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Episode 11: Banking on the Automotive Aftermarket

April 29, 2024
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Shop consolidation. Vehicle complexity. Rising repair costs. All these factors can affect investment strategy in the automotive aftermarket. Steve Huntzinger, co-founder of Dunham Lane Capital Partners, joins the podcast to highlight the opportunities and challenges impacting both the automotive collision industry and its investors.

Ryan Mandell: Welcome back to the Mitchell Collision Podcast. I'm Ryan Mandell and I am pleased to be here in Boston at the home office of Dunham Lane Capital Partners. I'm here with co-founder and managing partner, Steve Huntzinger. Steve, welcome to the program today.

Steve Huntzinger: Thanks, Ryan. It’s a delight to be here.

Ryan Mandell: We’re actually onsite with our guest so I'm really excited to talk to you about your business that you and your partner, Anthony, have grown. And maybe just to start off by telling us a little bit about what it is that Dunham Lane does; kind of how the business started and how it has evolved over time.

Steve Huntzinger: Sure. So Dunham Lane Capital Partners was co-founded by myself and my business partner, Anthony Olivieri, in 2016. He and I both met at Citi. We were on the fixed income side, which means bonds. So we were trading bonds for Citi and institutional sales and trading. And he and I had this grand idea in 2011 that we were going to start a partnership that he and I were each going to sink all of our net worth into and, essentially, just invite friends and family to join alongside if they want, with as much or as little of their net worth as they want to. But there was interest alignment, right, and that we were putting all of our money at stake and they could put as much or as little as they wanted to.

So in 2016, we started with just a couple million dollars and it's now eight years later and it seems like a little bit of a blur, but we're now 120 investors. We're well into the nine figures of capital. It's regular individuals, high net worth individuals, ultra-high net worth individuals and a few family offices that have entrusted us with their capital and we try our best to invest in what we believe are high-quality companies that are predictable and will be sustainable for the long term.

Ryan Mandell: That was going to be my next question in terms of understanding your investment strategy. Obviously, we're on a collision podcast, so we're talking about the automotive industry. So clearly you have investments in the automotive space.

Steve Huntzinger: Yes.

Ryan Mandell: So was that something that early on you knew that you wanted to invest in the automotive industry or is that something that kind of evolved over time? And maybe just tell us a little bit about what that investment strategy looks like from an automotive perspective.

Steve Huntzinger: So we did not know we wanted to be big in the auto aftermarket. But one of the first things we studied was AutoZone and we found ourselves very attracted to the mechanical parts side of the business. And one of our investors was friends with an individual here in Boston that you know well, Joe Sparacino, and introduced us to Joe and we were talking to Joe in his office at the time. It was at BB&T and we were telling him why we like the mechanical parts side of the business. And he was like, everything you're describing that you like about it, about the consolidation, about how it's recession resilient. Have you guys looked at collision? And the answer was no, and he said, well you should. He gave us three or four companies that we should just dust off and scratch the surface on. So we did and that was in July of 2016.

By September of 2016, we had initiated our first positions in Boyd up in Canada and Copart down in Dallas. We still own them to this day.

Ryan Mandell: And what is it about those two companies? We've talked about that offline before. What is it that you initiate those positions way back then.

Steve Huntzinger: Yeah, almost eight years.

Ryan Mandell: What is it that you see and that you find to be encouraging signs for those businesses that keeps you investing and keeps you trusting your clients money with those investments today?

Steve Huntzinger: Well, those two businesses, in particular, are first of all so well run by their collective management teams. They're fiscally very responsible. The markets in which they participate in are large and they're growing, but they're consolidating.

And it's like the example that Anthony and I were just talking about a few days ago was—as it relates to collision repair—if you go back say 20 odd years ago, the collision repair industry was easily half the size in terms of dollars spent on collision repair say 20 years ago versus today. But the number of players has gone from say 55,000 or there's 55,000 repair shops back then to today. Now it's closer to 35,000.

So the aggregate size of the pie is big, but there are less slices. And so if you're one of those people that can consolidate that market share—and Boyd certainly is one of them—you're going to do very well. And the same has happened in salvage. I mean, in fact, when we look at salvage and you say, oh wow, there's really two big players that own that market. And you look at mechanical parts, which is O'Reilly, AutoZone, Napa, Advance Auto Parts—there are four big players that probably have 60%+ market share. Frankly, when we look at collision repair and we look out 10 or 15 years from now, we don't think it'll be too dissimilar.

Ryan Mandell: And do you find that's something where in the future you might look for other segments of the industry that might be fragmented like that where there's opportunity for that kind of same pattern of consolidation.

Steve Huntzinger: The answer is yes. But where we do find ourselves a little attracted right now—but it's different—is auto glass. So in auto glass, there's one big player that has 50%+ market share and then I think the next biggest guy is you know at 5% and then the third guy, which is I think part of our business, is 1% or 2%. We're attracted there. We have exposure through Glass America with Boyd.

