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PANEL BEATER SECTOR STUDY

FINAL REPORT

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FINANCIAL SECTOR PROGRAM

PANEL BEATER SECTOR STUDY

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ACRONYMS

AFL	Alexander Forbes Limited
ASR	Advanced Structural Repairers
BEE	Black Economic Empowerment
BMTS	Benton Management and Transportation Services
CC	Close Corporation
DCA	Development Credit Authority
EGAT/DC	Economic Growth and Trade/District of Columbia (unit of USAID)
FSP	Financial Sector Program
M&F	Mutual & Federal
MAS	Mettle Administrative Services
MERSETA	Manufacturing, Engineering and Related Services Sector Education & Training Authority
MSME	Micro, Small and Medium Enterprises
MSR	Major Structural Repairers
NSR	Non-Structural Repairers
OEM	Original Equipment Manufacturer
PTY	Proprietary
SAARSA	South African Auto Repairer and Salvage Association
SAMBRA	South African Motor Body Repairers Association
SMME	Small, Medium and Micro Enterprise
SWOT	Strengths, Weaknesses, Opportunities and Threats
U.S.	United States
USAID	United States Agency for International Development

EXECUTIVE SUMMARY

Panel beaters in South Africa have significant working capital financing needs, because they must typically pay for parts and general overhead expenses 30 days or more before receiving payment from an insurance company. The vast majority of panel beaters are SMMEs and do not have large amounts of capital to use for expenses in the interim. While some panel beaters are able to obtain this financing from a bank, many choose instead to sell their receivables to a factoring company. The largest such company, Mettle Administrative Services (MAS), is being considered as a borrower under a DCA loan guarantee that would enable MAS to raise more capital than they can presently obtain without DCA support. These funds would then be used to expand panel beaters' access to factoring. This report is intended to provide background information on the sector, and constraints and risks faced by panel beaters.

Individual panel beaters face daunting challenges in accessing work from insurance companies, which is often more lucrative than cash-based work from uninsured persons. An oversaturation of panel shops relative to the number of insured South African drivers, and differences in size between SMME panel shops and large insurance companies, have given insurance companies substantial bargaining power to negotiate labor rates and parts markups, and even to restrict work to certain shops. In addition, shops must meet onerous requirements from vehicle manufacturers to be approved for repair work on a car that is still under a factory warranty. A 30 percent decline in the industry due to the worldwide economic downturn has hampered some shops, though others report stable or even growing revenues. A further decline is unlikely, because only minor vehicle repairs have elastic demand. Loss of vehicle usage has economic consequences for the average driver, and so a vehicle that is rendered inoperable by a crash must either be repaired or replaced.

MAS is largely insulated from the industry risks, because it provides financing after an invoice is issued or repairs have been authorized by the insurance company. Its client base is sufficiently large and diversified that it can simply serve whichever panel shops are able to obtain work from the insurers. MAS also mitigates risk by factoring with recourse, meaning that if MAS is unable to obtain payment from the insurance company for an invoice despite their best efforts, the panel beater must agree to repurchase the unpaid invoice. In practice, this rarely happens.

Additionally MAS finances based on repair authorization rather than an invoice; this is a parts financing product. MAS' current lender will not permit MAS to provide enough parts financing to meet existing demand, and expanding access to parts financing is one development objective of the proposed DCA guarantee. The guarantee will also help panel beaters improve their profit margins, increase their ability to function as a going concern, and position them for potential industry growth. This will, in turn, sustain and expand employment opportunities in a labor intensive industry for previously disadvantaged individuals, who make up the vast majority of panel beater employees. Another aim of the guarantee is to demonstrate to lenders that automobile receivables factoring is a viable borrower market at the wholesale level.

INTRODUCTION

The Financial Sector Program (FSP) supports the accomplishment of the U.S. Government's Economic Growth Objective in South Africa (SA). This task order is one of two main vehicles to promote vibrant growth of historically disadvantaged small and medium businesses (SMEs) and reduce unemployment and poverty. The objectives of this program are to expand access to financial services and lower financing cost for small and medium enterprises (SMEs) through reforming the legal and regulatory framework affecting the financial sector and business environment and improving the commercial viability of lending to historically disadvantaged SMEs in SA, thereby expanding SME access to a range of high quality and affordable financial services.

Activities under FSP focus on improving and expanding financial services and products; managing and mitigating financial risk and transaction costs; improving bankability of SMEs and business services by linking financial services with business service activities that can build SME capacity, productivity and competitiveness, as well as improve the capacity of financial advisory services to serve SMEs.; support the emergence of an efficient credit industry regulator that promotes an enabling environment for financial intermediation and risk management, and boosts the private sector's role and participation in the provision of financial services to SMEs; promote reforms to commercial laws, regulations, and administrative practices affecting the private sector and SME development; and, improve knowledge management through an accessible repository of knowledge about SMEs and finance in SA.

Mettle Administrative Services (MAS) is a specialized finance company that provides working capital financing, mainly through factoring of insurance company receivables, for panel beaters in South Africa. MAS is part of the Mettle Group, a South African diversified financial services conglomerate with total assets amounting to R 603 million as of 31 December 2008. This study of the panel beater (auto body repair shop) sector in South Africa was conducted as part of the feasibility assessment for a contemplated Development Credit Authority (DCA) loan guarantee or portable guarantee for MAS. The guarantee will provide MAS with capital for expansion of its panel beater receivables factoring business. Panel shops are the underlying retail-level "borrowers" in the wholesale financing MAS would receive under the guaranteed loan, and an understanding of the panel beating sector is thus critical to understanding the borrower risk in the contemplated single-loan transaction. The primary purpose of this study is to provide background information for the EGAT/DC risk assessor. Where possible, the assessment also takes note of important development considerations that may not be related to risk, but that may affect the desired impact of the proposed guarantee.

The analysis generally follows the model framework for borrower sector assessments developed by EGAT/DC. Some deviations have been made to account for the fact that the panel beaters are not being proposed as a direct borrower cohort that will receive DCA-backed loans, as would normally be the case with such an assessment.

