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SHIFTING GEARS IN THE AUTOMOTIVE AFTERMARKET: PUTTING 2020 IN THE REARVIEW MIRROR AND REVVING UP FOR 2021

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As was the case for many industries, 2020 began and ended on very different notes for the automotive aftermarket. A wide-ranging category, this ~$300 billion market includes the manufacturing, distribution, retailing, servicing and installation of vehicle parts, equipment, chemicals and accessories purchased by consumers in order to repair or enhance the vehicles they already own. On average, American car owners spend $1,186 annually on vehicle repairs and maintenance, a figure steadily growing over the last decade with the increasing complexity of vehicles and aging of the car parc.[1]

The events of 2020 profoundly affected our relationship with our cars – and hence these aftermarket products and services – with contradictory factors like stay-at-home orders significantly reducing vehicles miles traveled ("VMT"), commuters preferencing personal over public transportation (once such orders were lifted), and families trading in long-distance air travel vacations for road trips and outdoor recreational activities.

For important context, we outline a few key facts about the automotive sector in 2020:

- New light vehicle sales declined precipitously at the beginning of COVID-19, bottoming out at 8.6 million units on a seasonally adjusted annual rate (SAAR) basis in April, but recovering to 85% of 2019 levels as of December[2]
- Used car sales SAAR (which typically outsell new cars by a two-to-one ratio) declined only ~5% year-over-year, as consumers remain sensitive to costs during periods of economic uncertainty[3]
- Americans drove ~1 billion fewer miles in 2020 vs. 2019 (~13% decline)[4], but by year end, VMT began to normalize
- Approximately 20% of U.S. households delayed maintenance on their vehicle through the first half of the year, with nearly one-third opting to eventually do-it-themselves[5]

As we further reflect on 2020, it's clear that the dynamics of the pandemic greatly accelerated the time horizon for several key trends that will drive the automotive aftermarket in 2021 and beyond. We believe the following trends and themes will be at the forefront of analysts and investors' minds when evaluating the sector.

Please see our latest [Quarterly Report]() for additional detail on 2020 Automotive Trends

TRENDS		IMPACT ON SECTOR

WORK FROM HOME (WFH)

- Partial or full WFH now a viable long-term alternative to commuting to office
  - ~55% of U.S. workers employed in WFH-compatible sectors[3]
  - ~25-30% of workers estimated to permanently shift to partial or full WFH by 2021[6]
- Will continue to pressure VMT

SUBURBAN MIGRATION

- One-in-seven consumers moved or cited plans to move to suburbs due to COVID[7]
  - Migration data shows East and West Coast urbanites flocking to less densely populated states like Florida, Texas and Idaho[8]
- Statistically, a growing suburban population will lead to increased ownership (and use) of vehicles
  - Fewer than 70% of households own or have access to a vehicle in the New York metropolitan area compared to 90%+ in more suburban areas[9]
  - Residents of less densely populated states like Georgia, New Mexico, Missouri and Texas drive almost 50% more miles per year than residents of more urban states like California and New York[10]
- Single Family Housing starts as well as household formation, which are both positively correlated with vehicle sales, are up
  - One-in-four households plan to add a second (or third vehicle) in 2021[11]

RAPID DIGITALIZATION OF COMMERCE

- Do-it-for-me ("DIFM") service providers and do-it-yourself ("DIY") customers relied more heavily on e-commerce in 2020
  - Online sales of parts grew ~30% in 2020; double digit annual growth expected though at least 2023[12]
  - DIFM customers increasingly using online price transparency to purchase parts online and have pros install them (e.g., buy-online-install-for-me, or "BOIFM")

With the benefit of hindsight, we see that the automotive aftermarket sector proved to be resilient and adaptive through the toughest portions of the COVID-19 pandemic, even through the drop-off in VMT and vehicle sales. At the same time, we also believe certain consumer-driven behavioral changes brought on by the systemic shocks of the pandemic will provide long-term secular tailwinds in a post-COVID world. With these trends as a backdrop, we identify below three overarching themes that will drive investment and M&A in the evolving and increasingly attractive automotive aftermarket landscape in 2021 and beyond.

PRIVATE EQUITY ROLLIN' ALONG WITH ROLL UPS

Notwithstanding the complexities of 2020, we are confident the sector will continue to attract private equity investment driven by several key factors:

- the centrality of automobiles in consumers' lives, which provides for a high level of resilience through economic cycles
- the sheer size and diversity of the market – ranging from manufacturing to service to technology – and the ability to make strategic bets on a multitude of sub-categories and themes
- the ability to make platform investments, allowing stronger, well-capitalized players to drive scale and synergies

From a strategy perspective, investors see a highly fragmented landscape with increasing vehicle complexity benefiting more sophisticated players. Numerous opportunities exist for acquirors to add value by leveraging best practices across new locations, whether acquired or greenfield. This ranges from implementing a CRM system to modernizing the sales process to instituting omni-channel capabilities. And scale matters – as a store base grows, fixed costs and purchasing synergies are leveraged, providing margin benefits for the whole chain.

