CHAPTER SIX

Profiting from Vendor Leasing

PREFACE

This chapter highlights the significance and benefits of vendor leasing programs as a source of origination to independent and bank-based lessors. It provides the reader with a detailed list of vendor motivations to utilize lease financing. The complex motivator, revenue recognition, is explained in simple terms; with a conclusion that the best of both worlds for the two parties is for the vendor to sell equipment to the lessor with recourse amounting to less than 10 percent of the fair value of the equipment. The vendor benefits from immediate revenue recognition and avails of the benefits of sales-aid leasing; the lessor benefits from partial recourse, enabling it to be more competitive in the marketplace.

The chapter then details the various types of programs and lists the pros and cons of each program type to both parties, concluding that the two preferred types are third-party and private label programs. Pros and cons of a vendor choosing the captive approach are discussed. This guides independent lessors in convincing vendors not to form captive finance subsidiaries; thereby encouraging them to enter into alliances with third-party lessors.

The chapter concludes by listing and explaining the host of benefits that vendor leasing programs offer the vendor, the lessor and the customer — essentially a win-win-win! Lessors gain a thorough understanding of the key elements of a program, as well as techniques to mitigate risks emanating from the program. Emphasis is placed on vendor equity insertion. Management, business development, and sales personnel will benefit from the extensive explanations provided to either enter into or tweak existing vendor programs; others will gain an understanding about the significance, the benefits, and the mechanisms of the programs.

Introduction

Leasing companies use three principal means to generate new business. These are:

- **Direct** – where transactions are originated directly by the lessor's salaried sales team. This is done in person, as well as via telesales or telemarketing.

- **Indirect** – where third parties, such as brokers or packagers, are used to bring in transactions. Generally, third parties – particularly brokers, are more common when a country has a large land mass which makes it impractical to have sales representatives located in each and every principal location. Brokers are a source of business in large countries like Australia, China and the U.S.A. This is not to say that brokers do not exist in smaller countries such as the U.K.

- **Vendor** – where a manufacturer, dealer, or distributor – essentially, the seller of goods, originates lease financing transactions through its finance subsidiary, or enters into an alliance with a third-party lessor and provides the lessor with a steady source of volume

This chapter reviews why vendors are motivated to utilize lease financing, and the benefits of vendor leasing programs to vendors and third-party lessors.

Definition

Vendor leasing is often referred to as sales-aid leasing; and, it can be divided into two categories:

- Leasing done by captive lessors – where the seller of goods establishes a wholly-owned subsidiary to offer lease financing. Such a subsidiary is referred to as a captive lessor. Typically, a captive leases the products manufactured by its parent or sold by the dealer; but, many captives have strategically diversified into leasing products manufactured by others.

- Leasing done by third-party lessors – where the seller of goods chooses to lease products to its customers through an independent third-party leasing company, be it a bank or a pure independent.

When the expression "vendor leasing" is used in this chapter, it refers to either of the above two forms.

The substance, and therefore the content, in this chapter is focused on vendor leasing programs between a seller of goods and a third-party lessor. More so, the content is geared to independent and bank lessors having to do with why vendor leasing programs play – or should play, a significant role in their origination mix.

Vendor Motivations

Before delving into arrangements between vendors and third-party lessors, it is important for lessors to understand the motivations that vendors have to utilize lease financing.

Vendors establish leasing programs, be it on their own or with others, for numerous reasons. Although each vendor has unique motivations for offering lease financing, they all share certain common ground.

The motivations include:

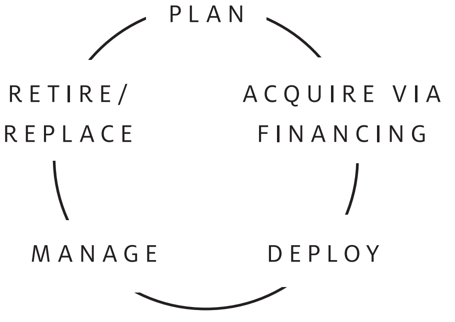
- Market control
- Market enhancement
- Competitive advantage
- Ancillary income
- Revenue recognition
- Services to parent company

Prior to reviewing the varied motivations and benefits, one needs to grasp the concept of asset life cycle management, as this is an integral part of vendor leasing and has substantial benefits to both the vendor and the third-party lessor.