METHODOLOGY

The information in this study was compiled through primary and limited secondary source research. The primary research consisted of confidential on-site interviews with 16 panel beaters of various sizes in Johannesburg, Cape Town, Rustenburg, and Pretoria, plus a parts supplier, an auto glass shop, the South African Motor Body Repairers Association (SAMBRA), the Manufacturing, Engineering and Related Services Sector Education & Training Authority (MERSETA), auto insurance industry representatives, and MAS personnel in Mettle's Johannesburg and Cape Town offices. Secondary source research was conducted using Web-based resources and supplementary materials provided by the persons interviewed.

RELEVANT MACROECONOMIC CONDITIONS

Credit environment. South African panel beaters are, probably without exception, classified as Small, Micro, or Medium-sized Enterprises (SMMEs[1]). As such, they face the same constraints, and enjoy the same advantages relative to other developing world countries, as their fellow SMMEs in South Africa. The poor supply of credit to such enterprises for either working or operating capital is of course well-known to the FSP program, and this was visible during the assessment. Only the panel beaters who owned their own shops (and could thus use land and buildings as collateral) reported any success in securing commercial finance for equipment upgrades and other capital expenditures. Even these enterprises had been unable to secure more favorable terms from banks or other financial institutions for an overdraft account or other sources of working capital than the terms offered by MAS, which is why they were clients of Mettle. Given the worldwide tightening of credit markets in light of the current recessionary environment, access to essential working capital credit is unlikely to improve for SMME panel beaters in the near to medium term.

Legal and Regulatory Environment. Panel beaters benefit from a more favorable business environment than SMMEs in most other countries in Africa. South Africa is ranked 32nd for Ease of Doing Business in the World Bank's 2009 *Doing Business* report. Business registration is relatively easy according to the panel shops, costing approximately R1000 to register a small, closely held corporation and taking an average of 22 days. The new Companies Act will create a one-stop-shop to further simplify the process, though it will also raise financial reporting standards. This may negatively impact panel shops, as described below. Land titling is sufficiently developed to allow owned property to be used as collateral. Competition policy enforcement is relatively strong. Medium and even some small-sized businesses reported during interviews that they feel the South African Competition Commission can and will protect their rights if they are able to band together through organizations such as SAMBRA and present a compelling case for why insurance companies or other actors are engaging in anti-competitive practices. This last point is particularly important for MAS, as some insurance companies have attempted to prohibit assignment of claims by panel beaters to third parties (such as MAS) to protect their own profit margins. This is described in further detail in the SWOT analysis below.

On the other hand, there is presently little or no ability to pledge either tangible or revolving movable assets as collateral, which hampers panel beaters' ability to leverage existing equipment—often worth millions of Rand—into loaned capital for expansion. Contracts enforcement is also weak, with lengthy delays in the court system and limited access to alternative dispute mechanisms for commercial litigation. Worker protection laws are out of balance with international norms, making it difficult to fire unproductive workers. The *Doing Business* report estimates the average cost to fire a worker at 24 weeks of salary. One panel beater cited this as a major constraint to efficient operations.

[1] This acronym is used in South Africa rather than the MSME term that is more common in the U.S.

SECTOR PARTICIPANTS

The panel beaters, and to a lesser extent MAS, are affected by the interests and limitations of a number of other sector participants. Auto insurance companies are the buyer, and their collective negotiating power enables them to set pricing terms that are not always favorable to panel beaters, as described below in further detail. There are also individual consumers who pay panel shops in cash for services not covered by insurance, but they are not relevant to the contemplated DCA guarantee because MAS does not factor cash invoices. The panel beater meets its working capital needs by taking a deposit from the customer, which insurance companies have thus far declined to provide for work performed and paid under an insurance policy. Shops of all sizes indicated they performed work on a cash basis, though the ratio of cash work to total work tended to be higher at smaller shops. MAS also factors a limited number of invoices for approved corporate clients, mostly vehicle rental companies. Some smaller shops had managed to secure significant cash work from a single repeat corporate or government client, such as the local taxi authority. These types of clients are generally self-insured and thus do not purchase commercial insurance policies.

A key means by which insurance companies influence the industry is through a “panel” system, which is the industry term for a list of recommended shops maintained by each insurance company. At least one company, the auto insurance arm of ABSA, has adopted a closed system and allows only shops on its panel to conduct repairs. This is the subject of ongoing battles with SAMBRA and other industry groups. However, most insurance companies will allow consumers to specify a shop not on their list. The difficulty for panel beaters is that the typical consumer does not crash cars often enough to develop a relationship with a particular panel shop, and is likely to simply allow their car to be repaired at the nearest shop recommended by their insurance broker. Thus, the insurance panels have a significant effect on the average panel shop’s access to insurance work. Many shops interviewed, even some of the more successful ones, reported difficulty in being admitted to particular insurance company panels. Explanations for rejection ranged from having higher labor rates than other shops, to oversaturation for a particular geographic area, to the rather common response of no explanation at all.

Insurance companies and panel beaters alike must, in turn, negotiate the complexities of the South African towing industry. In Johannesburg in particular, tow trucks compete heavily for the right to tow a crashed vehicle, in organized groups that sometimes employ questionable business practices. The trucks then bring the car to whatever panel beater they have a relationship with (the driver of the crashed vehicle being generally ignorant of particular panel beaters and eager to get out of the middle of the road). The shop might pay a commission to the tow truck driver in exchange for bringing them the car. The panel beaters will also pay a release fee that seems to range from 500 to 1000 Rand, though this is billable to the insurance company if the car is repaired at that shop. The panel beater may or may not have the requisite insurance company or manufacturer approvals, and will typically charge the insurance company a daily storage fee if the car will not be repaired at that shop. If a vehicle is not removed quickly from a shop that intends to charge a storage fee, the combination of towing and storage fees can turn a repairable vehicle into a write-off (or “totaled vehicle,” in U.S. parlance).