But, you know, I think we're looking at other ways to also play that industry as well. We probably are going to consolidate even further.

Ryan Mandell: So taking a step back, one of the things that you mentioned was the fact that average spend is going up in the collision industry. You know, you've got fewer players but the overall cost basis is going up for those repairs. Clearly, we do a lot of research in our business around rising costs. But what do you see, when you're looking at it from an investor's perspective? Where do you see that it’s being driven from? And where do you think that also has a benefit for players like Boyd or other consolidators in the industry?

Steve Huntzinger: Yeah. So one thing we always remind ourselves of is both Boyd and Copart as well as all their competitors, they're all B2B businesses. And in B2B businesses, what we've typically found is if you are a disinflationary force, you are going to win. If you help your customers, which are your partners, run their businesses more efficiently and more profitably, they will reward you with more share.

And so when I look at Boyd, when I look at Caliber, when you look at Crash Champions and when you look at all the relevant independents that are doing equally as good of a job and that are part of DRPs, they're getting more volume in exchange for having a more standardized process and a lower cost of repair per unit. In exchange, they're getting more units. So at the end of the day, everybody wins. Hopefully the insurance partners feel like they're winning and that, wow, our average cost of repair as a result of using a DRP is lower. But certainly we know the profitability of Caliber and Boyd and Crash Champions is higher. But everybody wins because we're all helping each other out, we're partners.

Ryan Mandell: And from that perspective, thinking about profitability, a lot has changed in terms of vehicle complexity and what has to be done on the vehicles now. We want a shop to be obviously operating profitably, especially a publicly traded company or any collision company. But there's now a lot more focus on doing the repair properly and doing a proper and safe repair—making sure that not only all the cosmetic and structural work is done right, but all the technological work. So what kind of investment is that leveraging on the collision companies themselves? How much are they looking at the investment they're going to have to make to be able to do that kind of work in order to produce a quality repair on these vehicles?

Steve Huntzinger: Much more so than, say, 10 years ago. We’re investing in technology to help our insurance partners and I hope this works. I hope that us investing in this technology certainly will help us make money on recalibrating vehicles. Hopefully in exchange for that, the velocity of impact because these things were recalibrated properly is going to reduce that velocity impact. It's going to save lives. It's going to save them money on bodily injury claims. So the investments are massive and, frankly, maybe this is why the industry is consolidating because you may have to have a number of shops to be able to justify that sort of investment.

Ryan Mandell: It's a lot easier if you have a network effect that you can rely on to be able to load level some of that work to centers of excellence within your operation. Where you don't have to have every single facility equipped with every single piece of equipment that you need to calibrate or scan every single vehicle I would imagine.

Steve Huntzinger: Yeah, Tim at Boyd specifically calls it the hub and spoke model. So you take a small MSO where you might have nine shops. You probably only need two if you can do static calibrations, as an example. Now all nine can be intake centers for those calibrations. But, yeah, you send the calibrations to the two parts of the hub where that needs to be done and then the customer can pick it back up where they dropped it off because we'll shuttle it back over.

Ryan Mandell: And with all this complexity, we do a lot of research where we're looking at the number of parts on vehicles, the number of sensors, all these different systems that are providing additional layers of safety and protection for drivers. But all that adds additional cost from the collision repair side, of course. What is the impact that you're seeing from a salvage perspective in terms of what kind of salvage returns companies like Copart or others in the industry are able to achieve based on how these vehicles are optioned today versus what they were maybe 10 years ago?

Steve Huntzinger: I mean, for sure, total loss frequency has gone up. When we first started investing in the industry in 2016, total loss frequency was around 16%. As we sit here today, I think we're approaching close to 21% and we do wonder if COVID never would have happened, where would it be? I think it would be a lot higher than 21%.

But think about two parts of the equation. When an insurance company decides if they want a total, it's the value of the vehicle relative to the cost of repair. And for sure the cost of repair is increasing at a faster rate than used car prices if you look at the trend line from 2016 until now. I do think that's not going to abate between now and, say, 2030.

Ryan Mandell: And now again thinking about your investments, I know you don't invest in parts companies right now, but clearly parts are just a huge aspect of the overall equation when it comes to collision repair. We see when we look at our numbers, every single year parts are becoming a larger portion of the spend for collision repair ROs. So what do you think the future of the parts industry looks like and maybe think a little bit about, you know, the OEMs' relationship to parts manufacturing, how the aftermarket plays into that and even maybe recyclers and what kind of role they might have in the parts procurement of the future.

Steve Huntzinger: So ever since we started investing from 2016 until now, alternative parts usage has been in the high 30s. I think somewhere around 37% to 38%. I don't know the exact decimal, but that has been the utilization of alternative parts. We do think as cars become more complex, OE parts will probably take more share from the alternative parts when we're talking percentages. That said, we know that the number of parts per repair is also going to be going way up.

So even though the percentage of alternative parts dollars may be coming down, if you still provide alternative parts—you're an aftermarket manufacturer of them or you're a distributor of them—I think your revenue and your profitability is still going to be higher even though your share of the pie is going to be lower. The pie is just going to get so much bigger.

