EQUIPMENT LEASING & FINANCE FOUNDATION

Your Eye On The Future

Captive Finance Firms in a Challenging Economy

Facing the Wave

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The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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Preface

Recent traumatic recession related effects on the equipment finance industry are resulting in unprecedented changes in the environment Captives operate. Business models, once proven to be effective, are being questioned and modified. The changing market landscape has demonstrated a great degree of disparity in the value Captives are delivering to their Parent organizations.

The ***Captive Finance Firms in a Challenging Economy: Facing the Wave*** study is the latest of a series of forward looking publications the **Equipment Leasing & Finance Foundation** (The Foundation) undertook as part of its continuing effort to bring new information to the industry. This study focuses on:

- Captive evolution
- Captive strategy and operating model
- Captive dependence / independence from its Parent
- Current events' affect on Captives
- Captive measures of success

The Foundation engaged Capgemini, a leading global consulting firm, to research and produce this study for the industry. The study is based on industry research and responses from many leading Captive organizations across a large spectrum of ticket sizes, market approaches and geographies. Participation in the study was voluntary and free of charge. A total of 18 companies took time from their daily operations to contribute to the study by completing a 50-question survey designed to gather important information about the current state of the Captive market place and the relationships between Captives and their Parents.

The Foundation and Capgemini would like to thank those companies that participated in the study. Without their support and the support of industry organizations like the Foundation, this study would not have been possible.

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Executive Summary

In good times, strengths and weaknesses of a business model are often overlooked. In bad times, as with the current global recession, weaknesses often come to the forefront. For Captive Finance Companies ("Captives")[1] this is the case. Recent tightening of credit has raised concerns over access to capital and credit quality issues, calling the "true Captive" business model into question.[2]

The responses to the survey associated with the ***Captive Finance Firms in a Challenging Economy: Facing the Wave*** study and supporting research suggest that Captives need to propel through current economic wave by concentrating on the basics and:

- Focusing on financing core Parent product
- Strengthening customer relationships

Captives also need to encourage activities that are essential to ensure they are ready to tackle the next wave head on by:

- Diversifying their approach to funding and access to capital
- Developing a core competency of strong asset management capabilities
- Examining measures of success

Focusing on Core Parent Product

While some Captives have remained focused on financing their Parent's core business product, others have expanded beyond their initial product offerings to leverage their expertise and easy access to capital, creating a diversified business strategy. Over the years, some of the diversified Captives were very successful and experienced impressive growth with a dividend payout ratio[3] of over 50%. Unfortunately, the credit crisis highlighted some of the risks associated with a diversified business strategy and one of the risks for any finance company's business model: a need for regular access to stable and competitively priced sources of financing. Additionally, rapid asset growth has had, in some cases, a negative impact on the market valuation of their

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[1] A Captive is defined as a company or business unit owned by the Parent, formed to provide financing to dealer networks or customers of the Parent's products that maintains an on-balance sheet portfolio of finance transactions.

[2] Fitch Ratings (2009, 07-31). *Capturing the Captives: A comparative Review of North American Captive Finance Companies*. Fitch Inc.

[3] The percentage of earnings paid to shareholders in dividends.

respective parent companies' stock due to the perception of capital, liquidity, earnings and risk issues.

Until recently, Captives were aided by their Parent's brand name and had access to relatively inexpensive capital. However, as the credit markets began to restrict the availability of any financing in mid-2007 and throughout 2008, some Parents had to contribute capital into their Captive organizations and the long-term profitability of these businesses had, in some cases, reduced. As a result, a number of Captives are "returning to the basics" of the financing of core Parent products while the Parent organizations are reexamining the effect of owning a Captive.

Strengthening Customer Relationships

A key driver in the establishment of the Captive is customer retention and value creation for the customer. A subjective goal of the Captive is to build brand loyalty and enhance the customer experience through the financing of equipment, i.e. strengthen the customer relationship. Unlike banks or independent finance providers, a Captive has a vested interest in maintaining a positive relationship with the customer because that relationship may affect the customer's decision to make future purchases of the Parent's product. With on-going customer contact through invoices and customer service, there is an opportunity to provide details on new products and be the "go-to" resource when an upgraded product is needed to increase capacity or replace obsolete technology. In addition, there is an opportunity to share information with the Parent on customer behavior. The Parent, through the end of term negotiations as well as general customer service requests, may glean insight into customer behavior, which competitors do not have. This can help shape new product offerings both for the physical product and the financial offering. In turn, this may create a competitive advantage and take some of the pressure off competing on price alone.