Parts suppliers, many of whom double as vehicle dealerships, sell the panel beaters inputs, and decide which parts have sufficient demand to keep in stock and which parts are too niche or single-use to justify importing them. This can have a significant impact on repair timelines, and thus on the payment date from the insurance company for panel beaters or MAS, as described below under "working capital requirements."

Manufacturers have an outsized influence on the South African motor body repair industry, with a monopolistic ability to set pricing for spare parts and a set of inordinately complicated procedures for approving particular panel beaters to perform work for cars under warranty. This approval process is not practiced in the U.S., or other markets with which the author or interviewees are familiar. Common requirements for panel shops include non-refundable application fees, monthly fees of R2000-4000, regular trainings for panel beater staff conducted by the manufacturer at the panel shop's expense, book-length procedures specifying details as minute as office layout (e.g., not having accounting staff in the reception area), and procurement of specific brands of equipment costing as much as R1-2 million Rand each. Some of the equipment sits unused because it is unnecessary for operations, but required for the manufacturer approval. One panel beater mentioned that he had three chassis straightening machines despite one machine being adequate for use on all vehicles, because different manufacturers required different machines. He intimated that improper relationships between vehicle manufacturers and equipment vendors may be partly to blame.

Insurance companies worry about having a customer's warranty voided, and thus are likely to recommend repair of a vehicle under warranty at a shop that has the appropriate manufacturer approval. However, merely having manufacturer approvals does not guarantee increased workflow for the panel beater. Some shops indicated they rarely or never received vehicles under warranty, despite the high and ongoing costs of maintaining manufacturer approvals. By contrast, a few shops reported success in obtaining vehicles under warranty for repair despite not having the appropriate manufacturer endorsement, because they had a relationship with either the customer or the auto dealer. Dealers can choose to honor warranties at shops that they know and trust, and some dealers will reinstate a warranty following an exhaustive inspection of the repaired car that costs the panel shop R2000. One shop estimated that 40 percent of vehicles under warranty are repaired at non-approved shops.

Last, SAMBRA and the South African Auto Repairer and Salvage Association (SAARSA) are competing associations that function as advocacy groups for their panel beater membership and as bodies that set and enforce standards. SAMBRA is an association of 1050 shops that operates a system of grading and certification. SAMBRA assesses panel beaters' equipment and capabilities and classifies them as Non-Structural Repairers (NSR), Advanced Structural Repairers (ASR), or Major Structural Repairers (MSR), with MSR being the highest category. This determines what type of work a panel beater can do for an insurance company. For example, a vehicle with a few dents can be repaired by any shop, including an NSR panel beater. However, a vehicle in need of chassis straightening would be sent to an MSR shop for more complicated (and lucrative) work. SAMBRA's grading system has been the subject of controversy, particularly from smaller shops who feel that they can perform structural repairs without expensive equipment. Some of the smaller shops interviewed even went so far as to intimate that SAMBRA was in league with the insurance companies to prevent smaller shops from gaining access to insurance work, though SAMBRA itself cited access to work for its membership as a major constraint and concern due to insurance company and auto manufacturer practices. SAARSA was founded to represent smaller shops that are unable to obtain a SAMBRA rating. Many SAARSA shops happen to be the ones owned by non-whites, though SAARSA was not specifically established to serve previously disadvantaged persons. Most shops are members of one organization or the other, and 44 panel beaters are members of both SAMBRA and SAARSA.[2]

[2] This data was provided by Gary Benton, a consultant who is currently engaged in an industry survey and the provision of technical assistance to panel beaters. His work is described in further detail below.

SECTOR OVERVIEW

Scope and structure of market. There are an estimated 3000-4000 panel beaters in South Africa, of which about 1200 have revenues large enough to capture a portion of the more lucrative insurance market. These 1200 shops are overwhelmingly white owned, though some of the shops visited during the assessment were of this size and were owned by members of previously disadvantaged groups. The remaining 1800-2800 shops are very small, typically with revenues of less than 6 million Rand per year, that perform most or all of their work on a cash basis.[3] These would include many of the shops in township and rural areas, who serve demographic groups that are not often covered by auto insurance in South Africa. This geographic factor, along with lack of access to financing and limited capacity for vehicle throughput, is a key reason why so many non-white shops have been unable to grow and attract a greater share of the insurance market.[4] MAS stated that they work with 800 shops, of which 300 are active clients, suggesting a 25 percent share of the current market.

Typical ownership profile. The vast majority of shops in the sector, even larger ones, are family owned enterprises with one to three owners (for example, a father and two sons). Most are incorporated as Close Corporations (CCs). A few larger shops are Private Companies (PTY), which confers additional benefits such as allowing more than 10 owners and allowing owners who can function as shareholders without a direct managerial interest in the concern. However, a PTY classification requires the submission of annual audited financial statements, whereas a CC requires only the designation of a qualified accounting officer and the submission of a simplified income statement to the Receiver of Revenue. The new Companies Act will eliminate the CC classification, and raise financial reporting standards for former CCs to the level currently required of PTYs, which may pose a challenge for smaller shops given their low level of managerial capacity; this is discussed below in the "corporate governance" section. At present, both CC and PTY structures provide for limited liability of owners and partners provided they have not acted recklessly. Both have the same rate structure for taxation. MAS indicated that a few small shops in the industry are sole proprietorships, which do not enjoy the liability limitations or tax advantages of CCs and PTYs. No sole proprietorships were encountered during interviews with panel beaters. MAS indicated that its risk assessment of potential clients takes account only of ability to perform the work, not of a shop's management structure or managerial capacity. This may be because MAS' primary exposure to financial and management related risks is with the insurance company, not the panel beater.

