

Vehicle Service Contract Industry

Large, Growing Industry with Strong Margins

The vehicle service contract (VSC) industry totals \$29.4 billion at retail and comprises a large and important component of automotive F&I sales and profitability. The industry value chain includes direct-to-consumer marketers, auto dealers, administrators, payment plan providers and specialty insurance carriers. This large group of firms provides many compelling investment opportunities. The industry has been growing and generates strong returns and earnings growth to investors. Recent M&A activity indicates strong investor demand.

- Direct-to-consumer marketers price VSCs to absorb high cancellation rates and can generate margins in excess of 25%. These companies require little upfront capital to get into business but demand ongoing investments in marketing to drive sales. Some of the best players invest in their own branded products. Growth in this channel has been driven largely by the proliferation of the payment plan providers. Automobile dealers also market VSCs to consumers at the point of sale and in the service department of the dealership.
- The VSC administration market is estimated at \$11.8 billion with over 100 industry participants. VSC administration involves program design, pricing, underwriting, billing and claims administration. Administrators maintain reserves to pay claims, provide ongoing actuarial analysis of their programs and manage program loss ratios. A well-managed VSC administrator can generate EBITDA margins in excess of 20%. Most VSC administrators back their reserve pools with reinsurance from highly-rated insurance carriers.
- The market for VSC payment plan providers and finance companies is estimated at \$9.1 billion. Payment plans generate short duration receivables with high yields and low losses. Large, successful payment plan providers require transaction processing expertise and deep access to low cost capital. Pretax margins can exceed 30%.

M&A activity in the VSC industry has accelerated. VSC sellers, administrators and payment plan providers are selling at robust values because strong demand exists among financial and strategic buyers for high growth, high margin services business.

Since early 2012, nearly 20 companies in the VSC industry have changed ownership. We anticipate further consolidation over the next few years as entrepreneurs decide to exit, private equity firms seek to harvest the value of their VSC investments, companies consolidate to benefit from increased customer relationships and expense synergies, mono-line firms vertically integrate to enhance margins and insurance companies that underwrite VSCs acquire administrators to capture or preserve books of business.

Vehicle Service Contracts

A vehicle service contract, popularly referred to as an extended auto warranty, 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. VSCs supplement or replace manufacturers' original warranties and provide a broad array of coverage options. VSCs are marketed to drivers who (i) anticipate owning the vehicle longer than the duration of the original warranty, (ii) anticipate "driving through" the original warranty by exceeding the mileage limitations or (iii) are seeking enhanced coverage to extend their new car warranty.

U.S. consumers spend an estimated \$29.4 billion annually on service contracts for their vehicles.

VSCs are typically marketed at three points in the life cycle of an automobile: (i) at original sale (the new vehicle segment – extended warranties), (ii) near or after expiration of factory warranty primarily via direct-to-consumer sales (the end-of-warranty segment) and (iii) at resale (the used vehicle segment).

VSC Market Participants

Customers	<ul style="list-style-type: none"> • New and used vehicle owners purchase VSCs for a specific coverage during a defined period. • Customers seek coverage for a term after the original car manufacturer's warranty expires or to enhance factory warranty coverage.
Sellers: Direct-to-consumer marketers and Dealerships	<ul style="list-style-type: none"> • Market and sell contracts on behalf of administrators and earn a commission. • Direct-to-consumer marketers: Reach potential buyers through direct mail, television, radio and Internet advertising. • Dealerships: Sell to customers through F&I department at point of sale and in the service lane at franchised and independent dealers. F&I agents are frequently intermediaries between administrators and dealerships. Independent F&I agents are highly fragmented and range in size from large groups with regional/national coverage to small F&I agent firms with a single client. • Examples of DTC marketers: Endurance and Repair Defense Network.
Lenders and Payment Plan Providers	<ul style="list-style-type: none"> • Lenders: Finance a VSC at point-of-sale at dealerships by including the price of the VSC in the underwritten auto loan which is reported to the credit bureaus. The customer is liable to the lender for payment. • Payment plan providers: Flexible and convenient for the consumer as it is interest-free and enables the customer to spread the payment over time ranging from six to 24 months. Non-recourse to the consumer. VSC seller is liable for the payment. • Examples of independent payment plan providers: PayLink, Omnisure and Mepco.
Administrators	<ul style="list-style-type: none"> • Responsible for program design, pricing, underwriting, and billing and claims administration. • Market to dealerships through a direct sales force or through independent F&I agents. • Maintain reserves to pay claims, provide ongoing actuarial analysis of claims and refunds and manage program loss ratios. • Administrators include captives of insurance carriers, captives of vehicle manufacturers and independent third parties. • Examples: APCO (independent third-party), Toyota Financial Services (Toyota), Warrantech (AmTrust).
Insurers	<ul style="list-style-type: none"> • Provides a contractual liability policy ("CLIP") to guaranty performance of the VSC in the event that the administrator goes out of business or is unable to pay claims. • The administrator pays the insurer a premium and a fee. The premium is allocated to a trust and claims are netted against the trust. If claims exceed the trust, the insurer is liable to pay the claims. • Examples: AmTrust, Assurant, Virginia Surety (Warranty Group).