ASSET LIFE CYCLE MANAGEMENT

Asset life cycle management and operating leases go hand in hand. Vendors, on their own, are fully capable of offering all the services having to do with the life cycle of a lease. Third-party lessors, particularly those who specialize in one or two asset types, are also fully capable of offering the services entailed in asset life cycle management; but, alliances between vendors and lessors provide enhanced benefits to their customers owing to the synergy between the two parties.

Asset life cycle management is best diagrammed.



Each stage is an opportunity for lessors to engage with the lessee and many stages create opportunities for profit.

- **Plan:** At the onset, the lessor assists the lessee in equipment acquisition planning. This includes arriving at the most appropriate equipment type and configuration for the intended term of the project. Lessors who specialize in a certain asset class are best-suited to offer this service.

- **Acquire:** The lessor offers on-the-spot financing. Volume purchase discounts enable the lessee to get favorable terms, if such discounts are passed on.

- **Deploy:** The asset is put into use. The lessor may finance services such as training and installation in order to get the asset ready for its intended use.

- **Manage:** This stage creates the opportunity to provide upgrades, maintenance, and additional products.

- **Retire:** At the termination of the lease, if the equipment is being returned, the lessor strives to get the lessee into new equipment financed by the lessor.

A detailed discussion on each of the vendor's motivations follows.

MARKET CONTROL

Market control, in its various forms, represents one of the most compelling reasons for a vendor to offer leasing. Market control ensues owing to the ongoing relationship between the vendor and the lessee created by the lease contract. Market control has varied benefits associated with it. Keeping in mind that a lease contract has three phases – inception, duration, and termination, the benefits include:

- Initial sale
- Sales during term
- Disposition
- Control over used equipment prices

Initial Sale

Market control through leasing begins with the initial sale of the equipment. Assume that a potential customer has decided to acquire some equipment, but is unwilling to consummate the transaction until financing has been obtained. Without on-the-spot financing provided via vendor leasing, any of the following events are likely to occur:

- While seeking financing, the potential customer might lose interest in the equipment – a type of premature buyer's remorse

- A funding source of the potential customer might dissuade the customer from acquiring the equipment in order to have the customer acquire a competing product which the funding source finances

- The potential customer might become discouraged, not with the product but with the process and hassle involved in obtaining financing

- During the search for financing, a competitor might convince the potential customer that its product is superior

Each of the above scenarios would result in a lost sale. Vendors therefore strive to close the transaction immediately, including the financing, to avoid any risks of losing the sale.

Sales during Term

Once the initial sale and its financing have been completed, another important control function begins. Ongoing contact throughout the lease term influences the lessee's purchase of additional vendor products and services.

Typical products and services provided by vendor-lessors during the lease term include equipment parts, supplies, maintenance, software and human resources. The vendor also has an inside track with the lessee when it comes to upgrading the equipment to increase efficiency or capacity.

Early termination options pertaining to operating leases, as explained in detail in Chapter Five, provide the lessor with substantial opportunities, both with the existing customer and a new customer who will lease the used equipment that has been returned.

Disposition

Another critical aspect of control occurs at the termination of the initial lease term. On operating leases, the lessee has three options to choose from at the end of the lease:

- Purchase the equipment
- Renew the lease
- Return the equipment

The lessee is contractually bound, in most cases, to inform the lessor in writing as to which alternative will be selected. This notification is required anywhere from one to six months before the end of the lease, depending on contractual negotiations between the two parties and the term of the lease. Once the lessee's intentions are known, the vendor can determine the lessee's new requirements. This contact occurs well before competition is even aware that an opportunity exists.

If the lessee opts to purchase the equipment, the vendor can offer to finance the purchase via another lease. A renewal provides the lessor with the opportunity to maintain continuing contact. If the lessee chooses to return the equipment, the lessor will offer to finance replacement equipment.

