Direct-to-Consumer Vehicle Service Contract Sales
April 2024

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DIRECT-TO-CONSUMER IS THE FASTEST-GROWING SEGMENT OF THE AUTOMOTIVE F&I INDUSTRY

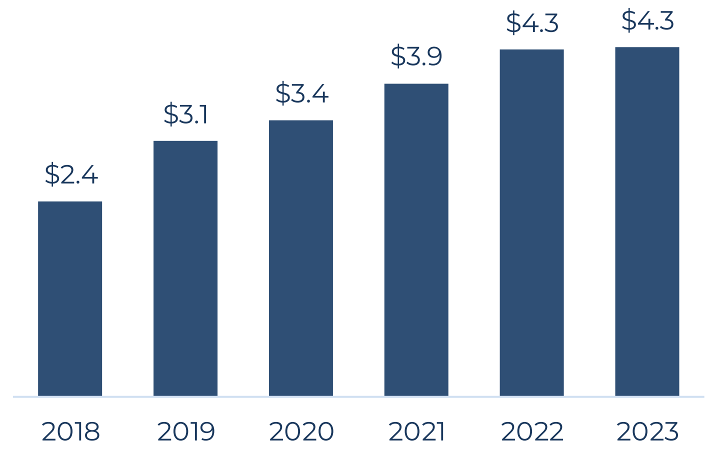
The direct-to-consumer market for vehicle service contracts (VSCs) is the fastest-growing segment of the $97 billion automotive F&I industry[1], growing at 12.3%[2] compared to 3.6% for the total industry[1]. The market opportunity is significant as 55% of vehicles on the road under 16 years old do not have a VSC[3].

This sector will experience heightened M&A over the next five years. The macro fundamentals are compelling, and the industry demonstrates high margins, strong cash flow, fragmentation, and significant growth.

Prior to 2023, the pace of acquisitions and investments in the automotive F&I industry was high. Most of the acquisitions were of F&I companies selling products through dealerships. The direct marketers have experienced fewer transactions as there have been a limited number of companies of scale. This structural limitation has changed as the sector has expanded and companies have matured.

DIRECT-TO-CONSUMER MARKET SIZE[2]

($ in billions)



Vehicle Service Contracts (VSCs)

- VSCs are purchased by vehicle owners to pay for mechanical failures and breakdowns for covered repairs
- Sold in dealerships at time of vehicle purchase and direct-to-consumer
- VSCs supplement manufacturers' original warranties (OEM) as they will cover mechanical failures not covered by the OEM warranty
- VSCs cover vehicles when OEM warranties do not: the average OEM warranty is 2-3 years while the average car on the road is 12.6 years old[4]
- VSCs often include other protections such as roadside assistance, reimbursement for a rental car

[1]NADA, Auto Rental News, Colonnade estimates
[2]Colonnade estimates
[3]NADA, Cox, StoneEagle, Colonnade estimates
[4]U.S. Department of Transportation

DIRECT-TO-CONSUMER VSC OVERVIEW

VSCs acquired through a dealership at the time of car purchase and those acquired direct-to-consumer are essentially the same products backed by the same companies. The financial products differ in how the consumer sees the marketing and how they pay for the contract.

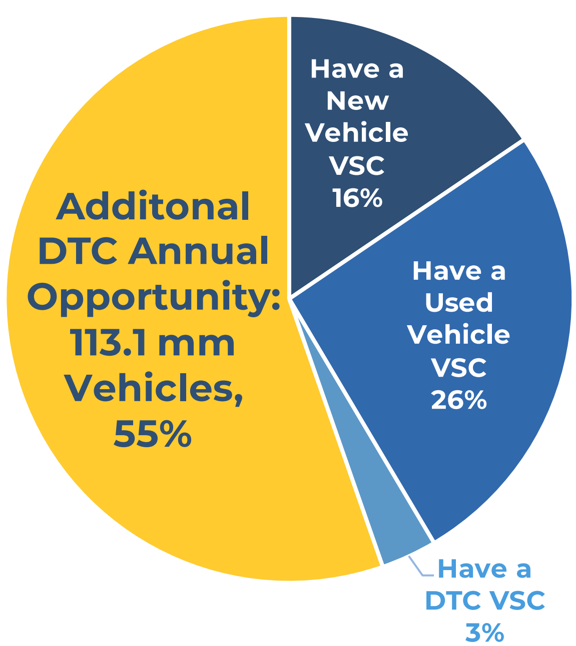
If a consumer did not purchase a VSC at the dealership at the time of vehicle purchase or their VSC expired, they can buy a VSC from a direct marketer. The marketers use direct mail, email, internet advertising, TV, and radio. Direct mail is highly effective as the products are relatively complex, infrequently purchased, high priced, and hyper-localized in the case of dealer second chance programs. In marketing across all industries, direct mail's return on investment is 112%, surpassing other mediums such as texting, email, and digital advertising[5].

