Advanced Corporate Finance

GUEST LECTURE CASE - Autoassurance

The situation

Dan Helle is a partner at Helle Capital, a private equity firm that invests in "middle-market" companies (roughly defined as companies with an enterprise value between $20m and $500m), with the hope of increasing the value of these companies and thus producing a profit for fund investors.

In 2007, Helle was contacted by an investment bank that told him that they had identified a company that was looking for a buyer as the company's founder was planning to retire. The company, Autoassurance, was a leading player in the automotive "ancillary finance & insurance" (F&I) market. Specifically, the company provided insurance-like products that covered maintenance and repairs that were outside of the scope of typical auto warranties and auto insurance policies.

The company was based in the southern part of the US and had over 100 employees and annual revenues of around $55 million.

Dan Helle was intrigued. He had acquired considerable experience related to consumer finance and insurance products. Helle Capital had also recently done a big study on services and products related to the auto dealership market and was looking for new investments in this space. Helle Capital already owned a company that provided "vehicle service contracts" (also commonly called "extended warranties"), which is one of the largest products in the ancillary F&I category. While Autoassurance didn't offer extended warranties, its business involved a range of related products that offered more specific coverage.

Products

Autoassurance currently offered six main products:

- *Guaranteed Asset Protection ("GAP") protection*. In case your car is involved in a crash in which the car is deemed a "total loss", GAP pays for the difference between the insurance payout and your remaining auto loan balance. Similar benefits apply in the case of theft.
- *Tire and wheel protection*. Repair or replacement for damaged wheels or tires.
- *Dent and ding protection*. Provides paintless dent repair for door dings and small dents.
- *Windshield protection*. Repair or replacement for damaged windshields.
- *Key replacement protection*. Replacement for lost keys.
- *Theft deterrence products*. Applies identifying tracking information on the car, e.g. on windows and invisible laser etching on the car body.

Autoassurance also had a strong track record of developing and launching new products.

These products were offered principally through auto dealerships (the dealerships got part of the sales price as a commission), to customers when they were buying new or used cars. When a customer purchases a car at a dealer, the dealership often provides an option to purchase extended warranties as well as these related insurance-like products. These products could be purchased either individually or as a bundle.

The main value proposition to customers is that these products can offer piece of mind and predictability if they are worried about facing unexpected auto expenses. Because of the strictly specified coverage these products provide, they are generally not that expensive, ranging from around fifty to a few hundred dollars.

The company currently sold around 1 million of these products annually. The largest product by units sold was theft deterrence, while tire&wheel protection was the highest revenue product (this was the most expensive product to buy, since the insurance coverage for the resulting losses on tires and wheels was the most expensive to provide).

The role of auto dealerships

Autoassurance doesn't directly face the end customer (*i.e.*, buyers of new or used cars), for which it relies on dealers. A key to continued success for Autoassurance is therefore its ability to recruit and retain auto dealers to offer its products over similar products offered by its competitors.

Dealers have an incentive to offer these products because they received part of the premiums paid, and to enhance the range of products they can offer to their customers. Profit from selling these and related F&I products have become especially important to dealers as margins on car sales have declined in recent years (see Figure 1).

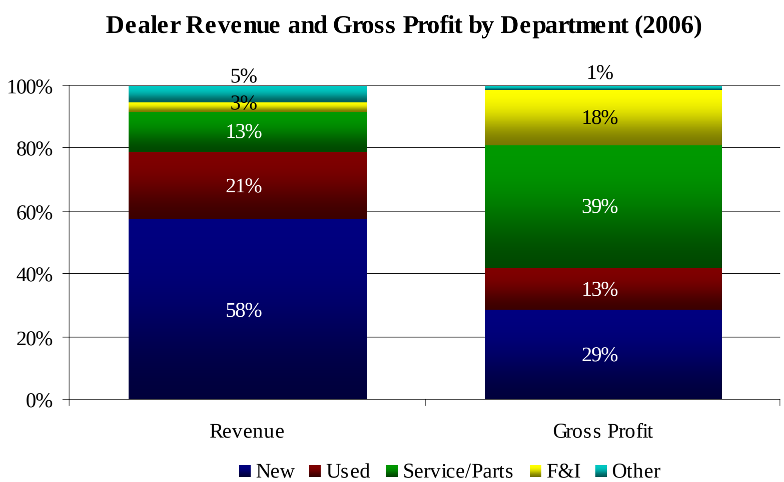

Figure 1. Revenue and profits streams for auto dealerships

Autoassurance currently offered its products through over 2,000 auto dealerships. Autoassurance didn't interface directly with most dealers, but instead relied on independent agents who had pre-existing relationships with these dealers. In total, the company had 200 such agents, spread through almost every state. For some very large dealers (e.g., those with dozens of locations), the company sometimes sold directly without going through agents—the company sold its products in this way to around half of the top-25 dealership groups. The company also sold some products as white-label offerings to the largest companies in the vehicle service contract (VCS) (*i.e.*, extended warranty) industry to be offered as a bundle with the VCS.