Control over Used Equipment Prices

Another important element of market control is the vendor's ability to impact the availability and prices of used equipment.

Used equipment becomes available to vendor-lessors from several sources:

- Equipment returned at the end of the lease term
- Equipment returned on early terminations
- A buy-back or repurchase at the end of the lease
- Equipment returned because of upgrades
- Repossessed equipment owing to default
- Trade-ins on new equipment

Through all of the above sources, the vendor-lessor obtains a large quantity of used equipment which enables it to impact and/or control used equipment prices.

Control over the resale price of used equipment ensures that used equipment prices do not become so low that the sales of new equipment are impaired; and, that yields in the vendor's existing and future leases are reduced because of the lessor's inability to realize sufficient residual values.

The cross-elasticity problems that impair sales can be solved through vendor leasing. The vendor-lessor can control the impact of used equipment on new equipment sales if, for instance, it can sell returned equipment in non-competing markets, such as those overseas. Keeping a vendor's used equipment out of its traditional markets helps reduce downward price pressures on both new and used equipment sales.

Low resale values on used equipment result primarily from technological obsolescence and the disposal of equipment by users and other parties at low prices. Obsolescence is caused by a host of factors. However, obsolescence is relative – what is inadequate capacity to one company is not necessarily inadequate to another. Leasing, with potential reversion of equipment to the lessor, allows the lessor to find another customer whose needs can be met with the same piece of equipment.

If the customer were to be allowed to dispose of the equipment, it might be sold at a price so low as to adversely affect the used equipment market. The lessor has a greater understanding of the marketplace because of its continual presence and its marketing organization. Such understanding usually leads to higher prices.

MARKET ENHANCEMENT

Market enhancement is another compelling motivation behind vendor leasing. The vendor benefits via:

- Increased sales volume
- Preservation of selling price

Increased Sales Volume

The expression "sales-aid leasing" has to do with the fact that lease financing increases sales. It was explained earlier that many a sale would be lost if it were not for on-the-spot financing that is made available through vendor financing. Besides preventing lost sales, vendor leasing makes financing available to facilitate incremental sales. Also, studies have shown that repeat sales occur more frequently as customers benefit substantially from the varied benefits that vendor leasing offers them.

Captive lessors, either on their own or through vendor programs with independent lessors, often offer rent-to-buy programs. The use of such programs is a technique used to expand sales volume. These programs entice users to purchase equipment by allowing a part of each rental payment to accrue towards the purchase price. This "try it, you'll like it" approach is valuable for both parties. Although the user may return the equipment at any time, the lessor has received at least a partial recovery of its investment from the rentals received.

Another method of expanding sales volume is through takeout/rollover leasing programs. A takeout occurs when the lessor takes out the customer's existing equipment so the vendor's new equipment can be installed. This obviously leads to incremental sales.

Many customers will not acquire equipment other than through operating leases. If the manufacturer does not provide an operating lease program, a sale might be lost. Hence, when operating leases are offered, incremental sales take place.

Sales volume can also be increased through the use of vendor guarantees. Manufacturers oftentimes are reluctant to provide financing on their own owing to a host of reasons – as will be explained later in this chapter. In this situation, third-party lessors will provide the required equipment financing and other services at attractive rates, thus promoting and increasing sales. Frequently, however, these independent lessors require vendor guarantees to mitigate their residual risk particularly on high-technology equipment that is deemed too risky and difficult to resell. Vendors can offer several types of guarantees to overcome the independent lessor's residual risk. The guarantees include the following:

- Guaranteed residual, where the vendor guaranties a portion of the lessor's residual.

- Priority remarketing agreements that require the manufacturer to resell the lessor's returned equipment ahead of other used equipment.

- Repurchase agreements that require the vendor to repurchase the lessor's equipment that has been returned or repossessed.

- Net loss indemnity agreements that require the vendor to reimburse the lessor for losses of any kind such as defaults, repossessions, and salvage. The losses are limited to a certain percentage of a block of leases funded over a fixed time period by the lessor.