Industry Trends Are Favorable

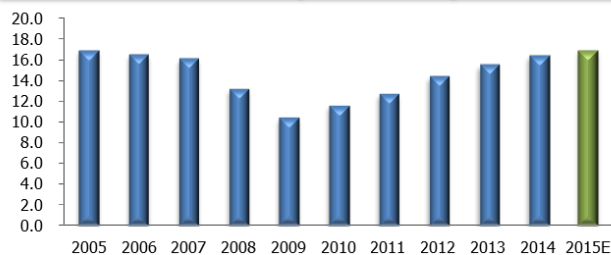
VSCs are sold to consumers at various points in the lifecycle of a vehicle: at the time of original sale, at the time of a used sale and at the end-of-warranty. VSC sales on new and used vehicles occur at the franchise and independent dealerships. End-of-warranty sales are directly marketed to consumers.

New Vehicles

Favorable industry trends are driving VSC sales for new vehicles as the new car market is increasing in size and the adoption rate of VSCs has increased markedly over the past decade.

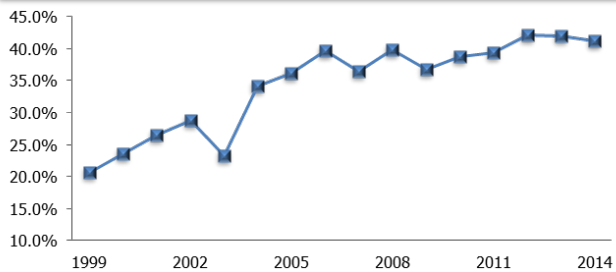
- Since the recession, new vehicle sales have rebounded, expanding the market for VSCs. New car sales grew to 16.4 million units in 2014, the highest level since 2006 and are expected to increase to 16.9 million units in 2015.
- New vehicles are sold through more than 18,400 franchised dealers in the U.S. Dealers sell VSCs to supplement the OEM's warranty and boost F&I income.
- Dealerships have been turning to the sale of VSCs and other ancillary products to increase profits. VSC income accounts for roughly 16% of total dealer profits.
- Recently, the VSC industry has benefited as GM has reduced the length of its factory warranty. The GM five year/100,000 miles powertrain coverage is being reduced to five year/60,000 miles. GM has also changed its free maintenance from four visits per year to two visits for the first two years.

New Vehicle Sales (units mm)



