

Customer & Market Due Diligence Of Collision Repair Supplies Distributor: Assessing Disintermediation & Margin Risks Amidst Downstream Consolidation

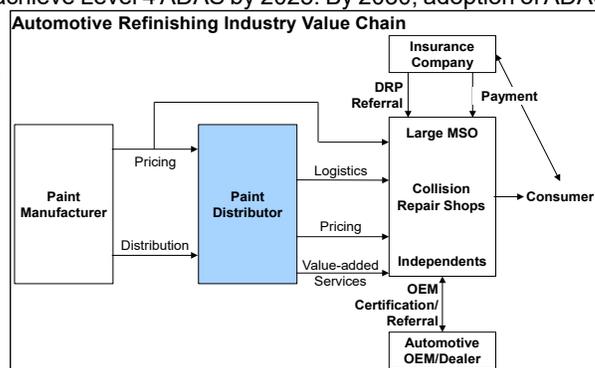
The Challenge: One of our long-term PE clients was looking to acquire a specialty distributor of paint and related consumables, primarily serving the collision repair market. Our client was interested in the opportunity to build a national distribution platform. Given consolidation in the collision repair industry and the associated rise of large multi-shop operators (MSOs), our client was concerned about disintermediation risk and downward pressure on margins. As such, our client asked Gotham to conduct a 3-week customer & market due diligence of the target as input to refining their investment thesis in preparation for the final bid; due diligence objectives were: (1) establish collision shop decision-making and competitive dynamics (2) establish paint distribution channel dynamics and determine the disintermediation risk; and (3) assess the implications of collision shop consolidation.

Collision Repair Industry Consolidation Impact Assessment: Gotham undertook a multi-pronged approach that entailed:

- Conducting 76 anonymous interviews with and 74 online surveys of collision shop owners, managers (independent, MSOs, and franchises) and distributors to gain insights into: collision shop-distributor relationships and the potential risk of collision shops switching paint manufacturers/distributors; the collision shop consolidation trend and its impact on distributors; key performance criteria for distributors and the importance of distributor value-added services; and collision repair industry trends and outlook
- Interviewing insurance companies to understand their direct repair programs (DRPs) and their impact on collision repair market
- Leveraging industry data and conducting research to establish: the automotive refinish market size/growth and key relationships; key MSOs and their acquisition/growth trends; and the collision repair paint distribution competitive landscape.

Collision Repair Industry Flat Despite Expected Decline In Collisions

The number of collisions is expected to drop moving forward due to increased adoption of advanced driver-assistance (ADAS) features, such as automatic emergency brakes – major OEMs plan to achieve Level 4 ADAS by 2025. By 2030, adoption of ADAS in vehicles is expected to reach over 80%. Nonetheless, the collision repair market is expected to remain stable due to an increase in cost per claim driven by growing severity of accidents, increased cost of replacement parts, and increased requirement for skilled technicians in the repair process. Further, there is growing complexity in paint and color mix, requiring specialized knowledge. In addition, cost of repair is going up with growing aluminum content in vehicles (12% by 2026) and repair of these cars requires investment in fresh tools and chassis equipment along with specialized training. Lastly, while electric vehicles are made with fewer moving parts and are cheaper to manufacture, they are more expensive to repair after accidents because lighter and more complex parts are costlier to repair and technically challenging.



Insurance Companies DRPs Driving Consolidation Of The Fragmented Collision Repair Industry

80% of auto insurance claims are for repairs and 90% of collision repair shop revenue is driven by insurance companies. The automotive insurance industry is fairly consolidated, with the top 4 insurance companies controlling ~50% of the market and the top 10, 70%+. Large insurance companies started setting up DRPs about 30 years ago to reduce claim processing costs, improve consumer experience, and hold collision repair shops accountable for their performance. They select collision repair shops to be in their DRP typically based on cost and ongoing performance (cycle time, return rate, on-time delivery, severity of repair, and OEM parts usage) and prefer players with multiple locations for administrative reasons. DRP programs have led to ongoing consolidation in the collision repair industry, with large MSOs comprising ~37% of market and the top 3 MSOs, ~21%. This increased scale provides large MSOs margin advantage – better pricing on supplies (including direct negotiations with paint manufacturers) and in-house technical and operating expertise at a lower cost than distributors' value-added services. Today's technician shortage and greater technical skill needs also provide MSOs an employee recruiting and retention advantage. These advantages large MSOs hold over independents continue to drive this consolidation trend – the number of collision shops is down to 31K in 2022 from 80K in 1980. Also, the size of collision repair shops is increasing to leverage capital investment over a larger repair volume, with 70% of the total being large collision repair shops (\$1MM+ revenue), up from 15% in 1995.

Opportunity To Build National Paint Distribution Platform To Better Serve The Low-margin MSO Business

Paint distributors' value proposition is to help the profitability of collision shops via value-added services like training, technology support, inventory management, process consultation, and KPI/benchmarking. The paint distributor-collision shop relationship is high-touch, with frequent deliveries, fast turnaround expectations, and regular visits by account reps desired. MSOs, on the other hand, directly negotiate contracts with manufacturers and develop in-house expertise with technical support from manufacturers and use distributors only for providing logistics. These large MSOs are compressing margins in this traditional high-touch, high-cost paint distribution industry. Despite consolidation, 50%+ of the collision repair market is still controlled by 20,000+ independent shops; the majority of whom plan to continue building their businesses, relying on superior service and knowledge to survive against larger competitors, suggesting a resilient customer base. The fragmented distribution industry, primarily comprising regional/local family-owned companies, is ripe for consolidation to create a scale player with a national distribution presence that can play with the "big boys" dominating the automotive refinish value chain (paint manufacturers, automotive insurers, and MSOs).

The Outcome: Gotham's assessment provided a fact-based view on the target's disintermediation and margin risks by establishing the distributor value proposition, the collision repair industry consolidation dynamics, and the impact of insurance DRPs. Our findings confirmed an opportunity to build a national paint distribution business, allowing our client to successfully close the deal.