From a category perspective, the automotive aftermarket offers "something for everyone" – there are bets to be made on cyclicality (e.g., non-discretionary or counter-cyclical discretionary), channel (brick-and-mortar vs. e-commerce) and consumer trends (DIY vs. DIFM). Certain categories, which were favorites of private equity investors pre-COVID, continue to thrive as attractive platform / roll-up opportunities, including:

ATTRACTIVE CHARACTERISTICS

MAINTENANCE

- Non-"Amazonable"
- Benefits from CRM improvements
- Non-discretionary
- High correlation to vehicle miles traveled
- Benefits from aging car parc and growing complexity of vehicles

CAR WASH

- Technology agnostic
- Non-"Amazonable"
- Benefits from CRM improvements (including membership model)
- High purchase frequency
- Not big ticket / recession resilient
- Benefits from growing car parc

COLLISION

- Technology agnostic
- Non-"Amazonable"
- Scale benefits / direct repair programs with insurers
- High correlation to vehicle miles traveled
- Benefits from aging car parc

A critical question facing PE investors in 2021 is whether the shift towards DIY experienced in the early days of the pandemic will prove persistent. With many consumers finding themselves with extra time at home (and potentially looking to save on labor costs), the DIY maintenance segment, which typically represents ~20% of the aftermarket, climbed as high as ~43% in early August before receding to ~36% by the end of Q3 2020.[5]

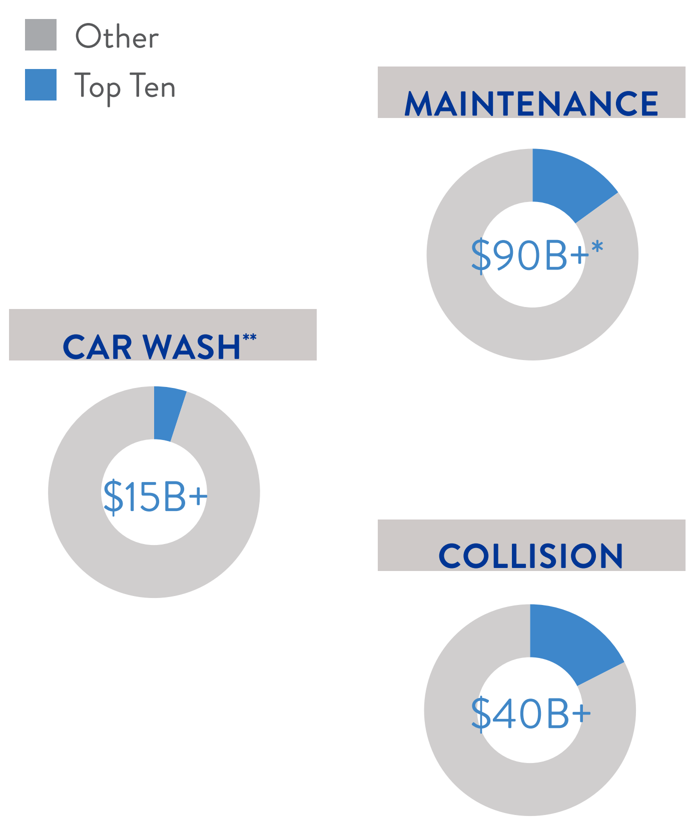
Regardless of the atypical trends witnessed throughout last year, DIFM is expected to rebound and grow faster than DIY in the long run due to the increasing complexity of vehicles and new technologies rapidly gaining prevalence. Further, consumers hold onto their vehicles longer during periods of economic pressure, which will serve to further age the car parc (currently averaging ~12 years) and make for attractive investments in platform opportunities across the major categories of DIFM repair, maintenance and collision services. In 2020 alone, we saw Meritage Group acquire Les Schwab, MidOcean Partners acquire FullSpeed Automotive, and Mavis Tire Express Service acquire Town Fair Tire Centers – all focused around DIFM service and repair. Also, Driven Brands went public in January 2021, closing up 21% on its first day of trading.

Car wash operators, and those that supply technology to car washes, are also proving exceptionally popular with investors, with highly competitive auctions and mid-teens multiples paid. This is a function of strong unit economics, attractive cost structures and the ability to pursue both greenfield and acquisition growth strategies. Recent transaction examples include Atlantic Street Capital acquiring Zips Car Wash, Golden Gate Capital recapitalizing Tidal Wave Auto Spa, Berkshire Partners recapitalizing National Car Wash Solutions and Genstar's acquisition of Sonny's Enterprises.