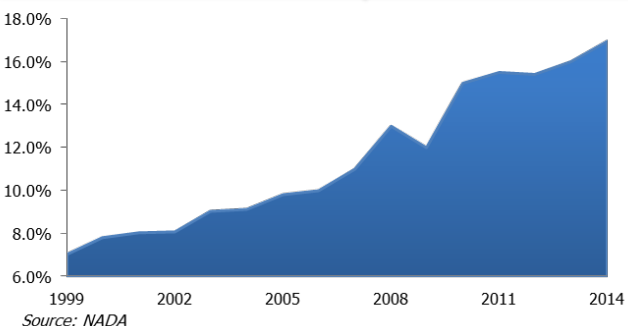
Source: NADA & IHS Automotive

New Vehicle VSC Penetration



Source: NADA & Baker Tilly Automotive Benchmark Survey

VSC Share of Dealership Profit



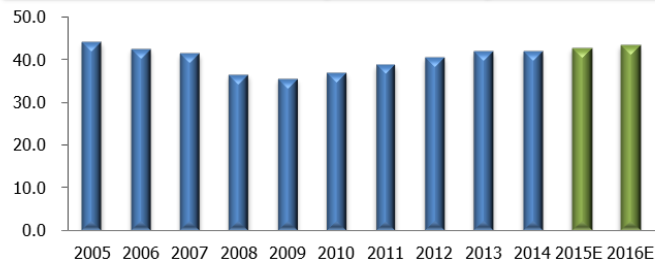
Source: NADA

Used Vehicles

Used vehicle sales are robust and dealerships are actively selling VSCs to enhance their margins.

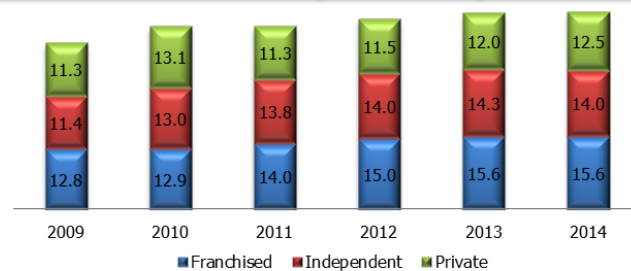
- The market for used vehicles is 2.6 times the size of the new vehicle market on a unit basis, reaching 42.1 million units sold in 2014.
- Used vehicles are sold through more than 36,000 independent and franchised dealers.
- Private sales accounted for about 12.5 million units in 2014, roughly 30% of the market.

Used Vehicle Sales (units mm)



Source: Manheim & CNW Research

Used Vehicle Sales (units mm)



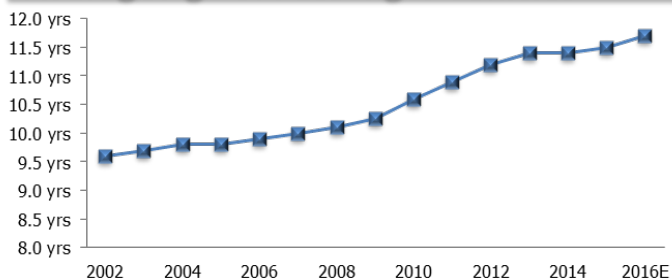
Source: Ward's Auto

End-of-Warranty

The end-of-warranty market is experiencing strong growth in VSC sales.

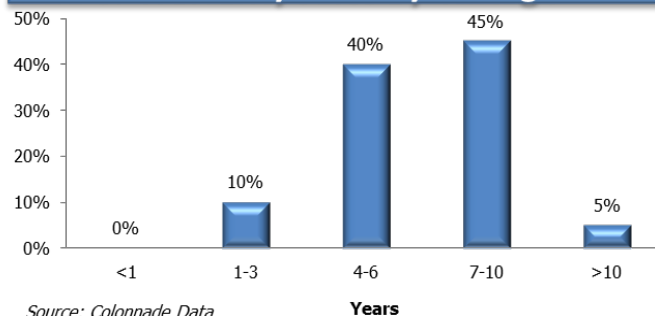
- Consumers are holding their vehicles for longer periods: an average of 7.75 years in 2014, according to Experian, compared to four years in 2001, according to IHS.
- More older vintage vehicles are coming off OEM warranty prior to a change in ownership.
- In 2014, there were 98 million cars on the road between model years 2002 and 2008.
- Buyers of new cars typically "drive through" the mileage limit on a three-year warranty in two and a half years and within four years on a five-year warranty.
- As new car sales have recovered between 2010-2014, the outlook for end-of-warranty VSC sales looks increasingly favorable.