Some of the guarantees are explained in greater detail later on in this chapter.

Preservation of Selling Price

In the context of price, the only effective tool a salesperson has is to discount the list price. Discounting, however, results in lower gross profits. When a vendor uses leasing, the product attributes and the financing are combined, thereby making the purchase price less visible.

List price discounting is avoided because the combined product and financial package divert the customer's attention from the purchase price. The elements of a lease (term, rate, purchase option, etc.) provide the salesperson with additional marketing tools. In many instances, the financing costs are not fully understood by the lessee and the diversion from list price discounting is easily attainable. Furthermore, when full-service leasing is used in which other services such as maintenance are bundled into the lease, it is difficult for even astute lessees to determine the real cost of the equipment component.

COMPETITIVE ADVANTAGE

Through market control and enhancement, the vendor is able to increase its market share – this by itself provides the vendor with a competitive advantage in the marketplace. If the vendor enters into a vendor leasing program with a third-party lessor, the customers benefit from a service-driven strategy – the benefits to the customers are detailed later in this chapter. Hence, the vendor not only increases market share but also services its customers much better than its competitors who do not enter into vendor leasing programs.

ANCILLARY INCOME

Besides the incremental income from the sale of products owing to sales-aid leasing, vendor leasing provides the vendor with a host of opportunities to create ancillary income. Such income includes:

- Direct income from leases
- Full-service leases
- Residual profit

Direct Income from Leases

If the vendor-lessor leases equipment on its own, the income depends on whether the lease is a finance or an operating lease from an accounting point of view:

- **Finance lease:** This type of lease enables the lessor to claim interest income. Interest income is accelerated; in that there is more income in the early years, less in the latter years

- **Operating lease:** This type of lease enables the lessor to claim a margin which is the difference between rental income and depreciation. The margin is generally linear.

Of course, if the vendor enters into a vendor program with a third-party lessor, the vendor will not show income from the lease – the third-party lessor will. The vendor will recognize revenue from the sale. A detailed explanation of revenue recognition follows.

Full-Service Leases

A full-service lease, in which additional products and services are bundled with the lease, increases ancillary income to the degree that these services and products represent incremental sales to the vendor.

Residual Profit

If equipment is returned to the vendor on an operating lease originated by the vendor in its own portfolio, and if such equipment is sold for more than its remaining book value, residual profit is created.

REVENUE RECOGNITION

The essence of vendor leasing is the fact that lease financing facilitates incremental sales, which result in incremental revenue. Recognition of revenue is a fairly complex issue. It is best understood by examining the varied sale options a vendor has. These include:

- Outright sale to end user
- Sale to third-party lessor with no recourse
- Sale to third-party lessor with limited recourse
- Sale to third-party lessor with recourse

In three of the above instances, the vendor makes a sale and does not book a lease in its portfolio. However, if the vendor sells the equipment to a third-party lessor with recourse, this does not constitute a sale as revenue is deferred.

Outright Sale to End User

This is the simplest of the above three scenarios. When a seller of goods makes an outright sale to the end user, revenue is recognized immediately.

Sale to Third-Party Lessor with No Recourse

Vendor recourse includes items such as repurchase agreements, residual guarantees, and first-net loss pools. These items will be discussed in greater detail in this chapter.

When a vendor sells equipment to a lessor and the vendor has no recourse, revenue is recognized immediately. This is no different than an outright sale to the end user.

Sale to Third-Party Lessor with Limited Recourse

When a vendor sells equipment to a lessor on a limited recourse basis, revenue, net of recourse, is recognized. What constitutes limited recourse, from an accounting point of view, is not very clear; but, has generally been defined as follows: the present value of the recourse is less than 10 percent of the fair value of the equipment.