A few shops operate as part of larger franchise networks. Most of these are not in MAS' client base, because they are able to obtain credit for working capital at favorable terms through their franchisor. However, MAS does have at least one franchise client, who has grown large enough that he is considering dropping the franchise relationship, so as not to continue paying royalties. The growth of franchises has some shops worried that they will not be able to compete with cut-rate franchise pricing. It also presents a possible threat to MAS' client base, because they create an alternative structure for working capital

[3] Ibid.
[4] Andrews, Matthew. "Is Black Economic Empowerment a South African Growth Catalyst? (Or Could It Be…)." Cambridge, MA: John F. Kennedy School of Government - Harvard University, June 2008. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266797.

financing. Other panel shops interviewed were not concerned about competing with franchises. They felt the qualifications of franchise employees, and the resulting quality of work, tended to be of a lower caliber than non-franchise shops and that the market would ultimately look beyond price and choose non-franchise shops based on a better overall value proposition.

Maturity of the market. There is wide variation in the number of years individual shops have been in business. Unpublished data provided by Mr. Gary Benton of Benton Management and Transportation Services (BMTS), a consultant who provides BDS type technical assistance for panel beaters, shows that panel shops at all size levels have been in business for as little as 1-3 years, or as long as 45-50 years. This is consistent with the information gathered during the assessment; however, owners of some larger shops that had a short history incongruous with their size explained they had previously owned smaller shops and then started a new business in a different location and under a different name rather than expanding the existing business. Also, the number of years in business does not necessarily reflect the experience of the owner in panel shop management. While the common family ownership model of a father and one or two sons often leads to the sons taking over their father's shop, several shops visited that had only been in operation for a few years had been started by owners who grew up in their father's shop and decided to set out on their own (or were pushed out) rather than taking over the family business. The vast majority of panel shop owners are themselves former panel beaters who accumulated enough capital to start their own shop.

Elasticity of demand in the industry/market. The panel beater industry enjoys relatively inelastic consumer demand. Repairs of minor scratches and dents can be delayed, but cars that have been rendered inoperable by a crash or other event must be either fixed or replaced. Depending on family circumstances, consequences of lost automobile function can range from social isolation to unemployment, particularly given the sparse availability of public transport in major South African cities. Thus, foregoing repair or replacement after a major crash is rarely a viable option.

However, there is considerable elasticity of demand between individual firms competing in the marketplace. Insurance companies can choose from among hundreds of panel beaters vying for their business, as can consumers and tow truck companies. This reality has a significant effect on pricing, as explained below.

Pricing determinants. Panel beaters negotiate contracts with insurance companies that specify the labor rates they may charge and the markup allowed on parts. Oligopsony dynamics are evident in these negotiations. With such a large number of panel beater sellers relative to the number of insurance company buyers for their services, the insurance companies have a significant advantage. Panel shops know that if they do not agree to the insurance company's prices, a competing panel shop is likely to do so.

The negotiations revolve mainly around labor rates, which range from R120 to R260 per hour depending partly on the negotiating skills of the shop owner and partly on the shop's SAMBRA grade. NSR shops are expected to charge rates in the lower end of this range and MSR shops in the higher end. Manufacturer approvals can also affect labor rates. One rural shop owner indicated that the manufacturer approvals had not resulted in any increased business for him, but he wanted to have three manufacturers' approvals for his shop, because he would then be able to charge labor at the top end of his insurance clients' rate scale. Opinion was mixed among interviewees as to whether the rates they had been given were sufficient to cover salary, overhead, and profit. Some shops were satisfied with their rates. Others indicated that the rates were insufficient to cover salaries for spray painters and other workers with niche skills, and that they would need to charge as much as 50-100 percent more to recover all of their costs. No discernible correlation was observed between the size of the shop and the degree of satisfaction with the labor rates. Several shop owners also expressed frustration at the rates that auto body shops attached to dealerships are allowed to charge. These reportedly range from R400-500 per hour, presumably due to the greater bargaining power that dealers and manufacturers have.

Shortfalls on recovery through labor rates are made up on parts, where a 25 percent markup is standard in the industry. A recent trend of parts price increases has made this markup more lucrative, and has also increased the average parts-to-labor ratio on repair jobs to 60-70 percent of the invoice. The average was closer to 50-50 several years ago. The price increases are due to a lack of robust competition in the South African motor industry, which does little to dissuade Original Equipment Manufacturers (OEMs) from charging high rates and increasing them annually by significantly more than the rate of inflation.

The increases in parts prices have caused some insurance companies to rethink either the standard 25 percent margin or their procurement relationship. A few companies have attempted to set up direct procurement relationships with parts suppliers rather than relying on panel beaters to source parts. The insurance industry views this as a mutually beneficial arrangement, because they can negotiate bulk pricing that smaller panel shops cannot, saving the insurance company money, saving the panel beater hassle, and still allowing the panel beater to recover their markup. However, insurance companies sometimes order the wrong parts when they become involved in procurement, which can delay the panel beaters' completion of the job, further pushing out the date on which the panel shop will be paid by the insurance company for its work. Additionally, some panel beaters reported that insurance companies with direct procurement relationships have begun pressuring panel shops to accept a lower margin on parts. Given that the parts margin helps to offset losses incurred under labor rates, this is a concern for the panel beaters. It is also a potential threat to MAS. Interviewees appear to rely on MAS financing as much for salaries and overhead needs as they do for parts, so it is unlikely MAS would lose clients on a large scale if direct procurement by the insurance companies becomes the norm. However, MAS would lose the parts portion of invoices from its revenue base, and would need to increase its market share by approximately 60-70 percent to maintain the same annual turnover.

Fortunately for MAS, the panel beater industry has shown an ability to mobilize in opposition to direct procurement. SAMBRA and the National Guild of Independent Auto-Body Repairers, a Gauteng-based organization, led a boycott of Mutual & Federal (M&F) insurance in 2007, following attempts by M&F to adopt direct procurement and impose what the panel beaters felt were inappropriately low labor rates. The boycott succeeded in reversing the labor rate policies. The fate of the bulk procurement policies remains uncertain.

