Roland Berger Focus

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Captive finance

A multipurpose strategic tool for manufacturers

Roland Berger

Management summary

Manufacturers of capital-intensive assets such as trucks, agricultural machines or production machinery relied in the past on loose partnerships with third parties to provide purchasers with financing or leasing arrangements. Recent changes in accounting legislation, combined with growing globalization, the desire for greater transparency and mounting competition, mean that such partnerships are not as attractive as they once were. As a result, increasing numbers of OEMs are asking themselves whether they would benefit from setting up their own finance companies – and if so, how to do so most effectively.

"Captive finance", although not a solution for all manufacturers, is unrivaled as a multipurpose tool: Applied correctly, it can generate major advantages for refinancing, enable manufacturers to offer their customers a one-stop shop and be a powerful boost for sales. To determine whether individual OEMs would benefit from establishing a banking or leasing captive, companies should ask themselves a number of strategic questions: Is it feasible for them to bundle their sales financing activities in a central entity? Should they provide the entire financing themselves? And so on.

We discuss these questions on the following pages. We also look at the real-life story of how one manufacturing company effectively leveraged captive finance, resulting in tangible improvements across a wide range of areas. Finally, we present our five rules of thumb for using captive finance as a multipurpose strategic tool, from aligning the financial services unit as a support function for the sales units to modifying the system of KPIs.

We believe that the time has come for all OEMs to develop an effective sales financing strategy. Not only will doing so protect their current profit levels – it will help them discover new areas of untapped potential.

Contents

1. From third-party financing to one-stop shop

As competition grows, OEMs are increasingly considering captive finance as a strategic tool.

Buying large machines or vehicles such as trucks, agricultural equipment, cranes, printing machines or production machinery is a major investment. The question inevitably arises of how to finance such purchases. In the past, only a minority of manufacturers of capital goods such as these offered financing options, while most customers needed to organize funding for the purchase of capital-intensive assets themselves. At best, the manufacturer had a loose partnership with a third-party provider; more often than not, they simply referred the customer on.

How did this situation arise? The truth is that most of the markets for these capital assets had a very low level of competition. OEMs – original equipment manufacturers – did not need to offer sales financing in an organized, professional manner as the customers would come to them anyway. Only in the automotive industry and a few other sectors where competition was traditionally high did OEMs have the motivation to offer customers a "one-stop shop", selling them the asset and at the same time taking care of their financing needs. For example, Volkswagen established a leasing subsidiary as early as 1949 and acquired a banking license in 1974.

Growing globalization, rising transparency and macroeconomic factors have forced OEMs to react.

Things began to change for OEMs at the turn of the twenty-first century. Growing globalization, rising transparency and macroeconomic factors increased the level of competition in the market for capital-intensive assets. OEMs were forced to react. In most cases they continued to cooperate with third-party providers, often formalizing or extending these partnerships. That might mean referring customers to one or more cooperation partners and receiving commission for doing so. Or it might mean working with a single partner and using the OEM's own brand for the financing solution – known as a white-label approach – with the OEM potentially receiving some of the profits through a kickback payment. It could even mean the OEM setting up a joint venture, being careful to strike a balance between the higher management costs that it incurs and the profits that it "internalizes" in this manner.

Another option – the approach that we focus on in this study – is for OEMs to set up their own "captive" finance company, be that a captive bank or a captive leasing company. In this case the OEM offers its own financing solution to customers for the purchase or lease of its products and acts as a complete one-stop shop, as we currently see with some car manufacturers and industrial goods producers. When it comes to leasing, of course, the existence of a large enough, liquid secondary market for the specific asset is key. After all, offering leasing only makes sense if the returned asset can be resold or at least has some residual value. Products with short innovation cycles tend not to have a secondary market as users generally want the very latest technology.

OEMs face a choice: Should they establish a captive finance company, or continue cooperating with a third-party financing provider as in the past? Their decision will be driven by a number of criteria. Obviously, the size of the potential market in terms of revenue is significant: As a rule of thumb, the annual financing volume of the

A: Captive finance or third-party solution?
Different approaches for different markets

	DESCRIPTION	ON/OFF-BALANCE SHEET FOR OEM[1]	LEASING/ FINANCING PRODUCT OFFERING
REFERRAL MODEL	Referral of customers to one or more cooperation partners by OEM OEM receives kickback payment from partner	Off-balance	Leasing & financing
WHITE LABEL	Referral of customers to a single cooperation partner by OEM – However, financing solution is branded with OEM's brand OEM receives kickback payment from partner	Off-balance	Leasing & financing
JOINT VENTURE	OEM and partner establish own legal leasing company Joint venture offers highly individual leasing services to its customers and internalizes entire profit (which is shared)	On/off-balance depends on split of shares in joint venture	Depends on legal structure
REFINANCING PARTNERSHIP	OEM offers own financing solutions To refinance its activity, OEM uses partnerships with partner to "shift" the asset	Off-balance	Often leasing only (financing requires banking license)