ILLUSTRATION

Equipment fair value	$100,000
Term	48 months
Interest rate in lease	10%
Residual value	$25,000
Vendor residual guaranty	$12,500

The vendor has guaranteed, on a first-net loss basis, 50 percent of the residual. The present value of $12,500 discounted over 48 months at 10 percent is $8,392.90, which is 8.39 percent of the fair value of the equipment. As 8.39 percent is less than 10 percent, the revenue, net of the provision for the guaranty, will be recognized when the sale is made to the lessor. Hence, revenue of $100,000 - $8,392.20 will be recognized up front in the transaction. The $8,392.20 will then be recognized as revenue when the performance obligation ends, which will be at the end of the lease term.

Sale to Third-Party Lessor with Recourse

When a vendor sells to a third-party lessor, and where the vendor is at recourse to an extent equal to or greater than 10 percent on a present value basis of the fair value of the equipment, revenue will not be recognized immediately; but, will be deferred until the performance obligation ends.

SUMMARY OF IMPACT OF SALES BY VENDOR

Based on the above, a summary follows:

Sale	Revenue Treatment	Impact and Comments
To end user	Recognized	Preferred revenue treatment for the vendor; yet, no benefit from sales-aid leasing.
To lessor, with no recourse	Recognized	Preferred revenue treatment for the vendor; both vendor and lessor benefit from sales-aid leasing.
To lessor, with recourse less than 10 percent of fair value of equipment	Recognized	Same as above. Lessor also benefits from vendor recourse.
To lessor, with recourse equal to or greater than 10 percent of fair value of equipment	Deferred	This is a mixed bag. Recourse is typically provided by vendors to facilitate operating leases done by third-party lessors. The vendor benefits via sales-aid leasing; yet, is not able to recognize revenue when the sale is made. The third-party lessor benefits from vendor recourse making it easier to do the operating lease, which in turn benefits the vendor as it facilitates the sale.

Vendor Books the Lease

In each of the above four scenarios, the vendor made a sale – either to the end user or to a third-party lessor. If the vendor chooses to lease directly, either on its own or through its wholly owned captive, there are two scenarios depending on the type of lease.

FINANCE LEASE

A finance lease (sales-type lease under U.S. GAAP) occurs when the economic substance of such points towards a conditional sales contract. If there is selling profit, where fair value is greater than asset cost, in a finance/sales-type lease, the selling profit can be recognized.
The lessor's income statement on a sales-type lease will reflect revenue, net

of the present value of the residual, when the lease is incepted; and, interest income will be reported over the term of the lease.

OPERATING LEASE

When the lease is classified as an operating lease, revenue is deferred and taken into income on a linear basis in the form of rental income less depreciation. Depreciation is limited to the cost of the goods.

An important point should be noted here. If some or all of a vendor's customers prefer operating leases, vendor programs with third-party lessors make good sense, as the vendor is more likely to recognize revenue immediately if it sells the equipment to its lessor partner. As previously noted, it is common for a vendor to be on recourse with respect to operating leases in a third-party program. But if the extent of the recourse can be less than 10 percent on a present value basis, which most vendor leasing programs strive for, then the vendor will recognize the sale and its revenue, net of the provision, when the sale is made. However, if the vendor directly does an operating lease, the revenue is deferred.

The above point should be used by lessors, over and beyond pointing out other benefits that accrue to a vendor from a third-party leasing program, to convince vendors – whose customers prefer operating leases, to not engage in leasing directly, but to enter into a vendor leasing program with the lessor.

Summary to Revenue Recognition

This section has briefly touched on revenue recognition to provide the non-accountant-type reader with a brief summary of how varied approaches impact the vendor's recognition of revenue. In the real world, revenue recognition has substantial complexities. Those seeking to better understand the topic should read IFRS 15 and Topic 606.

SERVICES TO PARENT COMPANY

Beyond the marketing and other objectives achieved through vendor leasing, the vendor's captive finance subsidiary can provide several valuable services to the parent.

Parent's Leasing Requirements

Because the captive lessor specializes in financing equipment, it makes sense to allow it to utilize its expertise in arranging for the financing and leasing of equipment used by the parent and its subsidiaries. The captive, in effect, becomes a specialized leasing agent for the parent.