Another risk for both panel beaters and MAS related to parts pricing is the risk of increased write-offs. As parts prices increase, there are more instances when the cost to repair a vehicle exceeds the value of the vehicle, in which case the insurance company simply provides the policyholder with a check for the value. This means the OEM, the parts supplier, the panel beater, and MAS all lose the revenue for that repair. The threat of write-offs is one of the only checks on the OEMs' pricing. SAMBRA has recognized and responded to this market dynamic with an initiative called Save a Car, in which they attempt to negotiate basket pricing with OEMs and dealers/parts suppliers on behalf of SAMBRA members, to increase the number of instances when a repair is more economical than a write-off. Likewise, individual shops have been able to avoid write-offs in some instances by persuading dealers and/or parts suppliers to discount one or two parts in an order that would otherwise lead to a write-off rather than a repair job.

Corporate governance and management capacity. Since most panel shop owners are auto body repairers first and businessmen second, and typically lack formal business education, corporate governance and financial acumen can be a weakness in this sector. The majority of shops visited used outside bookkeepers, including one larger shop with 60 employees, though the consultant also spoke with shops that had as little as 18 employees and used an in-house financial manager. Some used an in-house bookkeeper, but hired an outside party to sign off on the financial statements because their in-house person did not meet the qualified accountant standards set forth by South African law for CCs. A few shops seemed to have outsourced more than just the accounting, as the owner indicated he would have to consult his external accountant for the answers to such basic questions as the shop's annual turnover and the rate of recent growth/shrinkage in its business.

While financial reporting concerns are alleviated by the relatively strong South African legal structure and the use of qualified personnel for accounting, there remain concerns about fraud and invoicing that were openly discussed by a number of shops, parts suppliers, and insurance industry representatives. Some panel beaters have been caught installing secondhand parts and charging the client (insurance company) for new ones, and have even purchased new parts to generate an invoice for them, then returned the parts to the parts supplier. It is unclear how widespread such practices are. No panel beater interviewed admitted to having engaged in such behavior, though a number of them indicated that some shops feel they face a choice between closing their doors and trying to find ever more creative ways to cheat the system because they are unable to negotiate labor rates with the insurance industry that allow them to recover their costs. The insurance companies, in turn, have responded with regular unannounced audits of both large and small shops. Discrepancies uncovered can lead to demands for repayment and even to removal of the shop from the insurance company's panel. Parts suppliers have also tightened their policies on returns, which often result in a loss for them because cars have become too complex for most parts to be used on more than one model and year. One parts supplier indicated that 50-60 percent of the parts he purchases are "one-off" parts which cannot be easily resold.

In addition to gaps in financial literacy, marketing is a key capacity building need for panel shops. All shops visited were asked how they market their services and position themselves relative to other panel beaters. Nearly all replied that they rely either primarily or solely on the provision of quality service and the resulting word-of-mouth marketing. In some cases, this was supplemented with low-key marketing techniques such as paying for phone book advertisements or giving away promotional items with the shop's name on it. However, only a few shops had made proactive efforts to reach out to insurance brokers and companies, auto dealers, tow truck drivers or the general public and build relationships that could increase their client base at a faster rate. One owner of a large and growing shop, who regularly sends his son and co-owner on sales calls to insurance companies, cited the lack of marketing capacity as the key reason why competing shops had not been as successful as his. His shop and several other larger, more successful shops also frequently opined during interviews that marketing and personal connections were the key to accessing and remaining on insurance panels and factory approval lists. As they put it, “It’s not what you know, it’s who you know.”

Prospects for growth. The industry has contracted in the current economic climate. Most shops interviewed reported a revenue drop of 30 percent over the past year, particularly small shops. SAMBRA provided the same estimate for the industry at large. The reasons most commonly cited were: 1) There are less cars on the road as people seek more economical transport alternatives; 2) More cars are being driven with minor non-structural dents and dings, because owners have either dropped their insurance coverage or lack the cash to pay the excess (or “deductible,” as it is know in the U.S.) on their insurance policy. Mettle Group experimented, through a different entity than MAS, with microloan products that could help people pay their excess and prop up demand for insurance work at panel shops. Unfortunately, they found few creditworthy clients in the current economic climate. It is possible that a traditional microfinance institution with a greater ability to tolerate and absorb borrower risk would have more success in this area.

If the economy begins to turn around, the sector can logically be expected to see 30 percent growth; however this growth will simply reflect a return to normalcy. MAS indicated that they have been unaffected by the contraction, with a client pool that is growing by four new clients per month. MAS management believes this is because panel beaters who did not previously need their services have now lost access to alternative forms of working capital, such as bank line of credit facilities. Indeed, MAS seems to have more demand for factoring than can be served by its current sources of capital. One shop that uses MAS’ parts financing products indicated that MAS sometimes asks them to wait a few days for payment, because MAS has run out of available capital for parts financing. Since MAS’ current loan facility has covenants that permit only 10 percent of the total amount factored at any one time can be used for parts financing (i.e., making an unsecured payment against an insurance company authorization to perform a repair only, rather than a secured payment against an invoice), it is not surprising that MAS would be unable to meet the current demand for this product.

In the longer term, growth prospects should be understood from two perspectives: total sector and insurance work. Regarding the first, widespread and racially equitable economic development would increase the number of owner-drivers, as persons who currently travel by shared taxi—largely from previously disadvantaged groups—would begin purchasing vehicles and using them for transport. More cars on the road unfortunately means more accidents, thus presenting growth prospects for panel shops.

However, the potential market for MAS’ services can grow even if vehicle ownership does not increase. Currently, only 30 percent of the South African driving population has vehicle insurance. Both MAS and insurance industry representatives agree on this estimate. The vast majority of this insured population is white—as much as 90 percent, according to MAS’ estimates. Since MAS’ factoring products are only relevant for insurance work, and not cash work, an increase in insurance coverage would mean an increase in MAS' market base. This would be unlikely to occur in the current economic climate. South Africans are, if anything, more apt to drop insurance coverage at present, as they seek to prioritize known and necessary expenditures over coverage for possible expenditures. However, as the economy improves, the insurance industry could enhance marketing to non-white drivers and better explain the value proposition that auto insurance represents. They could also revisit pricing and the notion of tiered coverage thresholds to introduce lower-margin, higher-volume products targeting lower-income drivers, as a number of U.S. auto insurance companies have done. This would not only benefit previously disadvantaged communities by increasing access to insurance and financial risk mitigation, it would also be good for the insurance industry and MAS. Panel beaters would benefit as well. Although some cars not covered by insurance are sent to panel beaters for cash work, people who cannot afford insurance coverage are unlikely to be able to afford uninsured major repairs, and an unknown but presumably significant number of vehicles are lost to scrap yards that could be part of the panel beaters' target market.

