CAPTIVE FINANCE

Captives must find balance between risk and reward

Derek Soper

There is a recognition that the added value of a captive to a manufacturer is gaining in understanding among industry members. This value comes from three sources. Firstly, the additional sales of products that are driven by the close working relationship between the manufacturer and its captive. This is based on the principle of only serving one customer. Secondly, the inherent value in the captive as a business in its own right and capable of being sold in future, if required. Thirdly, the profit contribution from the financing activity.

Captive financing has gained momentum as more and more manufacturers realise their brand name has value that can be extended beyond the physical product. This value now also includes a dedicated source of financial services and a wider customer experience commensurate with the brand. The opportunity to tie the customer closer is attractive, as is the opportunity to boost sales and earn incremental revenue and profit from competitive financing. They also see the value of locking in the customer to repeat business.

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As captive financing gains in strength, it is recognised that the captive's role can be enhanced beyond just providing finance as a commodity product, to also being the provider of considerable value-added services. Many successful captives have demonstrated their capability of managing the business as an integral part of the manufacturer's activities, but some still struggle with this. An attractive range of in-house financing products and services not only satisfies customers' needs, it is also an important opportunity to gather customer data, resulting in the potential for excellent customer-relationship management.

Parents know best

A captive's contribution to the parent's bottom line will be driven by the parent's strategy. Senior management within the parent need to have an inherent philosophy in support of a captive, without which there will be a political gap that is difficult to bridge. This may mean controlled development of the captive, including making sure the required disciplines are in place and are not in the wrong hands within the organisation. It may mean providing excellent income streams and margin contribution. It may also mean providing sustainable profitability throughout the business cycle, which might involve strengthening customer loyalty. All these are good targets for a start-up captive.

A captive will always be mindful of the fact its parent is a manufacturer with different cultural behaviour to a finance subsidiary and that finance is not necessarily always a core group activity. A captive must, therefore, strive to add value and be innovative.

As captives serve their parent and a wide range of customers, expand into a broader range of products and services, and work collaboratively with the parent's brand, effective marketing is crucial. Having access to comprehensive customer data, captives can develop personalised marketing strategies structured to meet a customer's particular needs and focus on maximising lifetime value. Gaining a complete insight into customer needs improves captives' ability to cross-sell and up-sell financial offerings.

One-stop-shops

An important selling point is the convenience captive finance provides for customers, using one source for their equipment and financial needs where there is a strong emphasis on customer care and attention. The customer should enjoy a positive experience and will be looking for benefits such as simplicity, transparency, reliability, competence and flexibility. Also, wherever possible, the customer will be looking for a single invoicing source to cover all the goods and services supplied by a single manufacturer.

At the end of the lease term, both parent and captive are dealing with the relationship of a customer of the same group. A captive, in conjunction with its parent, should be able to sell used or off-lease equipment at the best prices, which might, in turn, facilitate more competitive pricing. It is also interesting to remember that, in the current circumstances of a world credit crunch, banks seem more willing to lend to their industrial customers than to each other. This has affected pricing and often the best deal can be done via the captive.

Frequently, we see tensions in the relationship between parent and captive, not least, for example, in the approach to residual values. The parent's focus on sales and market share may be at odds with the captive's objective of residual value accuracy. However, at the end of the day, they are both focused on enhancing the group's bottom line and common goals usually prevail.

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Pitfalls

Not all captives have been successful. Some have taken on the mantle of a 'general finance company' and consequently strayed so far outside of the parent's industry that they became strategically irrelevant. Some have failed to achieve the necessary 'simpatico' with the parent's sales activity. Some have gone the other way and generated just too much risk for the parent's appetite.

Clearly, a balance is needed and it takes a very aware management on both sides to ensure the imposition of financial disciplines within the finance subsidiary and couple this with the sales freedom that an equipment salesforce will seek.

A number of captive lessors have recently formed an informal union of like-minded businesses because their needs were not being met by any official trade association. The European Captives Forum, run under the auspices of my firm and funded by two major captives, meets regularly and provides an opportunity for the management of the captives to discuss market trends, common problems and issues, and how leasing and finance industry issues may affect them. There are some very prominent members of this expanding forum who value the opportunity to share concerns and experiences in an open manner.

The author is chairman of The Alta Group, 'Advisors to the Asset Finance Industry'

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