The typical VSC is purchased by the consumer for $3,500 to $4,000 for five years of coverage, whether from a dealership or a direct marketer. When purchased at the time the vehicle is purchased, the VSC is rolled into the auto loan and becomes part of the monthly loan payment. The consumer can pay in full or use a payment plan when purchased from a direct marketer. Payment plans enable monthly installments without incurring interest charges, making the products more affordable to consumers than paying in full.

DTC VSCs provide consumers with greater transparency into the monthly payment as they see the payment on monthly statements, unlike an auto loan, where it is consolidated with the vehicle purchase. This consumer-friendly product results in cancellations at a higher rate than VSCs in auto loans.

There are 288.5 million passenger vehicles on the road[6], of which ~71% are less than 16 years old. Only ~45% have a VSC[7], leaving substantial opportunity for marketers in this industry. The rest of the vehicles have a VSC purchased when the car was purchased or from a direct marketer.

204.4 million Vehicles in Operation < 16 Years Old[7]



[5]ANA Response Rate Report

[6]Experian

[7]NADA, Cox, StoneEagle, Colonnade estimates

DIRECT-TO-CONSUMER VSC ECOSYSTEM

DIRECT-TO-CONSUMER MARKETERS

At least 90 DTC VSC marketing companies operate in the U.S. Direct-to-consumer VSCs are sold mainly through direct mail, but also email, internet advertising, tv, and radio. DTC marketers typically have the highest margins in the industry.

ADMINISTRATORS

Administrators design the VSC, adjudicate claims, and are often the obligor for claims.

INSURERS

Insurers backstop VSC obligors against excess losses beyond the claims reserve coverage through a contractual liability insurance policy ("CLIP"). In some cases, the insurer may also manage the claims reserve on behalf of the administrator.

PAYMENT PLAN COMPANIES

Payment plan providers enable consumers to pay for a 60-month VSC in installments, typically over 18 to 24 months. The product is not a loan. Payment plan providers generate high yielding, short term receivables .

LEAD PROVIDERS, DATA ANALYTICS & FULFILLMENT COMPANIES

Lead providers and data analytics companies enable DTC marketers to optimize leads. Fulfillment companies send out direct mail marketing and copies of the VSC.

FIVE KEY TRENDS ARE DRIVING THE GROWTH IN DIRECT-TO-CONSUMER VEHICLE SERVICE CONTRACT SALES

1. Financial Reality For Many Vehicle Owners
2. Automotive Repair Inflation
3. Consumers are Keeping their Cars Longer
4. Dealer Second Chance Programs
5. Auto Warranty Robocalls are a Thing of the Past

1 FINANCIAL REALITY FOR MANY VEHICLE OWNERS

CONSUMERS NEED VEHICLE SERVICE CONTRACTS

43% Of drivers have been in debt due to vehicle troubles[8]

58% Of vehicle owners could not afford an unexpected repair bill of more than $1,000[9]

69% Of American consumers admit to putting off maintenance due to expense[9]