Average Age of Passenger Vehicles



Source: IHS Automotive

End of Warranty Sales by Vintage



Source: Colonnade Data

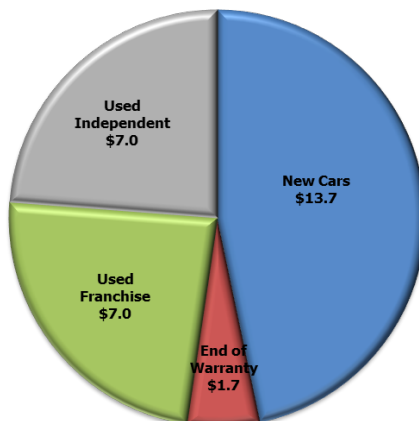
The Vehicle Service Contract Industry is Large

Since our commentary issued in 2013, we have refined our thoughts on market size.

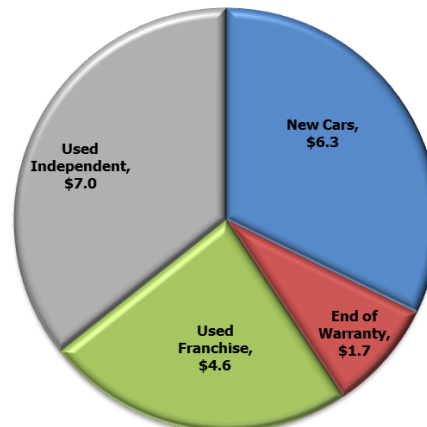
Retail Market Size

Colonnade estimates the total retail market for VSCs at \$29.4 billion in 2014. We estimate the addressable market for the independent companies at \$19.6 billion.

Total Retail Market
\$29.4 billion



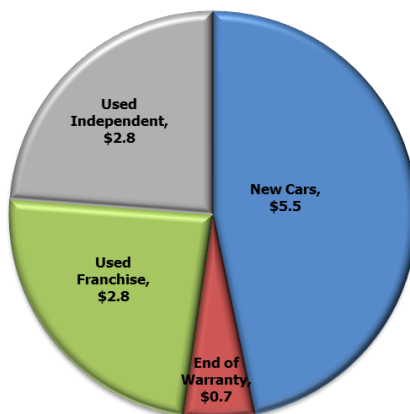
Addressable Retail Market
\$19.6 billion



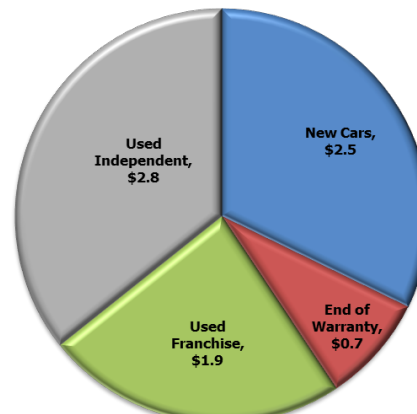
Administrators

Colonnade estimates the total administrator market for VSCs at \$11.8 billion and the addressable market for the independent companies at \$7.8 billion.

Total Administrator Market
\$11.8 billion



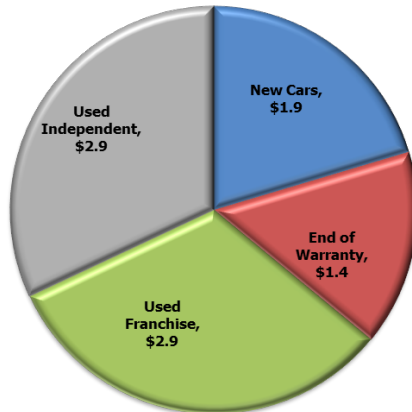
Addressable Administrator Market
\$7.8 billion



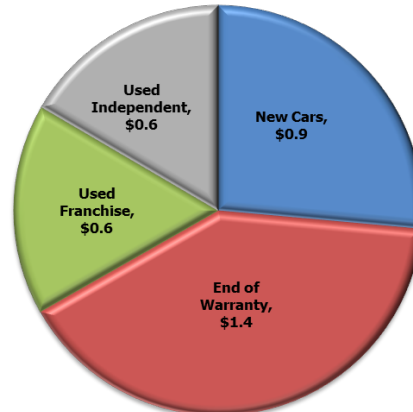
Payment Plan Providers

When utilizing a payment plan, a consumer typically makes a downpayment of 10% and the balance is financed. Colonnade estimates the total financing market for VSCs at \$9.1 billion. The addressable market for independent payment plan providers is estimated at \$3.5 billion.