1) According to old accounting standards

Source: Roland Berger

potential new business needs to be EUR 75 million or more in order to justify setting up your own captive. If there is a high level of standardization of the assets and a strong preference for leasing among customers, OEMs should consider setting up a leasing captive. If, on the other hand, customer demand for loan financing is strong, OEMs should consider setting up a banking captive. The larger the share of profits from servicing the assets, the more attractive the option of offering lease financing. Of course, the OEM's own credit ratings also need to be adequate to ensure stable refinancing of the captive. → A

2. Understanding the new reality

New accounting standards are forcing manufacturers to re-examine their approach

The introduction of the new accounting standards IFRS 15 and IFRS 16 has had a major impact on the strategic considerations of OEMs and is likely to continue to do so in the coming years. IFRS 15 deals with how revenue is recognized for accounting purposes. Prior to the introduction of the new standard, when an OEM sold an asset to a third-party leasing provider, which in turn leased the asset to a customer referred to it by the OEM, the OEM could record the entire price as revenue the moment the leasing contract began, although the OEM gave a residual value guarantee. Under the new standard, the OEM can only record the difference between the price and the residual value of the asset as revenue over the period of the leasing contract, as was previously the case with captive finance. In other words, when working with a third-party leasing provider, OEMs can no longer realize the price of the asset immediately – making this type of cooperation no more attractive than providing your own financing.

IFRS 16 deals with leasing. Before the new standard came into force, OEMs would establish "operating leases" with third-party companies so that they did not have to include the assets as a liability on their balance sheets. This meant that the OEMs had higher refinancing costs, but their leverage ratio did not increase. Under the new standard, all leases need to appear on all balance sheets. The OEM has to record the asset (with or without refinancing) on an individual contract level, for a high markup from the third-party leasing provider. As a result, the business model for third-party leasing providers essentially no longer exists, and new forms of portfolio refinancing make more sense for OEMs. → B

The new accounting standards are changing the ground rules for OEMs. At the same time, macroeconomic factors are forcing them to diversify their profitability by tapping new income streams, for example by transforming their sales financing from a service-focused activity to a profit-focused activity. Add to this the growing market pressure and it is clear that OEMs need to take a long, hard look at their current strategies and adapt them to the new reality.

This is where captive finance comes into its own as a

B: All change

Impact of the new accounting standards

IMPACT OF NEW ACCOUNTING STANDARDS

CUSTOMER
Elimination of off-balance leasing solutions

OEMS (WITH CAPTIVE)
Elimination of off-balance refinancing solutions

OEMS (WITH PARTNERSHIP)
New requirement to realize revenue over time, if residual value guarantee was given, and reduce total revenue by residual value

THIRD-PARTY PROVIDER
No change

Source: Roland Berger

truly multipurpose tool – one that manufacturers would be ill-advised to neglect. Potentially setting up a captive finance company should be high on the Chief Financial Officer's agenda as it can generate major advantages for refinancing in the area of leasing. It can also boost profits and improve revenue steering. It will likewise be of interest to the Head of Strategy as it enables manufacturers to offer customers a one-stop shop. At the same time, it strengthens the support provided to the Sales department, makes it easier to control prices and discounts, and removes any dependency on third-party providers. The Head of Sales will likely be in favor, too, as captive finance can be a powerful tool for increasing sales.

STRATEGIC QUESTIONS FOR OEMS

When weighing up the pros and cons of establishing a captive finance company, it can be helpful for OEMs to discuss a number of strategic questions at board level. First, if they currently offer sales financing via various units, they should ask themselves: "Can I bundle all my sales financing activities in a central entity?" Ideally, they should align all the products and processes in this entity closely with the sales units so that they provide optimal support for the sales units and the sales process. The other advantage of this approach is that it addresses the desire of customers for a globally standardized offering.

Second, before detailing their exact target operating model, OEMs must ask themselves: "Should I provide the entire sales financing myself?" If they choose to go down this path, they will need their own leasing or banking license. Of course, OEMs have the advantage of direct customer access and also possess strategic advantages compared to third-party financing providers. For example, thanks to their superior asset know-how and unique ability to manage the residual value of their assets, OEMs can offer much more competitive prices than traditional financial institutions.