Number and composition of employees. Despite the parts/labor ratio discussed above, panel beating is a labor intensive industry. Shops with between R6 and 9 million of annual revenue employ an average of 32.8 employees, and those with more than R9 million of revenue employ more than 50 people on average.[5] Even shops with as little as R2.5 million annual revenue reported during the assessment that they employ 10 people, and one shop with R74 million of revenue had 107 employees. Unfortunately, reliable data could not be obtained on the ethnic composition of these employees, but direct observations during the shop visits confirm that a clear majority are from previously disadvantaged groups. Estimates from Mettle and other interviewees suggest that 65-80 percent of panel beater employees are black or otherwise previously disadvantaged. This is corroborated by SAMBRA's membership roster, which is 90 percent compliant with South Africa's Black Economic Empowerment (BEE) program, with 84 percent of members rated BEE Level 4 or above. Thus, although MAS' client base of insurance-serving panel beaters consists primarily of white-owned shops working for predominantly white insured drivers, assistance to the panel beating industry can still support USAID's and FSP's broad goals for reducing unemployment and poverty among previously disadvantaged groups, given the employment opportunities that MAS' financing helps to sustain for such persons.

Seasonality. While a few panel beaters—primarily larger shops—indicated they experience an even workflow throughout the year, most described a busy season during the rainy months and the December-January holiday period, and a slow season during dry, non-holiday months. This is because crashes are more likely to occur during rainy weather or during holidays where alcohol tends to be consumed. Also, the closing of many panel beater shops for the holidays leads to a large January backlog. However, the rainy seasons are reversed in western and eastern South Africa, providing MAS with a stable revenue stream throughout the year, and MAS indicated they have not had difficulty in the past servicing debt at fixed payment terms.

Technical skills required. Auto body repair requires skilled laborers with specialized training in such areas as dent removal, structural repairs, glass replacement, and spray painting. These skills take years to fully master. MERSETA arranges apprenticeships at

[5] Unpublished data provided by Mr. Benton, based on a 2003-2004 survey of South African panel beaters.

panel shops on four-year contracts, and provides technical training curricula and assessments from one to four levels. Businesses with less than 150 permanent employees, which includes most or all panel shops, can apply for grants of up to R90,000 per learner. MERSETA stated that most panel beaters have not availed themselves of these grants, and they are working with SAMBRA to help panel shops through the paperwork process. Unfortunately, panel shops interviewed did not have a high opinion of MERSETA, with frustrations ranging from outdated training curricula to a feeling that they had been pressured to take on apprentices. Another concern expressed by the panel shops was the lack of technical trainings available other than apprenticeships. Many shops have experienced difficulty finding qualified workers. They attribute the shortage primarily to a lack of interest among younger South Africans in panel beating as a career, though the loss of existing workers to HIV/AIDS was also cited as a factor.

Working capital requirements. Panel beaters' working capital expenditures can be divided into fixed costs (e.g., employee salaries and overhead) and those that vary by job. The latter can include occasional labor. For example, some shops outsource glass replacement, or seasonally employ specialists in the rapid removal of multiple minor dents caused by hail. But parts are by far the largest working capital need. Parts suppliers typically expect payment within 30-60 days, and panel beaters are not paid by an insurance company until 60 days after a job is complete. More complex structural jobs can take 30 days even when all parts arrive quickly, which leaves a 30-60 day gap between the date the payment for 60-70 percent of the job is due to the parts supplier and the date the panel beater is paid by the insurance company. Long delays in the shipment of some parts from overseas suppliers can further push out job completion timeframe, and thus the eventual date of payment by the insurance company. In the meantime, the panel beater must also pay salaries, rent or building loan payments, and other typical business operating costs. It can take as long as six months to source some parts from abroad, though 2-4 weeks is more common. When the timeframe extends into months, some insurance companies will allow the panel shop to install secondhand parts, provided that this is disclosed to the consumer and that appropriate rates are charged to the insurance company for such parts.

This mismatch between payables and receivables turnaround is the reason MAS and its competitors exist, and the reason that many interviewees (all of whom were MAS clients) voluntarily expressed their belief that they would not be able to remain in business without factoring. A few shops also had overdraft or line of credit facilities, but most who had explored these avenues said they used MAS because MAS' terms were more favorable, because MAS was more responsive than a bank (answering calls and making funds available anytime, not only during banking hours), or because they could not obtain a facility from a bank that was large enough to meet their financing needs. Two of the rural shops interviewed had declined to pursue an overdraft facility because of negative overall perceptions they had about the banking industry.

Operating capital requirements and expenditure patterns. Startup costs for a panel shop that wants to perform insurance work are estimated at R2-3 million. Microenterprise shops performing non-structural cash-based repairs out of a small garage or even a backyard can, of course, start up for much less. All interviewees willing to share information on their startup financing sources indicated they had started their businesses with personal or family savings. After startup, equipment purchases and upgrades are the largest financing need. This can range from once-per-decade-or-two replacement of machines at small shops uninterested in expansion to regular purchases or upgrades of multimillion Rand equipment at growth-oriented larger shops trying to maintain manufacturer approvals and a competitive edge. As noted previously, those shops that owned their premises rather than renting them were the only shops that reported success in obtaining term loans for equipment purchases. Other shops sourced equipment on a 24 month installment plan provided by the manufacturers, and made installment payments using their available cash.