Diversifying the Approach to Funding and Access to Capital

Recent events have disrupted the financial markets. Captives are increasingly looking at ways to creatively find funding options to diversify their access to capital. Captives, reliant on the capital markets to meet funding obligations, are finding it is more difficult to obtain capital at an economical rate. Meanwhile, Captives that took advantage of various government programs are beginning to see an end to those programs. Captives need to reduce their exposure to single source options, especially those that were most affected by this current recession and develop a forward looking strategy focused on a collection of funding options, which provide cost competitive rates and offer better liquidity.

Developing a Core Competency of Strong Asset Management Capabilities

Historically, Captives have lagged behind industry competitors in most aspects of operating efficiencies. The current economic climate is pushing companies to focus on efficiencies in a way Captives have not had to do in the past. On the front-end, Captives must look at integrating credit underwriting processes with a greater understanding of assets and residuals as a cornerstone to their asset management capabilities. There should be greater emphasis on working with the sales team in the prequalification stage to ensure that increased risk is matched with a premium rate. Post-booking should have an increased emphasis on mid-term upgrades and trade-ins to take advantage of the Parent's product offerings and balance the price and availability of products in the secondary market. This continues into end of term negotiations where fair market values, inventory levels, as well as residual values can all affect the Captive's financial position. Captives naturally have special or inside information about the market, which is not widely known because of their close relationship with the Parent. Captives should be leveraging this information to make full use of their product offerings and asset placement capabilities.

Examining Measures of Success

Historically, Parents have measured Captives in ways that promote a standalone business division view. Some of these traditional views of Captives are highly relevant; however, they are often benchmarked against the wrong index. Parents need to pay attention to some key metrics affecting the overall organization, but alternative approaches for evaluating success may be appropriate given the evolution of Captives (see Exhibit 1).

Exhibit 1	
Traditional Perspective	**Alternative Approach**
Diversification of financing beyond the Parent's equipment creates unnecessary risk and should be avoided. Note: There are two aspects to view—one speaks to the creation of entire business units that finance only non-Parent assets (usually in adjacent markets) and the second focuses on the mix of Parent and non-Parent equipment at a transaction level. The survey and perspectives here address the latter.	Create policies that balance Parent vs. Non-Parent financing with risk. Risk in the form of both credit and asset management related risks—e.g. increase credit requirements and decrease residual positions as the balance shifts to non-Parent equipment.
Profitability measures such as Return on Assets (ROA) and Return on Equity (ROE) are benchmarked against the Parent's returns.	Utilize ELFA benchmarking data for relevant peer Captive data and internally, create a customer lifecycle profitability measure. Acknowledge the incremental profitability driven by the Captive activity, even though it may not directly accrue to the Captive profit and loss statement.
High penetration rates (percentage of Parent's equipment financed by the Captive) and large portfolios (as a percentage of the Parent's assets) increase leverage and as a direct result, in economic times such as these, volatility.	Develop the sophistication of their treasury capabilities to become more "bank-like" in terms of asset / liability management as portfolios grow in addition to a simple leverage measure.
Underwriting standards at Captives are more lax than at banks and other finance organizations. Overall asset quality is reduced, creating exposure during an economic downturn.	Develop a core competency of strong asset management capabilities, which reduces the exposure typically associated with a weaker credit profile portfolio.

The changing economic landscape is resulting in uncertainty in the viability of some Captives leading to a degree of disparity in the real and perceived success of Captives. Heeding the current economic conditions by returning to basics, focusing on financing core Parent product and strengthening the customer relationship will prepare the Captive for the post-recession market. Meanwhile, diversifying the Captive's approach to funding and access to capital, developing a core competency of strong asset management capabilities and examining measures of success will focus the Captive on the right tasks to ensure the successful maneuvering of the next economic wave.

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Your Eye on the Future

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- US Equipment Finance Market Study
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- Annual State of the Equipment Finance Industry report
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Journal of Equipment Lease Financing

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