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2022 M&A Predictions *for* F&I Agents

COMBATING COMPETITIVE INSURGENCY

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2022



PREDIC *for* F&I



TIONS Agents

M&A in the F&I sector will continue into the foreseeable future because private equity firms have record levels of dry powder, and add-on acquisitions will be utilized to bolster existing platform investments.

BY GINA COCKING

2021 was a big year for F&I agency mergers and acquisitions. Brown & Brown and National Auto Care were the highest frequency acquirers, having completed numerous deals. Based on current trends, 2022 will likely be an even hotter M&A market than 2021.

Mergers and acquisitions in the F&I industry mirror the more significant trends across all sectors. M&A activity in North America continued its bull run in the third quarter of 2021. As of September 30, an estimated 12,855 deals were completed in 2021 for a total transaction value of \$1,863.9 billion.

Private equity firms are driving the current frenzy in deal activity by their desire to take advantage of the booming economic growth and capitalize on the low-interest-rate environment, allowing private equity firms to stretch their equity checks. Notably, many firms are looking to deploy capital quickly to raise additional funds, especially with limited partner investors allocating more capital to the private equity sector. The resulting competition for deals creates a sellers' market resulting in higher valuations. However, there are headwinds in M&A, including high valuation multiples, inflation, and labor shortage concerns.

CHALLENGING COMPETITIVE DYNAMICS FOR INDEPENDENT AGENCIES

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 BUY-AND-BUILD STRATEGY

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 multiple 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. It has the ad-

competitive environment, the secondary buyers of platforms are willing to pay for full synergies on add-on acquisitions that are not yet integrated or completed. This trend of making add-on acquisitions late in the life of an investment is especially pronounced if the expected sale is to another private equity firm, as they are more tolerant than strategics of needing to continue the work of integrating recent deals.

THE GREAT RESIGNATION'S IMPACT ON M&A

Through October 2021, 38 million workers quit their jobs as part of what is being called the "Great Resignation." Workers are leaving for higher wages, better conditions, or just a change. While this disruption has been difficult, it is not as problematic as the elevated level of retirements. Approximately 2.5 million skilled, experienced people will not be returning to the workforce as one million were expected retirements, and 1.5 million were early retirements, according to recent research by Goldman Sachs. The automotive industry is not immune to the challenges of retaining, let alone increasing,

ing." Consequently, hikes in the discount rate are widely anticipated. Expectations of rate increases may prompt acquirers that rely on debt financing to move sooner to make deals rather than later.

It takes roughly six months to close a deal from the time an advisor is hired. The timing can be accelerated if the company is well-prepared and has multiple years of audits in hand. However, deals in the F&I industry tend to require 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 — is it an acquirer or a target? Buyers will review employee production metrics, their commitment to the agency, and non-competes. In reviewing the financials, buyers will hire an accounting firm to conduct a quality of earnings review, which takes approximately six weeks.

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vantage of mitigating high platform prices through multiple arbitrages. According to Pitchbook, 67.9% of middle-market deals across all sectors were add-ons in 2021, and the proportion was likely more elevated in the F&I industry.

Private equity firms are effectively using the buy-and-build strategy in the F&I industry. For example, the private equity firm Lovell Minnick acquired National Auto Care in 2018. During the last 18 months, National Auto Care has made 10 acquisitions, primarily of agencies.

Interestingly, private equity firms are adding onto their platform companies throughout the investment lifespan. Historically, private equity firms would stop making add-on acquisitions a year before selling the platform. However, in this

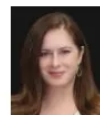
employees in this incredibly tight labor market, and leadership within the automotive F&I ecosystem is likely disproportionately impacted due to their average age. The F&I industry is a human capital-intensive sector, and employment is critical. To mitigate the employment problem, some companies will be using M&A as a near-term solution.

DEAL TIMING

In real estate, the adage is "location, location, location," and in M&A, it is "timing."

The availability of capital is one of the primary drivers of M&A activity, and investors are bracing for tighter liquidity. All are watching how the Federal Reserve will respond to inflation. The Fed has signaled that it will soon reduce "quantitative eas-

The F&I industry is all about relationships, and agents are the critical element in the dealership ecosystem. M&A 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, most importantly, companies need to remain on the offense with the competition. However, higher interest rates and exogenous variables can negatively impact valuations. **AE**



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