieces of collateral, and the value is determined at the time of the loan and evaluated regularly to review condition and value. Dealer floorplan loans are extended by the OEM captives, banks and non-bank finance companies.

To confirm their credit is secure, lenders audit the floorplan vehicles and documentation to verify inventory, review asset quality and monitor for vehicles sold out of trust (sold without repaying the bank’s loan). The Office of the Comptroller of the Currency (OCC) recommends that floorplan audits occur at least quarterly, but more frequently depending on trends at the borrower. This audit activity is capital-intensive and time-consuming. Larger lenders, such as Ally Financial and JP Morgan, have auditors on staff. Since it is inefficient for small lenders to field a significant team of field auditors, independent auto inspectors fill the void.

Dealership floorplan financings are often repackaged and issued as asset-backed securities, a market estimated at $45 billion currently outstanding⁴.

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⁴ Last five years issuances
INDUSTRY PARTICIPANTS

There are hundreds of companies in this sector and many that serve multiple segments. There are large multi-line claims investigation companies, such as Alacrity Solutions and SGS, that include auto accident investigation and pre-purchase inspection as a service. There are many independent national auto investigation, warranty inspection, pre-purchase inspection and floorplan audit companies that service large institutional clients. There are numerous small (less than 30 people) accident investigation, warranty inspection and pre-purchase inspection companies that address a specific region. There are a few companies that provide OEM warranty management services.

<table>
<thead>
<tr>
<th>Company</th>
<th>Accident</th>
<th>Warranty Inspection &amp; Management</th>
<th>Pre-purchase Inspection</th>
<th>Floor Plan Audit</th>
<th>Serves Other Industries</th>
<th>Number of Inspectors</th>
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<td>AiM Certify</td>
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<td></td>
<td></td>
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</tr>
</tbody>
</table>

5 Both independent contractors and employees
VALUE DRIVERS

The value of auto inspection and warranty claims management companies is driven primarily by scale and efficiency.

- **Geographic Footprint and Inspector Network Size**
  - A national footprint and a large network of inspectors enable firms to work with insurance companies, financial institutions and F&I product administrators and serve their customers nationally. Larger industry participants maintain regional or national networks of auditors.

- **Technology**
  - VSC, warranty, and pre-purchase inspections typically cost $800-$1,200. Tech-enabled companies have increased efficiency, resulting in higher margins.
  - Investments in technology can supplement the need for an inspector to visit the vehicle in person.

- **Client Diversification**
  - A diversified client base, defined as less than 20% of total revenues per client, lessens revenue volatility and adds value to the inspection company. Larger companies tend to attract and are better able to serve multiple large clients.

TRANSACTION TRENDS AND M&A OUTLOOK

Private equity firms have been investing in the broader claims investigation industry. Significant transactions include Aquiline’s acquisition of Alacrity Solutions (fka Worley Claims Services) from Seaport Capital, which Aquiline subsequently sold to Kohlberg & Company. Sedgwick is currently owned by Carlyle Group and Stone Point and had previously been owned by KKR and Hellman & Friedman. Trinity Hunt Partners recapitalized Veracity Research Company with its founders. These private equity-backed platforms have subsequently made numerous acquisitions of smaller companies, regional players, and across existing and new verticals.

There have been a few transactions in the pure auto investigation industry.

- In December 2019, TrueFrame, a provider of vehicle accident inspection reports to consumers and used car dealers, was acquired by ACV Auctions, which is backed by Bain Capital Ventures, Bessemer Venture Partners and Tribeca Venture Partners.
- In January 2017, Crawford & Company (NYSE: CRD-A and CRD-B) acquired WeGoLook, an online and mobile inspection firm that uses more than 30,000 mobile workers known as “lookers” to collect and verify information using their smartphone cameras. Crawford paid $42.5 million enterprise value, a 6.1x revenue multiple.

Despite the compelling industry fundamentals, few M&A transactions or investments have occurred in the auto inspection and warranty claims management industry. The sector is fragmented, has high recurring revenue, and performs well during a recession. We expect financial sponsor interest to increase in this sector over the next few years.
Colonnade is a leader in M&A in the Auto F&I Industry

For more information on M&A in the auto inspection and warranty claims management sector, please contact:

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