Captives White Paper acts as Blueprint

Marc Tendler, a Principal at The Alta Group EMEA, has authored this White Paper which covers the issues for a Manufacturer or Distributor to consider when contemplating the setting up of a financial services Captive organisation

As advisors to many of the world's leading lessors, The Alta Group ("Alta") has built an unrivalled reputation as the principal provider of specialist services to asset finance and leasing companies, whether bank owned, captive or independent, and equipment manufacturers and vendors. Alta's professionals are all highly experienced, senior executives with decades of experience across the leasing industry.

Manufacturers and distributors ("Originators") have embraced the provision of customer financing facilities for many years, and a number of them have shown significant growth and enhanced profitability as a result of developing financing products which are offered to their customers as an integrated part of their overall product and services mix. This for many Originators has become an important part of their sales cycle.

Originators have provided customer financing facilities through various structures. The most frequently used are:

- A third party financial services company (this arrangement being known as a Vendor Programme) where the customer financially contracts with the third party and the Originator has relatively little involvement in the business once it has been funded.
- A Joint Venture with a third party (usually a financial services company) who provides various specialist services such as risk assessment, administration, portfolio management & funding.
- Via an existing legal entity, where customer financing is offered as an additional product.
- Through a new legal entity, owned and controlled by the Originator, where customer financing is a specialism of the new company (this arrangement being known as a Captive)

For those Originators who are considering adding a customer financing capability to their own product offering, there are a number of factors which should be considered and balanced before making the final decision on which of the above structures to adopt.

For the purpose of this paper we are excluding the provision of customer financing via a third party (Vendor Programme) funding arrangement and looking at the various alternatives which require the formal participation of the Originator via a legal entity. The paper covers two generic areas which the Alta Group regard as applicable to most Originators; strategic issues and operational issues.

Strategic issues for the creation of a Captive can be segmented into 7 sections:

1. Capital Structure & Ownership.
2. Funding.
3. Impact on Parent Company Balance Sheet.
4. Income Recognition.
5. Sales volume to be financed.
6. Reporting Lines – Sales or Finance?
7. Introducing finance as an integral part of the sales cycle and fully integrated with the activities of the Originator

Operational issues can be segmented into five sections:

1. Recruitment & Optimal Staffing levels.
2. Systems.
3. Credit Policies & Risk Assessment.
4. Asset Risk.
5. Contractual documentation.

Strategic

1) Capital Structure & Ownership

The alternatives are :

(a) To offer financing via an existing legal entity, thus avoiding the need to establish and manage separate legal entities. This may not always be possible if financing is to be offered in countries where the provision of financial facilities can only be done via a specially formed, and possibly, regulated company

(b) To establish a new legal entity specifically to offer customer finance – this may be essential in some jurisdictions

(c) To establish a joint-venture with a third-party who can bring relevant expertise (e.g. funding, systems, risk analysis & management, staff etc). N.B. Historical advantages of being able to structure such joint-ventures "off-balance sheet" have largely been closed down by the regulatory authorities and are no longer relevant.

→ CAPTIVES OFTEN CHOOSE TO OUTSOURCE FINANCING ARRANGEMENTS IN LOW VOLUME COUNTRY ENTITIES

2) Funding
The major decision in respect of funding is whether to:
(a) fund the customer financing activities through the Originator's own cash resources (which includes bank facilities available to them)
(b) seek external specific funding from banks, lessors or other third parties (the latter will expect a significant portion of equity capital to be provided by the Originator), or to
(c) Sell the portfolio to third parties at regular intervals.

Funding can be a significant issue especially during the current "liquidity crisis" as Alta has found there is often significant internal competition for this scarce resource.

3) Impact on Parent Company Balance Sheet – Credit Rating Agencies
(a) Customer financing activities are highly capital intensive and can require significant amounts of longer term debt.
(b) Originators may choose to leverage the parent company balance sheet as it may be easier for them to raise capital than a financial services company in the current financial climate
(c) There is the potential for distortion of an Originator's key ratios such as Gearing, and this needs to be explained to both investors and the Rating Agencies in order to minimise any impact on market perceptions.

4) Income Recognition
Proposed Accounting Regulations may prevent the Originator booking full sales revenue on inception of a financing contract for the equipment which is executed between the customer and the Originator's customer financing arm. These proposals would require the Originator to account for such revenues over the life of the financing contract on an "as received" basis. This can have a significant impact on sales revenues, particularly in the first year of the customer financing activities. This area again needs to be considered and explained to investors, funders and Ratings Agencies.