"Key in our joint project was the early integration of the sales & services units into the process. Only with a holistic approach did we find a suitable solution to support KION's growth."

Wolfgang Köhne
Managing Director KION Financial Services

Third, if the OEM decides to offer sales financing itself, it should ask itself: "How will I meet my refinancing needs?" Under the new accounting standards, sale-and-lease-back solutions on an individual asset level do not offer significant advantages and are very costly. OEMs should therefore focus on two portfolio refinancing options: bond refinancing and ABS (asset-backed securities) refinancing. The former is only suitable for OEMs with very low leverage ratios and outstanding credit ratings from the capital market; in return, it offers attractive conditions and has lower operational requirements. By contrast, ABS refinancing offers highly attractive conditions but requires OEMs to have very precise, up-to-date data on the assets, their use and the conditions that apply. Moreover, only specific assets within the portfolio are suitable for ABS refinancing – assets with values above half a million euros are challenging, as the cluster risk is too high.

Finally, if the OEM decides to continue working with a third-party financing company, it should ask itself: "What partnership model should I employ?" In other words, should it be a white-label or a referral model? In all but a few, specific cases, a white-label model will be preferable; referral models no longer make financial sense under the new accounting standards, as we have seen. For smaller OEMs, a white-label cooperation can be attractive, as the partner provides the financing product under the OEM's brand and the OEM only needs to manage the standards of the overall financing process and ensure its optimal embedding within the sales process.

WHAT LIES AHEAD?

Looking to the future, we expect to see the competition continue growing, putting further pressure on OEMs' margins. One major driver of increased competition is new digital sales channels, especially for standardized and less service-intensive assets. Used machine platforms will also enhance transparency, putting pressure on the secondary market, which also competes with OEMs. In addition, trends such as the sharing economy are changing customer needs and usage models: Demand is shifting away from ownership and toward access. Some customers also prefer usage-based solutions as a way of optimizing their own cost situations.

These tendencies represent an opportunity rather than a threat for OEMs, giving them the perfect chance to vertically integrate. However, there is also the danger that if OEMs do not react and adjust to the new environment, other players will step in and steal their large potential profit pools and established customer access from under their noses. We look at the practical steps that OEMs can take to leverage captive finance as a strategic tool in Chapter 3.

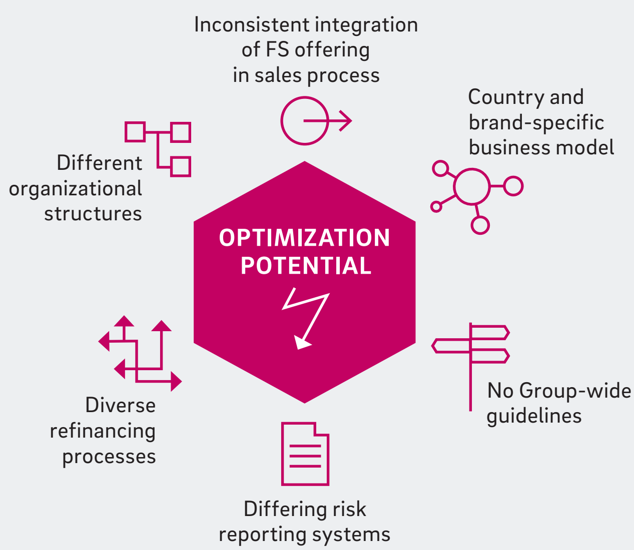
CASE STUDY

Optimizing KION Financial Services

The KION Group, with its main brands Linde and STILL, is the largest manufacturer of industrial trucks in Europe and the second-largest in the world. It is also a global leader in automation technology. Roland Berger worked with the company to develop a long-term strategic plan for its sales financing activities and tap the enormous potential that KION harbored.

Since its flotation on the stock market, KION's leasing activities had been reported in its Financial Services segment, while a few countries with significant leasing business had separate legal entities for these activities. The leasing business differed substantially from country to country, and no central steering and refinancing or single overarching IT system existed. In 2014 KION's Board decided to set up a strategy project

C: A new way forward
Analysis of optimization potential at KION



Source: Roland Berger

to define its future leasing strategy. This decision was triggered by two important events: the payback of the final carve-out related bond, which meant that KION Financial Services could completely renegotiate its refinancing schemes, and changes in the accounting standards, which were expected to have a significant impact on the leasing business.