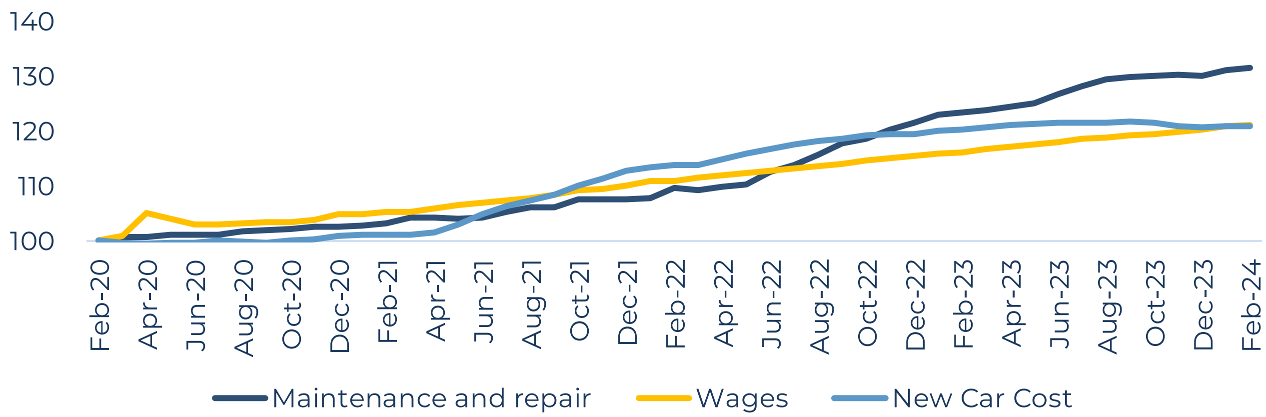
2 million Vehicles are towed each year for engine-related issues[10]

More people have cars than ever, but ownership is becoming less affordable. There are 288.5 million passenger vehicles on the road in the U.S.[11], and more than 90% of households have access to one[9]. Yet, 58% of owners cannot afford a repair bill of more than $1,000[9].

Affordability is a problem that has been building since early 2020. Although new car prices and wages have both increased 21% over the last four years, auto maintenance and repair expenses have increased 32%[12].

Vehicle owners have few alternatives. Most do not have efficient public transportation options, a situation that will not improve in the foreseeable future. Vehicle owners increasingly turn to peace of mind financial products, such as vehicle service contracts.

NEW CAR PRICE VS. WAGE VS. MAINTENANCE AND REPAIR GROWTH[12]



[8]Lending Tree
[9]United States Census Bureau
[10]AAA
[11]Experian
[12]U.S. Bureau of Labor Statistics

2 AUTOMOTIVE REPAIR INFLATION

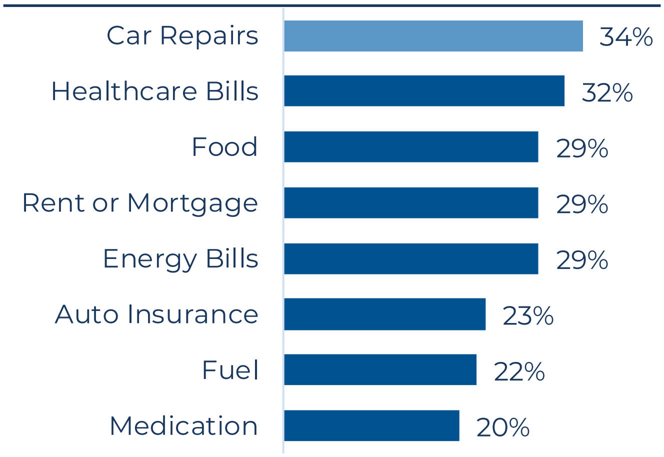
According to a survey by the Minneapolis Fed, car repairs have become consumers' top concern, even over healthcare costs. Repair costs have become unaffordable for many. Yet, car owners cannot ignore repairs when they depend on their vehicles to get to work.

Repair, maintenance, and servicing expense inflation outpaced general inflation over the past two years. While general inflation rose 9.4%, vehicle repair costs increased by 27.7%, and the cost of vehicle maintenance grew by 15.7%[13].

Numerous factors contributed to the growth in automotive repair and maintenance costs, which will not abate. Cars have become more complex, resulting in more expensive components and longer repair times. Owners are holding on to their cars longer; older vehicles require more repairs than newer ones. Auto repair technician wages have increased over 38% since 2012[13] due to a moderate shortage of workers, which will become severe over the next five years. Inflation, supply chain disruptions, and production constraints have impacted the supply of parts.