Diversifying the Parent's Income Sources

When sales of the parent's products decline in any given year, the interest earned on its leasing portfolio can help fill the gap. Since leasing portfolios consist of leases at various stages of maturity, a reduction in current year sales would not affect the portfolio's interest earnings for several years, thereby allowing time for the slump in product sales to reverse.

Many captives provide lease financing on equipment other than the parent's equipment that is of a non-competing nature from the parent's point of view. This helps augment the parent's income in consolidation.

Types of Vendor Leasing Programs

Vendors have a choice. They can provide equipment financing on their own, either directly or through a captive, or they can enter into third-party leasing programs with independent lessors. Some vendors decide to pursue both routes – maintaining their own portfolio and working with third-parties.
The choice(s) that the vendor selects depends on a host of factors to include

capital availability, efficient allocation of capital, vendor expertise, and cost constraints. But it is important to note that the varied motivations listed above, other than services to the parent company, can be achieved through vendor leasing in either form, be it through a captive or be it through a third-party program.

When a vendor works with third-party lessors, such can be done through one or more of the following program types:

- Referral
- Third party
- Private label
- Virtual joint venture
- Joint venture

The details provided below delineate the key characteristics of each program type and list the key advantages and disadvantages of each program type to the vendor.

Another section – far more important, will list the multiplicity of benefits of vendor programs to lessors.

REFERRAL

Many vendors do not enter into formal agreements with lessors. They choose to refer financing leads to a handful of lessors from a short list they have compiled.

Advantages

Not entering into an alliance with a single lessor provides the vendor with a broad choice of funders. This may also be of benefit to the vendor's customers as the leasing companies will each have varied strengths and weaknesses allowing the lessee to decide who to lease from.

Another benefit to the vendor has to do with performance obligations. Such obligations, to be discussed later, are typically found in formal programs. When a vendor simply refers transactions to lessors, such obligations are not the norm.

Disadvantages

Unless the vendor has done substantial due diligence on each of the short-listed leasing companies, a referral program could lead to unstable funding. As importantly, there is no organized central control of the program; essentially, a referral program is not a program at all! Most importantly, there is no synergy between the vendor and the various lessors, synergy being vital to the success of any concerted effort to increase sales and avail of varied other benefits.

THIRD PARTY

Third-party programs are perhaps the most common type of vendor leasing programs wherein the vendor and an independent lessor enter into a formal agreement.

The key elements of the agreement are as follows:

- **Lessor-branded:** The documents carry the name of the leasing company
- **Exclusive:** The vendor generally agrees to have all of its equipment, in a certain country or region, financed by its partner, the lessor

Advantages

Third-party programs offer a quick start to equipment financing. After each party has undertaken the necessary due diligence, and after the initial set-up work has been done, the two parties end up as reliable partners.

Some other key benefits of this type of program are:

- **Vendor leverages lessor's talent**

  This is a key benefit whereby the lessor's salesforce and its operations department take on varied responsibilities for closing the transactions. Whether the vendor refers the customer, or whether the end user submits the application for lease financing online, the lessor's salesperson liaises with the customer, gauges the customer needs, tailors the transaction where appropriate, and closes the transaction.

  Once the transaction is closed, the lessor's back office takes over – they bill and collect. Also, varied customer needs such as restructuring the lease, financing upgrades, etc. are met by the lessor.

  At the end of term, the lessor's asset management department steps in to remarket the equipment, unless the lessor has entered into a remarketing agreement with the vendor.

  To summarize, the vendor is hardly involved in the transaction other than when customers wish to upgrade or refresh the equipment; or, at the end of term as stated above.

- **Utilization of third-party balance sheet**

  This is another key benefit. Vendors almost always have a much lower gearing ratio than leasing companies do. Higher gearing obviously means higher risk. If a vendor chooses the captive route, its consolidated balance sheet will show the higher gearing ratio. The higher ratio, in turn, translates into a higher cost of capital which can have many adverse consequences.

Also, a pure manufacturing company is likely to have a higher price earning multiple as compared to a diversified entity which includes a finance subsidiary. This is a principal reason why many publicly listed manufacturers have shed their captive subsidiaries.