Working closely with KION, Roland Berger carried out a detailed analysis of the sales units' current capabilities and requirements. This revealed numerous areas of optimization potential, on the basis of which we started our project. → C

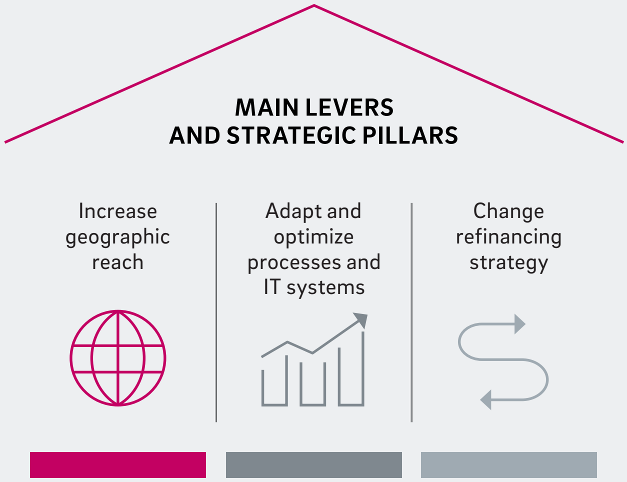
THREE LEVERS

It soon became clear that the entire organization, including governance, needed to address three key levers. These levers then formed the basis of the new strategy.

The first lever was optimizing processes and IT systems. The core processes for KION Financial Services – credit checks, dunning procedures, data quality and residual value methodology – needed to be aligned across the different operating models. Standardizing processes not only improved quality standards, it also significantly shortened time-to-market. Unifying the IT system improved management and control, and also the interface with the sales unit. In addition, the new system has enhanced data quality and data history, both of which are prerequisites for optimizing refinancing. Continuously improving process quality and efficiency cut fixed costs compared to the portfolio under management. It also more than compensated for the increase in tasks and activities, such as sales support and the insourcing of contract management and accounting.

The second lever was changing the refinancing strategy. KION previously funded its leasing business solely with sale-and-lease-back on an individual asset level and indirect leasing, which are both costly and complex, as well as requiring the involvement of a financing partner. To optimize its funding position, the company needed to move from individual contract refinancing to portfolio refinancing, such as ABS. Funding responsibility was transferred to KION Group, and a Financial Services Treasury was established in 2016 to change the funding structure and enable state-of-the-art funding tools. KION could now fund at more competitive rates and increase its independence from existing leasing/banking partners by relying on capital market investors. Improving the refinancing conditions enabled KION Corporate Treasury to significantly reduce its refinancing costs. The low refinancing cost is structurally dependent on professional credit checks, clear dunning procedures, segregation of duties (between Sales and Services on the one hand, and the captives on the other) and low customer default rates.

D: A new way forward
Three steps to overhaul the entire organization



Source: Roland Berger

Icon: rajakumara/The Noun Project

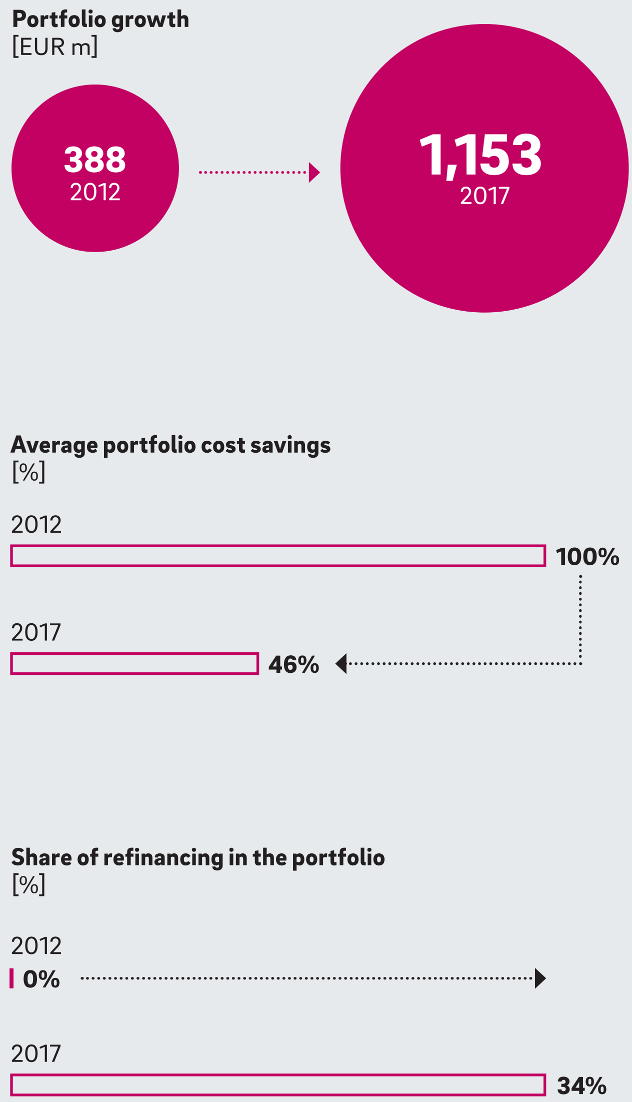
The third and final lever was increasing geographical reach. Roland Berger developed a new concept that distinguished between hubs (countries where KION has a captive), spokes, and remaining countries. This model enables optimal coverage of the leasing business in any country where KION is present, while taking the differing local conditions into account. Captives ensure full coverage of the local market. They are set up as separate legal entities, make their own leasing business and grow their own portfolio. Spokes are used in countries with less leasing business. They can be a separate legal entity and have their own staff, but they receive services from their hub in order to tap into synergies and achieve economies of scale. In the remaining countries, the leasing business forms part of the local sales and service entities. Employees of the local unit manage the leasing business but are supported by a dedicated contact person at the KION Financial Services headquarters. → D