Total Payment Plan Market
\$9.1 billion

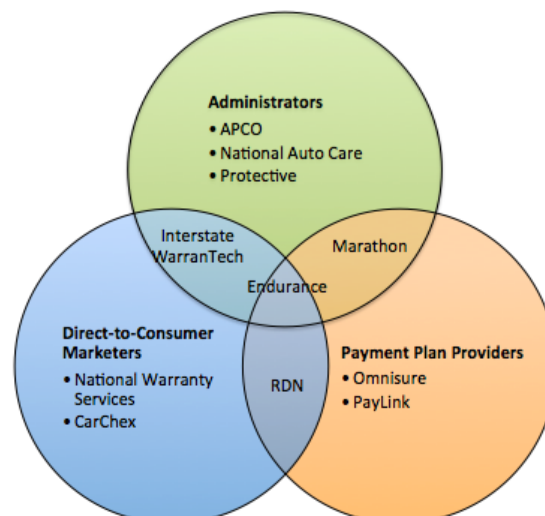


Addressable Payment Plan Market
\$3.5 billion



Business Model Differentiation

There are multiple segments in the VSC industry and companies use varied business models. There are pure play companies in each of the industry segments and others that integrate multiple segments, as demonstrated in the example below.



Direct-to-Consumer Marketers

There are at least 90 direct-to-consumer marketing companies in the U.S. focused on the VSC industry. These companies use three primary origination channels: direct mail, Internet and television/radio. The direct-to-consumer marketers are typically marketing on an unbranded basis, but a few are working to establish their own brand, which requires significant monetary investment and time. Compared to sales through dealerships, direct-to-consumer marketers experience higher cancellation rates (in the 40%-60% range), including cancels during the first month post-sale. Dealerships, which are rolling the VSC financing into the vehicle loan, typically experience a cancellation rate of 5%-10%. The cancellation risk is priced into the VSC. As the direct-to-consumer marketing companies have higher expense levels associated with marketing costs and cancellations compared to the dealership sales, their contracts are generally priced higher.

Direct mail is the largest channel and most well established. Direct mail requires the development and acquisition of consumer lists, marketing response models and materials testing. Many direct mail marketers send out unbranded pieces ascribed to "your motor vehicle department". Consequently, compared to the other channels, average call times and conversion rates are lower as consumers are responding to the receipt of the piece of mail and are not necessarily ready to purchase. The low conversion rates can be improved upon by using branded marketing pieces. Overall, direct mail is an effective channel for the direct-to-consumer marketers.

Internet marketing generates more informed customer leads. Potential customers have the opportunity to engage in product research and price discovery, resulting in higher conversion rates. For direct marketers, inbound calls are generally longer and yield higher sales. Internet marketers do risk higher adverse selection which can be mitigated by extending wait periods to make the first claim.

Television and radio advertising is the least utilized channel by direct-to-consumer marketers as it is the most expensive; however, it generates higher brand awareness. In addition to driving calls into the sales call center, television and radio advertising pushes consumers to the Internet to learn more about the products. Thus, marketing spend efficiency ratios for television and radio advertising should be reviewed in conjunction with Internet marketing effectiveness.

As the VSC industry has matured, administrators, payment plan providers and insurers have become more selective in choosing direct marketing partners. Direct-to-consumer marketers need to distinguish themselves and do so through Better Business Bureau ratings and by being certified by the Vehicle Protection Association (VPA). The VPA is a not-for-profit trade association promoting regulatory transparency, education, accountability, compliance and stability in the marketing and servicing of VSCs. The VPA created the Standards of Conduct, a uniform code to define ethical business conduct for association members. It also certifies members via a rigorous certification process.

Administrators

The administrator universe is fragmented with over 100 operators. The largest administrator has less than 8% of the total market and we estimate that the top five administrators have 30% of the market. Administrators are selling their products to the end consumer through dealerships or through direct-to-consumer marketers. To reach the dealerships, administrators utilize a direct sales force and/or independent F&I agents. With an independent F&I agent sales force, the administrator's reach is broader, however F&I agents are not exclusive and the administrator can sometimes struggle for agent mindshare. The direct sales force receives salary plus commission,

whereas the independent F&I agents are compensated via a mark-up to the VSC upon sale at the dealership. Administrators also resell their products through direct-to-consumer marketers which typically offer their customers the products of multiple administrators.