In terms of customer concentration, the 10 biggest agents/dealerships together represented around 47% of total revenues, and no customer had over 10% share.

An important feature that Autoassurance offered to dealers was a software solution that allowed dealers to present these products in a unified way to customers. The software allowed dealers to also bundle products from other providers for products that Autoassurance didn't offer (such as extended service contracts). This was an important benefit to dealers who thereby could avoid using different software to display each product they offered (the average time an auto buyer spent in the F&I office was usually around 25-30 minutes). Autoassurance also offered training courses for the dealers that offered its products, as well as processes to ensure compliance with disclosure rules and other legal requirements when selling these products.

The economics of the ancillary F&I market

To illustrate the economics of the market, suppose the dealer sells a product (e.g., GAP insurance) to a customer for $250. The dealer may retain $50 as its markup and remit $200 to Autoassurance. Autoassurance pays the agent that maintains the relationship with the dealer a commission (e.g., $50), and retains the rest ($150). Part of the $150 is then added to reserves to cover future losses and the rest can be recognized immediately as revenue.

Autoassurance bears the risk that losses may exceed the amount put in reserves, or it may realize an additional profit if eventual claims are lower than the amount projected in reserves. Autoassurance retained the profit and loss of underwriting all its products, except for GAP insurance for which it sold the risk to an external insurance company (this relationship was due to end in 2008 after which Autoassurance would bear the risk---and get any underwriting profit---from also the GAP policies).

Historical loss rates had been quite high. Especially in the earlier years when many of these products were new, claims commonly exceeded reserves, resulting in unexpected losses. This was partly due to lack of experience in pricing products which in turn was a consequence of having limited actuarial data. But in recent years, loss rates nevertheless became more predictable. The company closely monitored the underwriting processes, and responded quickly to unexpected loss patterns trough surcharges on dealers with those losses, coverage modifications, and price increases.

Competition

The primary competition came from one comparably sized independent competitor (also recently acquired by a PE firm), numerous smaller competitors that offer a more limited number of products, and from a few insurance companies that offer a GAP product. Competition was thus quite limited in the product categories that Autoassurance focused on, but it wasn't impossible that a large insurance company or a company in the service contract industry would enter these ancillary markets.

Management

The key employees in the firm's management had been with the company for around 10 years, and they had overseen the considerable growth and expansion of the firm to date.

Historical and projected cash flows

Helle had created the following financial projections. Forecasted financial results are based on the following assumptions: (i) limited growth in contract volume of 4.2% - 4.7% annually, (ii) no margin increases, and (iii) the recognition of an additional underwriting profit beginning in 2008 from self-reinsuring GAP policies.[1]

Table 1 presents historical (2004-2007) and forecasted future (2008-2012) financials.

Table 1. Historical and forecasted financials

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Units sold (#)	849,125	897,816	955,516	974,139	1,019,784	1,065,636	1,112,757	1,160,482	1,208,896
Revenues ($,000)	30,439	39,881	54,603	56,463	48,047	58,567	66,083	71,052	74,389
EBITDA ($,000)	4,363	8,267	8,811	8,861	9,843	11,873	13,594	14,703	15,510
Capex ($,000)	423	97	663	603	400	400	400	400	400

Debt Financing and co-investment

Helle Capital has approached two lenders (Lender A and Lender B) to ask for terms (see spreadsheet for detailed terms). Both lenders are willing to lend up to $28 million to finance the deal and with two tranches of debt (Term A, which is amortizing, and Term B, which is not). Helle can choose to only take the Term A or take both Term A and Term B from either lender. The fees, interest rates, and required amortization schedules varies across lenders. Lender B was further only willing to lend at these terms if it can invest $500,000 in equity alongside the PE fund; the lender would pay a fair price according to the deal valuation for its equity stake, but it would thus also share in any equity gains from the deal, thus reducing possible profits for the fund's investors.

As part of the deal, the current management would also roll over part of their current ownership and continue to participate in the equity of the firm, retaining a 20% equity stake. The seller (*i.e.*, retiring

[1] In other words, the reason that earned revenue decreases but profit still increases in 2008 is that the company will start to reinsure its GAP reserves rather than relying on an external insurer and therefore begins to recognize this revenue stream only on a deferred basis.

founder) would provide additional debt financing of $5 million in the form of a seller note (at an interest rate of 7% and is not amortized until the Helle Capital eventually sold the company), bringing the total available debt financing up to a maximum of $33 million.