PROJECT SUCCESS AND OUTLOOK

The project resulted in a vast improvement in refinancing conditions: Refinancing costs were cut in half. The company has seen significant portfolio growth and now enjoys systematic economies of scale and improved risk management. These factors have led to a substantial increase in the profitability of the business model. In addition, KION Financial Services and its captives have been fully accepted and are in demand as active sales support solution providers across the globe.

Going forward, KION plans to develop along three axes. First, although a large share of the business is already covered by KION Financial Services, additional potential exists due to the fact that some new business still goes to external bank partners. Using the captive for this business will lead to substantial growth of the portfolio. Second, KION aims to capture the full market potential of new captive countries by rolling out its own presence in several markets, either with full-fledged captives or using the hub-and-spoke model. Finally, the company aims to further raise the profitability of its business model by improving process quality and efficiency on a continuous basis. → E

E: A success story
The impact of KION's new refinancing model



Source: Roland Berger

3. Lessons learned

Five rules of thumb for effectively leveraging captive finance

How should OEMs approach captive finance? And how can they maximize its potential as a multipurpose strategic tool? Our work with companies such as KION has given us a number of insights. Below, we present our five rules of thumb.

1 ALIGN THE FINANCIAL SERVICES UNIT AS A SUPPORT FUNCTION FOR THE SALES UNITS

The financial services unit must be set up with the needs of the sales units in mind. It should also be involved in the sales process at an early stage. Aligning the financial services unit in this fashion will enable it to realize its full potential as a contributor to the company's overall profitability.

2 INVOLVE THE SALES UNITS EARLY ON IN THE STRATEGY PROCESS

It is important that the strategy developed by top management is accepted – and implemented – by the entire company. Involving the sales units early on in the strategy process increases the likelihood of the new strategy taking root within the company. To ensure buy-in it is also critical to take the special requirements of the sales units into account.

3 REFINANCE THE PORTFOLIO INTELLIGENTLY

OEMs must choose appropriate refinancing instruments. This is the key to being able to offer attractive conditions at the point of sale and to making the financial services unit profitable. For portfolios of at least EUR 75 million, an ABS transaction is advisable.

4 UNIFY THE PROCESSES AND IT SYSTEM

Unifying processes and the IT system generates economies of scale and guarantees fast response times. Core processes should be clearly defined and harmonized. At least five years of data history is required for refinancing – and the better the data quality, the better the refinancing conditions that the OEM can achieve. Companies should also consider setting up an interface between the ERP system and the contract management system.

5 MODIFY THE KPI SYSTEM

Captives are usually subject to the company's overall KPI system. OEMs should therefore modify the KPIs so that they take the specific nature of the financing business into account. This should be done at the very beginning of the process as it takes time to measure the direct impact of financing operations. The choice of financing instruments may also depend on the KPI system. For example, if the company uses net cashflow to steer its operations it will not be able to implement global borrower's note loans.

Times have changed for OEMs. If it wasn't already clear from the macroeconomic factors, new competitive dynamic and growing customer demand for one-stop shops, then at the very latest the recent changes in accounting standards force manufacturers to take swift action. This is the last chance for OEMs to react to the new realities and develop their own effective sales financing strategy. If they make the necessary changes they will find that they not only maintain current profits but can tap new profit pools. If they fail to do so, they face difficult times ahead.

WE WELCOME YOUR QUESTIONS, COMMENTS AND SUGGESTIONS

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