

CAPTIVE FINANCE HOUSES

The rise and rise of the captive

Alan Leesmith looks at how captive finance houses create shareholder value

At the recent *Leasing Life* Vendor Finance Summit in Paris, I raised the question as to what was leading to “the rise and rise of the captive”. In the motor sector the captive has been long established and more widespread than in some of the equipment sectors I was addressing, but many of the observations remain the same.

First, we must define what we mean by a captive. This is probably easier said than done, since there are many variations in what people mean. I would suggest that there are probably two key factors necessary: firstly, that the manufacturer/distributor recognises the opportunity for potential profit from a captive in its own right; and secondly, that the manufacturer establishes its own in-house operation dedicated to handling the financing of the provision of its equipment. Beyond that there is a whole range of variations as to whether the captive holds the leases on its own balance sheet, whether it takes the credit and other risks.

“A CAPTIVE NEEDS TO BE A FINANCIAL SERVICES COMPANY, NOT JUST ANOTHER SALES ARM, YET ITS PRIME PURPOSE IS TO SUPPORT AND INCREASE SALES”

The challenge that faces a captive is the fact that it needs to be a financial services company, not just another sales arm, and yet its prime purpose is to support and increase sales, leaving it with the very difficult task of managing the demarcation line between “yes” and “no” on credit. However, if it can successfully manage the portfolio in a manner which maintains, protects and grows the parent company’s customer base, then the sensitivity over a



■ Alan Leesmith

rejected credit can almost go away. Another challenge is working in an environment where a different business philosophy is bound to exist between a financial services company and a manufacturer, particularly in the approach to human resources.

One should also overlook some of the macro issues at a strategic level. The return on capital a manufacturer will normally be looking for (at least in good times) will be higher than one would normally expect to see from a finance business. The extensive borrowings that a captive will need may impact significantly on the parent company’s balance sheet, leading to competing for resources.

The impact of regulatory and compliance issues across numerous countries will introduce challenges to a parent that it will not be used to dealing with. If the finance arm decides that it wishes to become a bank, for what it may see as regulatory benefits (very broadly speaking, supervision primarily coming under the one regulatory authority), this could completely unnerve a parent board used to dealing in a manufacturing environment; particularly now US parents have so many concerns over

Sarbanes-Oxley.

A matter more of concern for the captive rather than the parent will be the expectation of provision of support and facilities in many geographical markets where the volumes are small, and cannot support a finance company infrastructure. The captive may need to find ways to service those markets.

“THE IMPACT OF REGULATORY AND COMPLIANCE ISSUES ACROSS NUMEROUS COUNTRIES WILL INTRODUCE CHALLENGES TO A PARENT THAT IT WILL NOT BE USED TO DEALING WITH”

So why do so many manufacturers go it alone and set up their own captives when there is no shortage of professional finance companies to support them and provide the facilities? At the conference, there was a view expressed by several speakers that perhaps third-party lessors are nowadays falling short on meeting the needs of vendors; in other words, they have not kept pace with the changing demands of the market.

The captive is much closer to its customer base than a third-party lessor and can sometimes see good reasons for accepting a credit that a finance company may not. If, as a result of a lessor only accepting part of the business, a vendor decides to accept the odd deal or two, or three or four and the numbers accepted grow, then the vendor ends up in the leasing business anyway. As more get accepted then the vendor needs resources to administer them – and, worse, it will almost certainly be taking the poorer business and giving away the best. At that stage the inevitable question arises as to why it is sharing the

profits when it is taking the major part of any risk.

But we have yet to reflect on the most valuable part for the vendor and that is shareholder value. If done properly, a captive enables a manufacturer not only to have access to a finance provider that is more focused and ‘understanding’ of the business and product cycle, but also to create a valuable second business which is profitable in its own right. In turn that also generates increased earnings per share, leading to an increased share price. That captive, if run properly, will create a valuable standalone business that can be sold should the desire or need arise in the future.

“THE CAPTIVE CAN SOMETIMES SEE GOOD REASONS FOR ACCEPTING A CREDIT THAT A THIRD-PARTY LESSOR MAY NOT”

In the past we have seen examples of captives go on to be full third-party lessors of considerable value to their shareholders, for example GE Capital, and others that have more than proven their worth by being available to sell when the parent needed the cash, such as GMAC. It will be interesting to see what the future holds in store for Ford Motor Credit, Ford having already sold Jaguar and Land Rover in order to raise cash.

In conclusion, I leave you to ponder the question: “What does the manufacturer who uses a third-party lessor have to show in its balance sheet at the end of the day and how does it explain the lack of value to its shareholders?” I am sure this question will provoke some debate.

The author is managing principal – The Alta Group EMEA