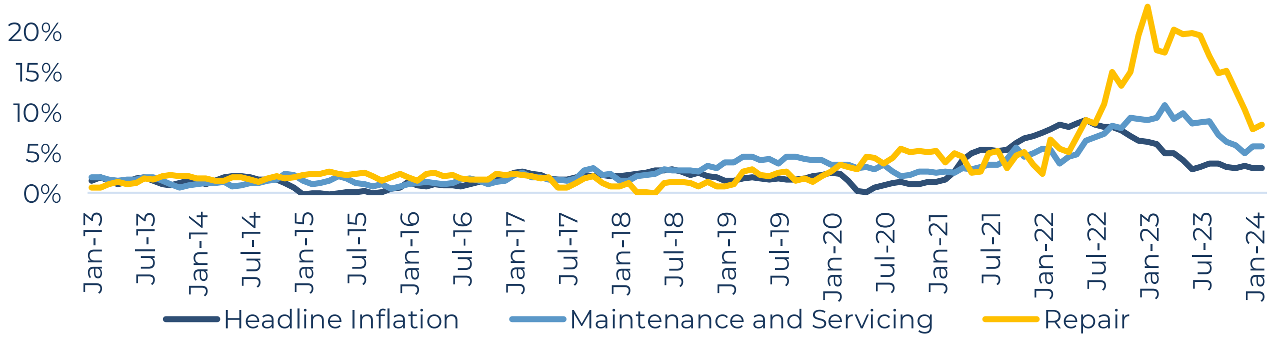
The increased costs of parts and services lead some owners to delay scheduled maintenance and servicing, which can result in more expensive repairs in the future.

TOP FINANCIAL CONCERNS[14]



AUTOMOTIVE MAINTENANCE AND REPAIR INFLATION[13]

(year-on-year percentage change)



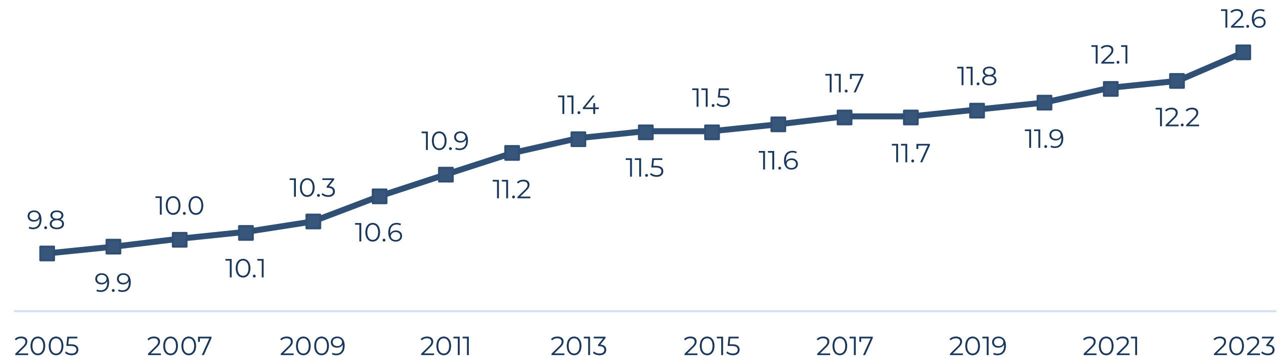
[13]U.S. Bureau of Labor Statistics
[14]Minneapolis Fed

3 CONSUMERS ARE KEEPING THEIR CARS LONGER

Consumers are keeping cars longer. The average length of new vehicle ownership stands at 96 months, increasing 60% over the last 10 years[15]. Older, higher mileage vehicles have heightened maintenance needs, increasing consumers' demand for after-vehicle purchase VSCs.

AVERAGE AGE OF VEHICLES ON THE ROAD[16]

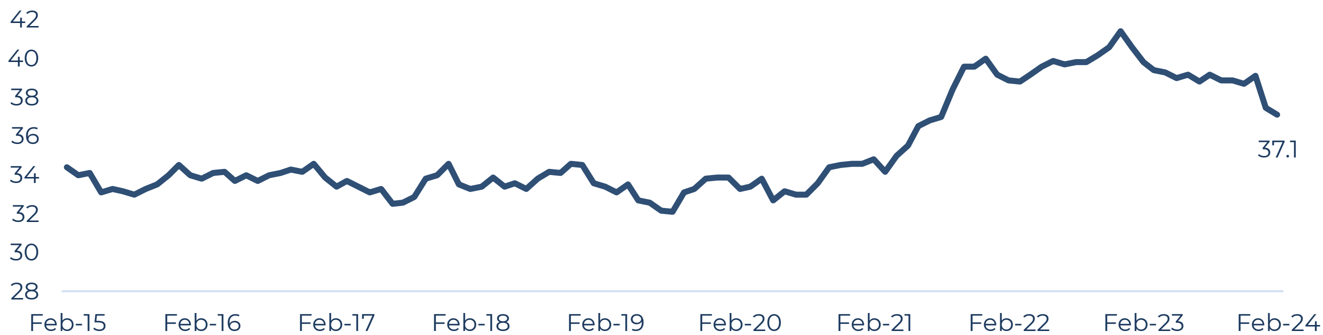
(years)