Administrators are frequently differentiated by the dealerships they address: franchise versus independents. The franchise dealerships have greater F&I sophistication. The competition among administrators to establish a relationship with franchisees is higher, resulting in longer sales cycles. Additionally, many franchise dealerships are interested in participations on the residual value of VSC sales and reserves. The independent dealerships typically represent older used cars with higher mileage, so the product offering is different from that of new car dealerships. The independents historically tended to have a lower level of technological sophistication, resulting in more costly contract set-up.

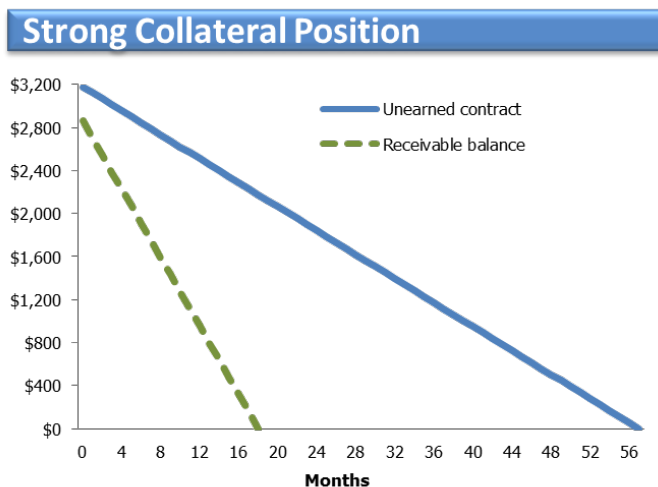
Administrators make the determination to be self-insured or to purchase a CLIP to reinsure claims. Administrators that purchase CLIPs pay a premium into a trust which is jointly controlled by the insurer and the administrator. Many dealerships, as well as consumers, prefer to work with administrators that market VSCs backed by highly-rated insurance carriers.

Payment Plan Providers

Payment plan providers generate high yielding, short term receivables. There are fewer than ten independent firms specializing in providing VSC payment plans.

A payment plan receivable originates when a buyer of a VSC (outside of the auto loan) 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. 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 VSC. VSC finance receivables typically have an average life of six to 12 months.

The payment plan receivables enjoy strong collateral as the VSC administrators are financially responsible for any VSC claims. The payment plan provider does not assume consumer credit or claims risk under the VSC. 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 to the right illustrates, a properly structured VSC payment plan receivable is always collateralized in excess of the



finance company's exposure.

Payment plan providers with a diversified receivables portfolio can attract significant third party leverage to boost equity returns.

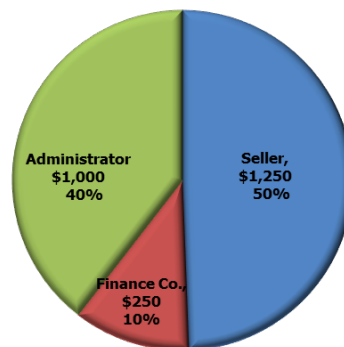
Vertically Integrated VSC Companies

The vertically integrated business model captures incremental value in the VSC sale. This model may result in higher margins and lower cancellations.

- A direct-to-consumer marketer that is also an administrator benefits from higher margins and lower cancellation rates due to the opportunity for early intervention in a cancellation scenario as well as an enhanced customer experience. Typically, if a customer calls to cancel, he/she contacts the administrator. An integrated marketer will take the call and have the opportunity to deploy strategies to save the relationship as opposed to handing off the call to a third-party payment plan provider. Customers generally have an enhanced experience with an integrated provider when making a claim as he/she is contacting the same entity that he/she bought the VSC from. In addition, the direct-to-consumer marketer is able to remarket to the customer.
- An administrator or direct-to-consumer marketer that also provides payment plans eliminates the 5%-15% fee paid to the payment plan provider. Typically, little additional headcount is needed to administer the payment plan, as some marketers are already monitoring payments and following up with customers in order to mitigate their own liability. Vertically integrated firms can deploy excess capital and leverage corporate lines of credit to finance their own receivables, although they lack a diversified pool of receivables relative to the independents.