Collision repair also continues to attract substantial private equity interest. This is due to the highly fragmented nature of the sector and the potential for revenue synergies stemming from the growing preference among insurers for direct repair programs. Those insurers would rather do business with multi-unit collision repair operators, able to operate with consistency across the chain, versus working with single unit independent operators. While collision claims dropped precipitously during the early days of the pandemic, analysts predict volumes will largely recover by the second half of 2021[13]. Growing investment requirements for state-of-the-art equipment, facilities, technician training and OEM certifications is likely to benefit better-capitalized, institutionally backed platforms. Recent relevant transactions include TSG acquiring Joe Hudson's Collision, Dealer Tire acquiring Dent Wizard, New Mountain acquiring Classic Collision, and CenterOak's formation of CollisionRight.

HIGHLY FRAGMENTED INDUSTRY

MARKET SHARE OF TOP 10 COMPANIES BY CATEGORY[14]



* Includes independent maintenance service and tire sales. Excludes dealership service and parts sales.
**Based on share of conveyor car wash locations only.

One potential uncertainty for investors executing roll-ups in categories that depend on miles driven (e.g., brakes, oil change, tune-ups and collision), is whether sole-proprietor operators – the life-blood of a roll-up strategy – will be in selling moods. Some may wish for performance to rebound after a tough 2020, whereas other weaker (or less well-capitalized) operators may have no choice but to sell, and likely at very buyer-friendly multiples. Either way, should private equity investors feel confident about the future, we anticipate the rollup trend to keep rolling on – and potentially even gain speed.

GROWING ENTHUSIAST-DRIVEN, DIYER CUSTOMER BASE

Similar to powersports (see our report, Powering Through COVID: Why the Acceleration of Powersports is No Passing Trend), the automotive aftermarket will benefit from a growing consumer base of enthusiasts and DIYers driving increased discretionary spending within the category. This group views automobiles not simply as a mode of transportation but as a means to express individuality via their uniquely styled, performance-enhanced or otherwise modified beloved machines.

MASSIVE AUTOMOTIVE MARKET OPPORTUNITY

As noted above, during COVID-19 lockdowns, many drivers discovered (or rediscovered) the joy of tuning and customizing their rides with their own two hands. This shift in consumer preference for DIY during the pandemic drove significant same store sales at product retailers like AutoZone and O'Reilly Auto Parts, with latest comparable store sales increasing 12.3% and 16.9%, respectively.[15] Furthermore, e-commerce companies catering to DIYers and enthusiasts have done exceptionally well, with Hedges & Company and Revolution Parts reporting 30% growth in online sales of new auto parts & accessories in 2020, with DIY, enthusiast and more discretionary categories tracking even higher.[16]

For years, industry prognosticators have spoken of the eventual demise of personal vehicle ownership, as cars would become shared, autonomous, or simply sterile, commoditized appliances. The success of enthusiast driven products during 2020 evidences that these prognostications – while still seemingly remote possibilities in the long run – are far from imminent. Most drivers will continue to want to make their cars an extension of themselves and their homes, while true level 4 or level 5 autonomous driving still appears years away. Nonetheless, industry watchers and investors will continue to monitor for signs such shift may be occurring and, should that happen, pivot investment strategies to meet the future opportunity. In the meantime, we expect that there will continue to be strong interest from strategic and private equity acquirors in capturing this highly engaged enthusiast customer base. This will be either through new platform acquisitions, or through add-ons that extend capabilities or tap an underserved consumer base. Recent examples of PE investments in enthusiast businesses include the acquisition of Morris 4x4 Center by Auto Anything (owned by Kingswood), Cortec Group's acquisition of Enthusiast Auto Holdings, Novacap's acquisition of an interest in FortNine and Holley Performance Products' acquisition of Drake Automotive Group.

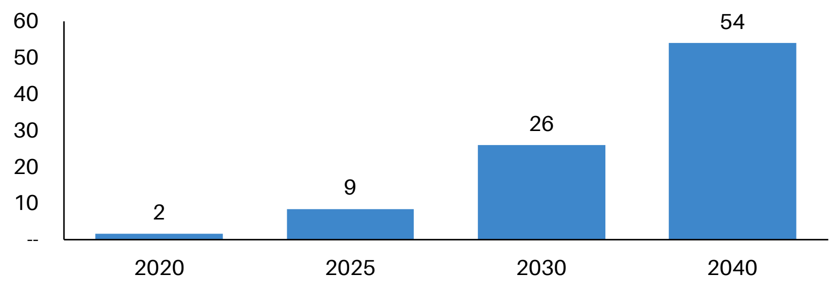
ELECTRIC VEHICLES GIVE A JOLT TO NEW AFTERMARKET OPPORTUNITIES

The accelerating adoption of electric vehicle (EV) automobile technology will require automobile aftermarket operators to develop new product lines and new technical skills. Traditional operators who are slower to adapt run the risk of losing market share or becoming completely obsolete (think of Blackberry's demise after consumers got hooked on iPhones).