After many stable years, vehicles are less affordable to American car buyers than before the pandemic. Scarcity and inflation have increased prices while elevated interest rates on loans and lower purchasing power of the average consumer have reduced their ability to make monthly payments. The Cox Affordability Index measures the number of weeks a consumer must work to purchase the average new vehicle; as of March 2024, the average car buyer must work 37 weeks to afford a new car, an increase of over 10% compared to the historical range of 32 – 35 weeks experienced from February 2012 to August 2021[17].

COX AFFORDABILITY INDEX[17]

(weeks of income to purchase a new vehicle)

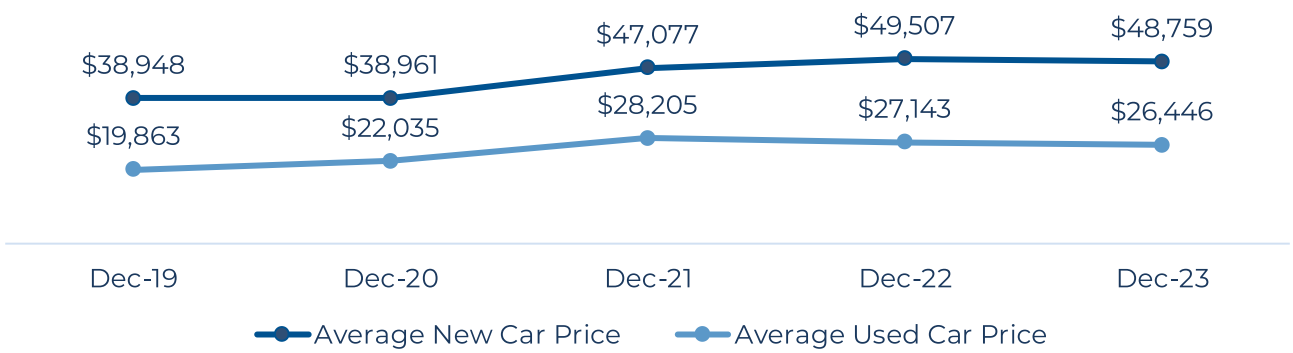


[15]The Zebra
[16]U.S. Department of Transportation
[17]Cox Automotive

New and used vehicle prices have increased 6% and 7%, compounded annually, since 2019[18]. Higher sales of trucks, more electronics, electric vehicles, and rising manufacturing costs drove up pricing. In 2023, high pricing marginally abated as supply increased post-pandemic.

AVERAGE VEHICLE PRICE[18]

($ in actuals)