A company that is completely vertically integrated by selling, administering and providing payment plans captures the greatest portion of the revenue stream of a VSC sale.

VSC Price Breakdown



Investment Case for the Industry

The vehicle service contract industry is attractive for investors as companies are exhibiting strong growth, attractive margins and high cash flow. Vertically integrated companies are positioned to potentially capture a higher margin.

Consumer Demand is Strong

- Consumer awareness of VSCs is driven by:

- Positive experiences
 - Advertising
- Consumer demand for VSCs is driven by:
 - Increased duration of vehicle ownership
 - Increased age of vehicles
 - Lack of consumer wealth to pay for unexpected repairs
- VSCs provide consumers with “Peace of Mind” against large, unexpected repairs
- Purchase decision is frequently based on monthly payment, not total cost
- Expansion of VSC payment plan providers fuels improved affordability and drives sales of VSCs

Attractive Margins

- VSC companies have high margins from 20% to 35%
- Businesses are scalable and technology-enabled

High Cash Flow

- Payment plan providers allow direct-to-consumer marketers and administrators to receive nearly full payment upfront for all contracts sold. Sellers generally reinvest in additional marketing to drive further sales
- Payment plan providers structure payments to generate high yielding, short term receivables with low losses

Vertically Integrated Companies May Capture Higher Margins

- Sellers that also provide payment plans generally have higher margins as they are eliminating the 5%-15% fee paid to the payment plan provider
- Direct-to-consumer marketing companies that are integrated with administrators and payment plan providers offer customers a seamless experience, which results in lower cancellation rates and greater remarketing opportunities

The VSC Industry is Complex with a Unique Set of Challenges

GAAP versus Modified Cash Accounting for Administrators

GAAP financial statements do not represent the cash flow of a VSC administrator. Per GAAP, the revenue and expenses must be recognized over the life of the contract. For example, if a VSC is priced at \$1,000, is a 60 month contract and has associated expenses (CLIP premiums, etc.) of \$700, per GAAP the administrator recognizes \$5 of income per month (\$300/60). However, the administrator receives \$1,000 in cash revenue and pays out \$700 in expenses in the first few months for a net cash profit of \$300. Most administrators utilize some form of modified cash accounting to manage their businesses. A key challenge for administrators looking to raise

capital or sell their company is educating lenders and investors on modified cash financial statements.

Cancellation Reserves for Direct-to-Consumer Marketers

As previously noted, direct-to-consumer marketers experience high cancellation rates (in the 40%-60% range), including cancels during the first month post-sale. The balance sheet reserves for future cancellations are created based on static pool analyses. The challenge is that these analyses apply cancellation curves from historical vintages to future potential claims. If a marketer does not have a deep, long-dated set of historical data, the cancellation curves may not be robust enough for predictive static pool analyses.

CLIPs and Reinsurance Positions

The insurance premium trusts and reinsurance positions created as part of the CLIPs offer both opportunity and confusion for investors. Often, the trusts are over-reserved, meaning there is a higher level of funds in the trust than is needed to cover future claims. Some administrators are able to negotiate releases from the trust reserve that are recognized on the income statement. When valuing a company with these reserve releases periodically flowing through the income statement, a multiple should not necessarily be applied to this income stream as future reserve releases are not guaranteed. Conversely, an opportunity for future income includes the release of excess funds from the trusts. Separately, entities (such as dealerships) may have participations in these trusts.

Regulatory Issues

As with all financial services sectors, regulatory issues are always front-of-mind.

- The industry has been bruised by bad actors in the direct-to-consumer space which has led to more self-regulation and transparency. U.S. Fidelis, a direct-to-consumer marketer that committed fraud and subsequently filed for bankruptcy protection, is firmly in the rearview mirror but serves as a warning to investors. Emerging from that time period, the VPA was formed and it set industry standards.
- Occasionally, attorneys general will make a splash in the industry. For example, in September 2014, the Minnesota Attorney General sued EFG Companies for allegedly violating three consumer protection laws for the way it handled cancellations and refunds on service contracts sold through third-party sellers. Through an audit, the AG found that EFG paid 96% of all consumer refunds within the 45-day period required by Minnesota law. The case was dismissed in 90 days without civil penalties or fines.
- As the CFPB focuses on the auto lending market, there is some concern that it will target the VSC industry participants (along with other ancillary F&I products) that sell through dealerships.