5) Sales volume to be financed
(a) It is important to have a clear idea of the volume of customer financing to be written and when, so as to ensure availability of funding and that the correct staffing and resource levels are in place when the business commences.
(b) Achieving critical mass is also very important as it is usually more cost effective to have a small number of high volume country entities rather than a high number of low volume entities.
(c) Captives often choose to outsource financing arrangements in low volume country entities.

6) Reporting Lines – Sales or Finance
Typically, customer financing activities report into either the sales/marketing organisation or the finance group. This is an important consideration and the Originator should consider which is most appropriate. Whichever route is taken, it is essential that the customer financing activities are run on an "arms length" and therefore commercially viable basis.

7) Ensuring that finance is an integral part of the sales cycle and fully integrated with the activities of the Originator.
In Alta's experience, highly successful customer financing activities have comprehensive procedures in place to incentivise the equipment sales operation. Such incentives are variable and flexible, ranging from cash bonuses to the recognition of all or part of the profit from finance operations in the overall performance.

Operational
1) Recruitment & Optimal Staffing levels
(a) As with any specialist activity, there are a number of key roles which require specific expertise and which should be managed and controlled through the customer finance operation.
(b) The Originator may wish to "second" existing personnel in order to ensure integration into the mainstream activities – that is certainly a valuable benefit but should not be at the expense of bringing in any essential specialist expertise, e.g. in Credit, Collections and Treasury/Funding.
(c) Staffing levels will largely be based upon anticipated sales

→ THERE ARE A NUMBER OF IT PROVIDERS WHO OFFER SUITABLE LEASING SOFTWARE, AND THIS IS A KEY AREA FOR EARLY AND CORRECT DECISION MAKING

volumes (that is, expected average transaction size and numbers of transactions rather than simple high level monetary amounts), combined with the degree of systems automation to be implemented.

2) Systems

(a) Customer financing requires varying degrees of automation, depending upon the expected individual transaction values, the number of transactions, and the distribution channels used by the Originator.

(b) Consideration must be given to the availability and level of integration into any online "E-Commerce" platforms utilised.

(c) Dependant on the size of a customers individual financing requirements the Originator will need to consider the level of credit automation. Low value/high volume flow business tends to be highly integrated into the sales process with automated decision making and documentation; high value transactions are normally customised solutions and therefore less automated.

(d) There are a number of IT providers who offer suitable leasing software, and this is a key area for early and correct decision making as it can impact dramatically on staffing levels and efficiency i.e. the speed of the transaction turnaround times and the productivity of the business.

3) Credit Policies & Risk Assessment

(a) Customer financing is typically much longer term (3-5 years) than traditional trade credit provided to the customer and therefore risk assessment requires very different techniques and expertise.

(b) For Originators whose average unit sales are £25,000 (or equivalent) or below it is possible to implement automated decisioning software which will adjudicate credit using rules-based criteria and drawing information from online credit bureaux.

(c) For larger transactions it is normal to use experienced credit underwriters who will make a judgement decision based upon financial information, knowledge of the customer's market and the value of the asset.

4) Asset Risk

One of the key elements in the credit decision is having a thorough understanding of the current and future resale value of the equipment to be financed together with knowledge of and access to the most efficient way to remarket the equipment. The Originator is best qualified to know those factors. Detailed asset lifecycle knowledge should underpin the credit process and should provide a source of competitive advantage compared to third party funders.

5) Contractual documentation

(a) Properly enforceable documentation is vital in securing the customer finance company's position in the event of customer default and the Originator should obtain a full suite of specific contracts and other documents rather than relying on adapting any existing sale agreements. This is a specialist area and requires appropriate professional advice

Key Advantages & Disadvantages

Specific advantages of creating a Captive

1) Provides a fully integrated bespoke sales finance operation into the organisation
2) Proactively enhances the customer proposition and customer retention programmes.
3) Eliminates reliance upon the capabilities of third party funding partners
4) Reduces dependency upon the credit appetite of funding partners
5) Permits leverage of the parent company balance sheet.
6) Will add to the shareholder value of the parent.
7) Allows a customised approach to different countries and/or distribution channels and alignment to the parent.

Possible disadvantages of creating a Captive

1) The Originator will take responsibility for the funding process.
2) The Originator must attract and retain specialist staff.
3) A poorly managed Captive could incur significant credit/equipment losses.
4) A one size fits all approach may not be entirely satisfactory for all geographic locations.

The Alta Group Europe Principals have specific experience and expertise in all areas of customer finance, in industries ranging from aircraft, materials handling, construction, technology, office equipment and healthcare. They are uniquely placed to advise on the available options, and to then support clients in the decision making process and implementation of a chosen project route. ■

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This White Paper has been written as general advice and is not to be construed as specific advice. The Alta Group can provide specific tailored advice after discussion with your organisation.