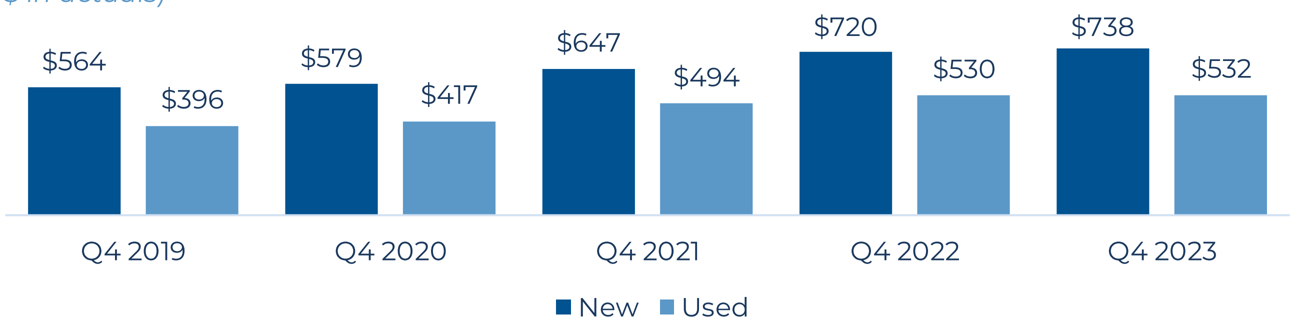


High vehicle prices and interest rates continue to drive up monthly loan payments. When interest rates were low, buyers extended loan terms to mitigate the impact of rising prices. Between 2018 and 2022, the average term on a used vehicle loan increased from 64 months to 68 months. However, rising interest rates in 2023 forced borrowers to reduce terms to an average of 67 months[19]. The decline in average term, despite vehicle prices remaining high, exacerbated the problem of unaffordable monthly loan payments.

Since Q4 2019, monthly loan payments for new vehicles and wages have increased by 7%, while used car payments have grown by 8%, compounded annually[19,20]. At the current average salary of $59,384, the typical employee will spend 19% of after-tax wages on a new car auto loan and 14% on a used car auto loan[19,21]. These costs make a new-to-the-buyer vehicle unaffordable for many. Thus, they keep their vehicles longer, increasing their annual repair costs as the vehicle ages.

MONTHLY LOAN PAYMENT[19]

($ in actuals)



[18] Kelly Blue Book, The Zebra
[19] Experian
[20] U.S. Bureau of Labor Statistics
[21] USA Today, NerdWallet

4 Growth in Dealer VSC Remarketing Programs

F&I revenue contributes 26% of an average dealership's gross profit[22]. Yet, as 52% of new car buyers do not purchase a VSC at the dealership when they buy the car[23], the industry is missing out on $72 billion in revenue annually[24].

Some VSC marketers are addressing missed opportunities in partnership with dealerships. In a VSC remarketing program, the marketer will market VSCs to dealership customers via direct mail, outbound calling, and email using the dealership brand. The marketer will book the sale and share product revenue or profits with the dealership.

In addition to improving a dealership's profit, VSCs improve customer loyalty. VSCs drive car owners to the dealership service lane, which represents ~50% of a typical dealership's profitability[25]. These business lines are even more critical in 2024 as low affordability will continue to depress vehicle sales.

DEALER VSC REMARKETING PROGRAMS

New and Used Retail Customers

- The F&I office did not offer a VSC
- The buyer did not want to spend any more time in the dealership
- The buyer wanted to wait until the end of the original warranty or when the vehicle is older

Service Department Customers

- Accesses service department records to get contact info
- Many service department customers did not buy their vehicle from the dealership

Customers with Expiring VSCs

- Highest response and closing rate as customer has product experience

[22]Based on Q4 2023 SEC filings from AutoNation, Asbury, Group 1, Lithia, Penske, and Sonic Automotive
[23]StoneEagle
[24]NADA, Cox, StoneEagle, Colonnade estimates
[25]NADA

5 AUTO WARRANTY ROBOCALLS ARE A THING OF THE PAST

In 2021 and 2022, everyone with a phone received a few dozen auto warranty robocalls. Americans received approximately 13 billion auto warranty robocalls in 2021. A few bad actors perpetrated these calls. The federal government cracked down and reduced auto warranty volume by over 99% in 2022[26].

The problem began in the mid-2010's. Technological advances have made it easier for scammers to reach more victims, leading to a spike in auto warranty robocalls in late 2021 and early 2022. Unfortunately, the scammers frequently used the names of well-known companies in the direct-to-consumer VSC industry.