Typical types of collateral used. Real property was the only type of collateral that interviewees had convinced a lending institution to accept. There may be an opportunity for leasing products to support equipment investments for panel shops that rent their premises, though the resale value of repossessed equipment from a lessee would have to be examined in greater detail to determine the viability of such products.[6] For working capital expenditures, MAS and its competitors seem to be the primary lenders. The factored invoices and the promise of recourse to the panel shop function as a collateral substitute for these loan-like transactions.

Strengths, weaknesses, opportunities and threats (SWOT). The exhibit below presents a SWOT analysis for the panel beater sector that summarizes the issues discussed above. The analysis is conducted from the perspective of the DCA transaction. Thus, what might be described as an opportunity from the panel beaters' perspective would instead be classified as a threat if it could help panel beaters finance their working capital requirements without the aid of MAS' services. Likewise, the sectoral imperfections that create a demand for MAS' services are classified as strength.

SWOT Analysis – Panel Beater Sector, from MAS Perspective	
Strengths • Inelastic industry demand. • Mismatch between A/P due dates and A/R receipt dates for panel shops creates strong demand for factoring. • Factoring with recourse insulates MAS from most industry risks.	**Opportunities** • Increasing insurance coverage among driving population would expand MAS' potential market. • Movable collateral registries would enhance panel shops' access to equipment financing, enabling them to obtain factory approvals and increase throughput. • Increased number of vehicle owner/operators as the economy expands • Increased funding will allow MAS to expand its financing of panel beaters.
Weaknesses • Panel shops captive to multiple competing interests with greater bargaining power (manufacturers/dealers, insurance industry, tow truck drivers, SAMBRA, SAARSA). • Lack of business acumen and marketing skills among panel shop owners. • Shortage of qualified workers and poor resources for vocational training. • Unfavorable financing terms for major and necessary equipment upgrades. • Insurance company panels and manufacturer requirements make access to more lucrative revenue streams increasingly complex and challenging. • Oversupply of panel beaters relative to insurance industry demand.	**Threats** • Protracted economic downturn, maintaining present reduced levels of demand. • Continued inflation of parts pricing leading to an increase in insurance company write-offs. • Direct parts procurement by insurance companies. • Widespread adoption of deposit payments by insurance companies. • Continued loss of qualified workers to HIV/AIDS. • Growth of franchise networks. • Insurance company prohibitions on factoring • Insurance companies (or their subsidiaries or related companies) offering a competing factoring product. • More stringent reporting requirements under new Companies Act may be difficult for some shops to comply with.

[6] Leasing is a product the Mettle could consider, but it would have to create a new SPV for that purpose, as MAS' articles of incorporation restrict it to its existing lines of business.

Most of these factors, and applicable limitations or mitigants, have been discussed already. Those that are not addressed above are explained here in further detail.

Factoring with recourse insulates MAS from most industry risks. MAS factors with recourse, meaning that if they are unable to obtain payment from the insurance company for an invoice despite their best efforts, the panel shop must agree to repurchase the unpaid invoice. This means MAS is not vulnerable to losses from parts fraud or other irregularities unearthed by insurance auditors, non-payments due to concerns about manufacturer approvals, and the like. There is some risk that a panel shop that owes MAS funds for a repurchase will not have the cash on hand to pay, but if the relationship is ongoing, MAS can offset repayments owed against future invoices. Moreover, the nature of MAS' business makes it unlikely that the company would be unable to service the debt on a DCA-backed loan even if faced with a major and prolonged industry downturn, as this would simply mean that less of MAS' capital would be used to factor invoices. In such cases, MAS would still be able to use the capital it retains for factoring to make loan repayments. However, the guarantee is intended to make capital available for factoring, not simply for loan repayment. It is therefore recommended that the EGAT/DC risk assessment and financial viability analysis not focus merely on loan default risk, but also address the likelihood that loan repayments can be made from MAS' operating profit rather than from funds intended to be lent to panel beaters.

Widespread adoption of deposit payments by insurance companies. If the insurance industry began offering deposits to panel shops, it would reduce the amount of financing panel beaters need to obtain through factoring with MAS and its competitors. However, this is an unlikely scenario. Interest on cash float is a key source of revenue for insurance companies, and deposits would reduce their profit margins and likely force them to raise premiums. Insurance companies are in a self-described "cutthroat" market for customers, and the price of premiums is a major factor in attracting and retaining clients. Unless all insurance companies were simultaneously forced to adopt a deposit regime by an external actor, it is likely that those companies choosing to offer deposits could be undercut in premium price by those that did not.

Insurance company prohibitions on factoring. Some of MAS' clients have encountered provisions in their contracts with insurance companies that prohibit payments to third parties, in an effort to prevent MAS or its competitors from providing the panel shop with financing. The insurance companies employing such provisions have threatened to remove panel beaters from their panel of recommended shops if they engage in factoring. The insurance companies do this with the expectation of negotiating a 5 percent "prompt payment" discount with the panel shop if the invoice is paid within 30 days of job completion instead of the usual 60 days. Interviewees indicated such discounts are unattractive to them for two reasons: 1) The insurance company often misses this deadline by two weeks or more, but still insists on the discount; 2) MAS pays immediately and only asks for the same 5 percent discount.[7] MAS believes that such insurance company prohibitions are anticompetitive behavior. However, MAS' management has thus far

[7] MAS' margin is 6.5 percent if the panel beater is accessing their parts financing product. The extra 1.5 percentage points cover the risk of what is effectively unsecured lending, since no invoice has been issued by the panel beater at the time the work is authorized by the insurance company. Because of this increased risk, and the loan covenants mentioned earlier, MAS only provides parts financing to clients who have been with them for some time and have a proven track record of satisfactory repairs.

elected to counter insurance company pressure through confidential discounting—where the factoring relationship is not disclosed to the insurance company—rather than filing a complaint with the Competition Commission.

One insurance company, Santam, previously pressured panel beaters not to use MAS because it is the parent company of Anglo-African, MAS' largest competitor in the auto receivables factoring market. MAS was able to convince Santam that this was an anti-competitive business practice. Anglo-African now appears content to compete with MAS on price. One panel shop that was an MAS client said he uses MAS for most work because he prefers their customer service, but he chooses Anglo-African when performing work for Santam because they only charge a 4 percent fee instead of MAS' 5 percent fee.