Ryan Mandell: We're seeing a lot of shift in terms of how vehicles are manufactured and the types of materials that are being used. And so there's got to be some sort of, I would imagine, lag time so to speak to where the aftermarket needs to kind of catch up to be able to produce the same kind of material and the same kind of processes. So I would imagine there's going to be some level of adaptation that takes place over time from the aftermarket to still be able to compete.

Steve Huntzinger: I think you're right. I mean I think you have more insight than we do on that. But one thing that's always allowed the aftermarket to compete—and we don't care if it's collision, we don't care if it's mechanical parts—is that this is all so slow moving in terms of percent of new complex vehicles that enter the parc. When they do, they're 1% or 2% of the parc per year. That gives the aftermarket a heck of a lot of time to adapt and still remain relevant.

Ryan Mandell: I think that's the other part of the equation with all this. Everything we've talked about is related to adding cost to the overall claims process. So if you're an insurance company—and, again, understanding that you don't invest in the insurance space per se, but looking at the auto insurance industry as a whole and looking at the larger players that are out there and even some of the regional companies that exist—how do they navigate these waters? How do they kind of go about and become successful in this environment where cost pressures are all around them?

Steve Huntzinger: It's a very healthy balance between customer experience and being efficient. So something we've all talked about a lot is just take the total loss equation or that entire process: how many totals as an insurance company or are these other companies potentially doing where you really didn't need an estimate and you really didn't need to take it to a body shop. You really didn't need to pay seven days for storage. You really didn't need to pay to have that car transported from the body shop to either Copart or IAA where literally there could have been through some form of AI at first notice: totaled. Done. That could have saved hundreds of dollars on that claim which, in turn, then gives you a lower combined ratio which then, in turn, allows you to probably lower your premiums and gather more market share.

Now that's on the totaled side of the equation. On the on the repair side of the equation, I think you want to find a combination of a company that's going to do a fantastic job on repair but not charge a hefty premium to do so. That creates a scalable operation for both the insurance company as well as the collision repair shop.

Ryan Mandell: I think it sounds like a lot of it is making sure that you're very process oriented and driving the most efficient process possible—both on the repairable side and the total loss side of the house—but also ensuring that not only are you being efficient, but that you're guaranteeing the highest level of customer experience.

Steve Huntzinger: That's exactly right. I couldn't have said it any better.

Ryan Mandell: Well, thank you. Maybe just to kind of close out, I think so much has changed. I mean even since you and Anthony got in the business in terms of the automotive side, you know so much has changed in the 20 years that I've been in this business. It looks totally different now than it did 20 years ago when I started in the insurance industry. So what do you think the collision industry is going to look like 5-10 years from now? How are we going to see it evolve over time as a result of consolidation, as a result of some of these changes we talked about, but also the complexity of the vehicles themselves?

Steve Huntzinger: I think just a continuation of the same really. I think further consolidation like we said earlier, I think the big three or big four players in collision are probably going to have 60% market share combined. When we wake up in 10 or 15 years, I think cars are going to be insanely more complex than they are now. I mean, we think about this all the time. Like when we wake up 12 years from now, 2024 vehicles are going to be 12 years old. When we really think about how many cars are complex as a percent of VIO, it's maybe 30% or 35% of cars and we know when we wake up in 10 or 15 years, it's going to be 70% of cars. That creates a heck of an opportunity to service them, but it also creates a heck of a challenge for the insurance industry as well.

And we're asking a lot of questions. We have to always look over our shoulder and we ask you this a lot like are these cars going to self-calibrate in a couple of years? Is that good? Do the OEs want that liability? I mean there is a lot to think about.

But every day is a little bit different, but it does change slowly. And that's honestly what excites us about investing in this space is that even if there's change against us, we think it's going to happen so slowly that we'll have plenty of time to adapt and not potentially get run over. No pun intended.

Ryan Mandell: I think you're right. I like that. I think the complexity wave is not going to crash anytime soon. I think it's going to continue going and I think we're going to see challenges that surface in the next 5 to 10 years that we can't even contemplate right now. You're going to see materials that are being used in these vehicles that we can't or we don't even know exist today. So I think there are certainly advantages for those businesses that are making investments today to be able to meet those challenges in the future.

Steve Huntzinger: Yeah, and I hope it serves everybody well. Certainly we want the insurance partners to be more profitable as a result. We want lives to be saved. We want bodily injury claims to go down and us as shareholders, we certainly want to be rewarded if we help serve all of them.

Ryan Mandell: Well, Steve, you and Anthony have built a great business and I really appreciate your time spent with us today and appreciate you having me here in your office and wish you nothing but the best of luck.

Steve Huntzinger: It's our pleasure. We've always enjoyed working with you and we enjoy your friendship as well.

Ryan Mandell: Thank you, Steve.

Steve Huntzinger: Got to run. Thank you.

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