M&A Activity in the Sector

The pace of mergers and acquisitions in the industry is accelerating, with at least eight announced deals in 2015. Interestingly, nearly 70% of the transactions in the past four years involved private equity buyers.

M&A Activity

Date	Target	Buyer	Segment
Jun-15	Endurance Warranty Services	Transportation Resource Partners	DTC Marketer, Administrator and Payment Plan Provider
Jun-15	Premier Dealer Services	Prairie Capital	Administrator
May-15	Wells Fargo Dealer Services	AmTrust Financial Services	Administrator
May-15	Auto Group Services	NFP (Madison Dearborn Partners)	F&I Agency
Apr-15	Dent Wizard	Gridiron Capital	Automotive Reconditioning
Mar-15	SouthWest Dealer Services (owns Century Administration Company)	Spencer Capital	Administrator & other F&I
Mar-15	Kingstar (Repair Defense Network)	Minority Investment by Flexpoint Ford	DTC Marketer
Dec-14	Fortegra Financial Inc.	Tiptree Financial Inc.	Administrator
Oct-14	Omnisure Group	Fortress Investment Group	Payment Plan Provider
Sep-14	G-W holdings	The Portfolio Group (Frontenac)	VSC Reinsurance
Aug-14	Warranty Group	TPG Capital	Administrator
Jul-14	PayLink Payment Plans	Milestone Partners	Payment Plan Provider
Dec-13	O'Neil Financial Services Agency Inc.	Brown & Brown	F&I Agency
Jun-13	PWI Holdings	KAR Auction Services	Administrator
Feb-13	The Portfolio Group	Frontenac	VSC Reinsurance
Feb-13	GWC Warranty	Stone Point Capital	Administrator
Jan-13	National Auto Care "NAC"	Trivest Partners	Administrator and Marketer
Jan-13	Safe-Guard Products	Goldman Sachs Group	Administrator
Nov-12	Budco Financial Services	Founder and Evolution Partners	Payment Plan Provider
2012	CarChex	Assurant (minority investment)	DTC Marketer
Dec-11	Innovative Aftermarket Systems	Genstar Capital	Administrator
Dec-11	PayLink Payment Plans	Oxford Financial Group	Payment Plan Provider

Bold indicates Colonnade clients.

Conclusion

We anticipate further mergers and acquisitions over the next few years as:

- More entrepreneurs decide to exit or gain liquidity in a strong market
- Private equity firms seek to harvest the value of their VSC investments
- Companies consolidate to benefit from increased customer relationships and expense synergies
- Mono-line firms vertically integrate to enhance margins
- Insurance companies that underwrite VSCs acquire administrators in order to capture or preserve books of business

Colonnade is a Leader in M&A in the VSC Industry




has raised private equity capital from




Colonnade acted as exclusive financial advisor to Endurance Warranty Services, LLC and Endurance Dealer Services, LLC


Colonnade Securities LLC



has been sold by management and



to



The undersigned acted as exclusive financial advisor to Omnisure Group, Lincoln Park Capital and Management.

Colonnade Advisors LLC



have sold



to



The undersigned acted as exclusive financial advisor to Harbert Management Corporation, Northstar Capital LLC and management of Preferred Warranties Inc.

Colonnade Securities LLC



has sold



to an investment group led by



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

Colonnade Securities LLC



has been acquired by

Independent Bank Corp.
(NASDAQ: IBCP)

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

Colonnade Securities LLC

For more information on the Vehicle Service Contract Industry, please contact:

Gina Cocking
Managing Director
312.425.8145
gcocking@coladv.com



Christopher Gillock
Managing Director
312.870.6212
cgillock@coladv.com



Jeff Guylay
Managing Director
208.726.0788
jguylay@coladv.com



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