TECHNICAL ASSISTANCE NEEDS AND CURRENT PROGRAMS

As shown in the above SWOT analysis, small to medium sized panel beaters would benefit from technical assistance in financial literacy and general management principles, which may assist them in accessing credit for equipment upgrades and eventual business expansion. Gary Benton, of Benton Management and Transportation Services (BMTS), is currently providing technical assistance in business acumen and enterprise development to four pilot panel beater groups. BMTS is largely funded by the South African Insurance Association, though they are actively pursuing funding from the Retail Motor Industry Organization (SAMBRA's parent group) and other parties to enable them to appear to beneficiaries in a more neutral light. The pilot projects have an access to credit component that is relevant to the FSP project, as BMTS plans to help beneficiary panel shops approach lenders for financing, and to persuade these lenders to make loans based partly on projected cash flow rather than solely on the amount of fixed and cash assets the firm can produce as collateral. One such effort with 30 SAARSA members in the Western Cape stalled when the economic downturn reached South Africa, but BMTS has included this group as one of its four pilot projects and plans to revisit the financing issue with both banks and the Khula Enterprise Fund in the near future.

The only other significant technical assistance initiative uncovered during this study is the Adopt-a-Panel-Shop program sponsored by Alexander Forbes Limited (AFL), a South Africa-based international insurance company. This program, funded at R5 million per year, seeks to upgrade and improve the service levels of black-owned panel shops through trainings and financial assistance for equipment upgrades or shop renovation. AFL also uses its position as an insurer to help these shops obtain a healthy turnover from its client portfolio. Four pilot shops have been assisted to date, with the most recent result being the upgrading of Zombodze Panelbeaters in Soweto.[8] The program appears to be well regarded, but has had difficulty scaling up beyond the four shops supported thus far. It appears that the program will be phased out, as AFL currently is looking to sell its panel beater loan book to MAS.

[8] "Alexander Forbes Annual review and financial statements for the year ended 31 March 2009: Sustainability Report", http://www.financialresults.co.za/alexander_forbes_ar2009/aforbes_review2009/sustainability_03.htm, and "Third upgrade of Soweto panelbeater shows South Africa the way," July 9, 2009, http://www.alexanderforbes.com/News/OtherNews/2009/07/ThirdUpgradeSowetoPanelbeater.htm.

CONCLUSIONS

Although panel beaters in South Africa face significant challenges from the complex interaction of diverse stakeholders, MAS is largely insulated from the risks inherent in the sector. They have sufficient market share to capture a large portion of insurance-funded repairs regardless of which panel shop obtains the work, and they have the infrastructure to expand their market share further given the capital to do so. Factoring with recourse provides further insulation from market risks, and even in the event of a truly seismic change in the industry, MAS would be able to use its existing capital base to repay debt. The risk of default under a DCA-covered loan would therefore be minimal.

From a development perspective, the proposed guarantee would help MAS provide a greater number of panel beaters with working capital financing in general, and with parts financing in particular. This can improve the panel beaters' profit margins by reducing the amount they have to borrow from sources with less favorable terms, and improve overall revenue by providing them with the financing needed to pay up-front costs for more complex and lucrative repairs. Increased availability of factoring can also improve panel beaters' prospects of continuing as going concerns. Working capital financing is the life blood of a panel beater. A typical panel shop will not remain in business long if they must wait 60 days or more from job completion for funds to purchase parts and pay employees and rent or mortgage expenses. Thus, maintaining and increasing funding available to MAS through the proposed guarantee is key to the vitality of this crucial service industry, as MAS is the largest financier of South African panel beaters.

While banks provide some panel beaters with overdraft or line of credit facilities, the terms are not always favorable and can be altered according to the whims of bank management. Factoring companies and panel beaters have a mutual dependency that is lacking in bank-panel beater relationships, and MAS has a vested interest in ensuring that panel beaters' needs are served by its financial products. Serving these needs and increasing panel beaters' revenues can, with appropriate financial management, potentially position the panel shops for growth. If MAS is unable to obtain financing without a guarantee, which appears to be the case at present, the requirement that USAID be the guarantor of last resort would, *ipso facto*, be satisfied. With the majority of panel beater employees coming from previously disadvantaged groups, and with most or all panel beaters classified as SMMEs, DCA support for MAS would ultimately help to maintain and increase employment and economic growth opportunities for USAID's target groups.

The impact of the guarantee would be improved with complementary technical assistance to panel shops that improves their financial literacy, marketing savvy, and general business acumen, helping them to take full advantage of the financing provided by MAS and to use it to position themselves for growth. Shops could be selected based partly on BEE scores and ownership if USAID wishes specifically to target as many previously disadvantaged persons as possible, though even lower-scoring shops may be able to score higher if they begin growing and hiring more employees. A more difficult, but potentially more significant, avenue for technical assistance would be to help insurance companies market automobile insurance products to the 70 percent of South Africans who are uninsured.[9] For example, shops performing cash work could be used as venues to distribute literature about how much less the repair job would have cost if the owner had been insured. Expanding insurance companies' market share would be good for MAS and good for the panel beaters, who are currently in an oversaturated market for insurance work and must often rely on less lucrative cash work to fill their portfolio. Needless to say, the expansion of coverage would also benefit the largely non-white drivers who will no longer have to choose between paying large cash outlays for repairs and losing access to what may be an economically essential vehicle. However, an expanded insurance market would require sustainable access to wholesale funds by MAS and its competitors to operate at maximum efficiency. Demonstrating to lenders that automobile receivables factoring is a viable borrower market at the wholesale level would help the industry position itself for potential expansion.

[9] Given the huge proportion of uninsured vehicles, it does not appear feasible to change the regulatory environment such that vehicle insurance would be made mandatory. However, perhaps the insurance companies should offer low cost, low coverage policies.