Demonstrating the fast ramp of EV sales around the world, consider that while Tesla had delivered just 2,450 EVs within the first four years of launching its Lotus-based Roadster, it delivered nearly 500,000 vehicles in 2020 alone.

BLOOMBERG NEW ENERGY FINANCE FORECASTS

Global BEV sales will grow from 1.7 million in 2020 to 8.5 million in 2025, 26 million in 2030 and 54 million in 2040, representing 58% of anticipated new car sales.[17]



Looking beyond the US borders, the evidence of the transition is even more stark. For instance, Norway saw EVs account for 54% of all new vehicles sold in 2020 – a fact referenced in GM's 2021 Super Bowl ad calling attention to the company's accelerating EV transition efforts.

While efforts to develop and manufacture technology associated with EVs have long been in the works, 2020 appeared to be a major inflection point in the public markets' view of the transition to EVs. Tesla increased its market capitalization nearly 800% in 2020, while multiple vehicle upstarts, some even in the pre-revenue stage, went public via IPOs or combinations with SPACs. Most try to prove they offer compelling products that can overcome the challenges of the still nascent EV charging infrastructure, as "range anxiety" remains EV adoption's number one deterrent. Further validation of the EV revolution is coming from large and established traditional vehicle manufactures (e.g., Audi, BMW, Ford, Mercedes, Volvo, and the aforementioned GM), all of whom have ramped up efforts, with major vehicle launches happening last year or in 2021, and with charging infrastructure showing significant improvements. Franchise dealers are also coming around – willingly or otherwise – with one-third planning to upgrade their facilities to support further EV sales in 2021.[18]

SELECT EV-RELATED MANUFACTURERS THAT WENT PUBLIC IN 2020

New electric vehicles will require a new ecosystem of components and services. These include battery and charging components and tech, and electric motor / drivetrain parts and repair, as well as the development of independent service providers with EV expertise, and the continued growth of enablers of electric infrastructure. While the average age of EVs on the road is currently only ~2 years, we anticipate a robust repair, replacement, upgrade and personalization market for EVs to develop within the next 3 to 5 years as vehicles age out of warranty, and as consumers of these increasingly common vehicles look to stand out from the crowd with personalized modifications.

Longer-term, EV adoption will have negative effects on parts and service providers catering primarily to ICE platforms. However, many categories are relatively technology-neutral (e.g., tires, body repair, brakes, accessories) and EVs will open the doors for entirely new automotive aftermarket categories. But with the current ~290 million vehicle U.S. car parc, and with the average age of vehicles on the road continuing to increase (currently approaching 12 years), ICE will remain a significant component of the aftermarket landscape through at least 2035. The punchline is in the near to medium term, ICE-related investment opportunities will remain robust, but will be supplemented with exciting prospects in the EV-focused parts and service ecosystem that is just beginning to develop.

We progress into this new year with optimism, as the automotive aftermarket stands to benefit considerably from the market trends discussed above. Boosted by continuing tailwinds, strong investor appetite and solid demand drivers for enthusiasts and non-enthusiasts alike, sector participants should use the coming months to assess their capital needs and sharpen their long-term strategic visions. And while time will tell what the "new normal" looks like and whether businesses will revert to 2019 form or be changed forever (for better or for worse), we anticipate M&A is likely to be a key tool to continue to reshape the landscape.

At PJ SOLOMON, we are a globally recognized strategic advisor to leading automotive aftermarket retail, parts and service companies. Our team has significant experience and a proven track record providing M&A, restructuring and financing advisory services to corporate clients ranging from global large-capitalization corporations to smaller, high-growth privately held companies. We welcome the opportunity to share our perspectives and insights as our clients tackle key strategic decisions in what will undoubtedly be a complex 2021— and beyond.

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FOOTNOTES

[1] Source: AAA.
[2] Source: NADA (as of December)
[3] Source: Cox Automotive
[4] Source: U.S. Energy Information Administration.
[5] Source: IMR Inc.
[6] Source: Global Workplace Analytics.
[7] Source: Wells Fargo.
[8] Source: North America Van Lines and Allied Van lines migration data.
[9] Source: ValuePenguin, a subsidiary of LendingTree.
[10] Source: Car & Driver and I Drive Safely.
[11] Source: Cox Automotive.
[12] Source: Hedges & Company.
[13] Source: CCC.
[14] Percentage of market share based on aggregate store count. Source: Autocare Association, AAMCO, International Carwash Association
[15] Source: AutoZone Q1 2021 earnings press release and O'Reilly Auto Parts Q4 2020 earnings press release.
[16] Source: Hedges & Company and Revolution Parts.
[17] Source: Bloomberg New Energy Finance as of May 2020.
[18] Source: Cox Automotive.

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