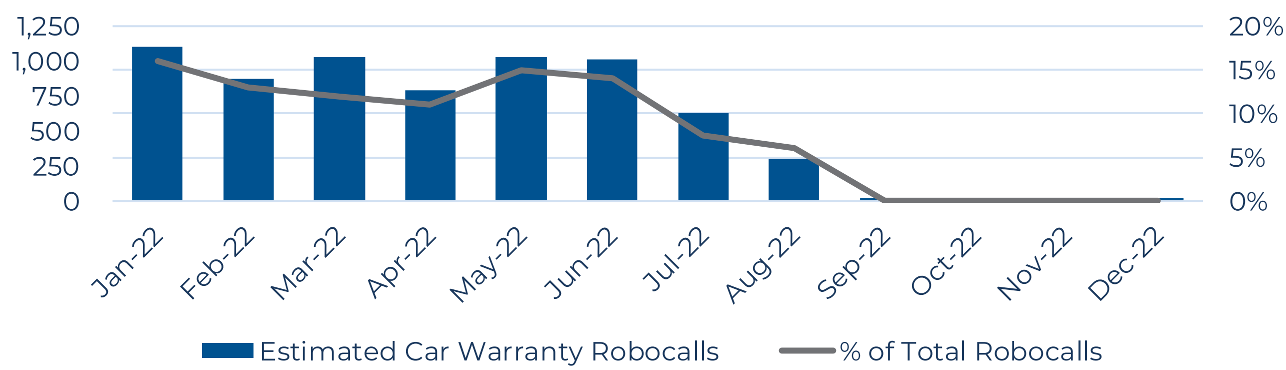
In July 2022, the FCC unveiled a series of measures to address and reduce robocall scams. Actions included:

- An investigation into the largest robocall operation
- Sending cease-and-desist letters to eight carriers utilized in their previous scams
- Ordering all networks to be on the lookout for robocalls generated by known bad actors

By the next month, robocall volume had already decreased by 80%. By fall 2022, volume had dropped more than 99% since the start of the crackdown[26]. In August 2023, the FCC levied a record-breaking $300 million fine against the largest robocall scam agency after determining that it was responsible for more than eight billion illegal calls during a four-year period[26].

ESTIMATED CAR WARRANTY ROBOCALLS 2022[26]

(Calls in millions)



[26]Robokiller

COLONNADE IS A LEADING ADVISOR TO THE AUTOMOTIVE SERVICES INDUSTRY

Reynolds & Reynolds
acquired
Xzilon
COLONNADE

Reynolds & Reynolds
acquired
AGWS
COLONNADE

SkyAuto Protection
was sold to
Fortegra
COLONNADE

PMC Protect My Car
was sold to
Crestview
COLONNADE

Endurance
was sold to
TRP Capital Partners
COLONNADE

AutoAssure Extended Repair Coverage
was sold to
Endurance
COLONNADE

VSC Marketer
was sold to
Strategic
COLONNADE

CalTex
was sold to
Spectrum Automotive Holdings
COLONNADE

Milestone Marketing Solutions
was sold to
Spectrum Automotive Holdings
COLONNADE

smart autocare
was sold to
Tiptree Inc.
COLONNADE

openroad Lending
was sold to
Clarion Capital Partners, LLC
COLONNADE

PMC Protect My Car
acquired
Direct Media Partners, LLC
COLONNADE

APC Integrated Services Group
was sold to
Southfield
COLONNADE

Mepco
was sold to
Seabury Capital Group
COLONNADE

Streamline Recon
was sold to
SolutionWorks
COLONNADE

tricolor auto
was sold to
Ganas Auto
COLONNADE

Southfield
acquired
Vanguard Dealer Services
COLONNADE

Automotive Development Group
was sold to
APCO Automobile Protection Corporation
COLONNADE

Omnisure
was sold to
Fortress
COLONNADE

PACCO Preferred Automobile Credit Co.
was sold to
AFS Acceptance Supreme Automobile Financing
COLONNADE

PWI Preferred Warranties Inc.
was sold to
KAR Auction Services
COLONNADE

PayLink Direct
was sold to
Oxford Financial Group, Ltd
COLONNADE

Mepco insurance premium financing
was sold to
Independent Bank
COLONNADE

Automotive Digital Marketer
was sold to
Private Party
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This advertisement was prepared April 2024. It is not investment advice, and Colonnade undertakes no obligation to update the information contained herein.

Sources: Minneapolis Fed, Auto Rental News, ANA Response Rate Report, Experian, United States Census Bureau, The Morning Consult, Bloomberg News, Federal Reserve, St. Louis Fed, U.S. Bureau of Labor Statistics, AAA, The Zebra, U.S. Department of Transportation, Cox Automotive, Kelly Blue Book, USA Today, NerdWallet, StoneEagle, NADA, Robokiller, FCC.gov, Automotive News Research & Data Center, Reuters, Haig Report, AutoNation, Asbury, Group 1, Lithia, Penske, and Sonic Automotive