- **Few resources required**

  Money is not unlimited. Many, actually most, vendors prefer to allocate scarce capital to their core business. Also, direct originations require a large salesforce with a commensurately large back office. Given that third-party programs require few human resources – one or two key sales coordinators who coordinate with the lessor's sales team and a few personnel in asset management, many a vendor chooses to go the third-party route.

Disadvantages

There are no disadvantages to third-party vendor programs. There is risk sharing. This will be discussed in a later section in this chapter.

PRIVATE LABEL

The major difference between a private-label program and a third-party program is that the private-label program is vendor-branded while the third-party program is lessor-branded. Private-label program documents carry the name of the vendor, though it is the lessor who finances the transaction and is responsible from start to finish.

Advantages

Private-label programs provide the vendor with the same key benefits that third-party programs do other than one additional benefit — the program is seamless. The customers, the end users, get the impression that it is the vendor who is offering the financing as it is the vendor's name that is placed on varied documents.

A not so subtle benefit comes from the fact that the vendor has slightly more control over these type of programs; such control perhaps being necessary owing to the fact that the vendor's name is on the paper.

Disadvantages

Just as with third-party programs, there are no inherent disadvantages.

VIRTUAL JOINT VENTURE

This type of vendor program gives the vendor's customers the impression that a separate company has been formed as a joint venture between the vendor and its lessor partner to finance the vendor's equipment. In reality, it is a joint venture in appearance with no specific entity behind it, just an extensive agreement between the two parties.

The program is vendor-branded and staffed with personnel from both parties.

Advantages

Over and beyond all the benefits offered by the private-label programs – which have a benefit or two more than third-party programs, a virtual joint venture has one additional key benefit. The vendor, owing to the staffing, has more control over the selling process.

Disadvantages

More resources and more co-ordination are required.

JOINT VENTURE

A separate entity is formed by the vendor and its partner. The entity is jointly staffed.

Advantages

Besides the benefits derived from virtual joint ventures, there is increased control over decision-making.

Disadvantages

Besides resource requirements – capital and human resources, accounting issues arise having to do with consolidation.

CHOOSING THE BEST PROGRAM

The vendor has the choice to finance its sales via a captive or via programs with third-party lessors or both. Its choice is influenced by the pros and cons of the two options. The pros and cons of the varied options of creating a vendor leasing program with third-party lessors were reviewed above. Hence, one needs to examine the pros and the cons of the captive option.

Vendor’s Point of View

A “captive” is one where the vendor finances equipment sales either through a department or division within the parent, or through a wholly owned subsidiary.

BENEFITS OF A CAPTIVE

Manufacturers benefit in many different ways by leasing on their own. Generally, they have the following advantages over their competitors, be it banks or pure independents:

- Existing customer base
- Knowledge of equipment
- Ability to refurbish and/or recertify returned equipment
- Understanding of the secondary market
- Ability to benefit from offering full-service leases
- Built-in salesforce
- Shared infrastructure resulting in reduced expenses
- Ability to subsidize the transaction

It is no small wonder that many captives have been extremely successful. Besides the above advantages, the manufacturer enjoys benefits such as complete control over the financing of its equipment and the scope for higher profits. Also, it is not that difficult to unwind the finance unit, as has been seen on many recent occasions, where the parent sells most or all of the portfolio to independent lessors.

DISADVANTAGES OF A CAPTIVE

The scope for higher profits comes with the potential of higher risk; risk having to do mostly with default and residual losses. Also, there are significant balance sheet implications having to do with a higher gearing ratio. For listed companies, the price-earnings multiple is most likely to be lower than what it would be if the parent did not have a finance unit.

Running a successful finance unit is not easy, it takes expertise and skill. Also, large amounts of capital have to be allocated to the captive; this may not be the most efficient allocation of capital.

Many manufacturers have shut down their captives for another significant reason. It is a distraction from their core business.

Based on a thorough analysis of the pros and cons, a manufacturer will decide whether to lease on its own or through alliances with third-parties.

CAPTIVE STATISTICS

Detailed statistics compiled by the Equipment Leasing and Finance Association (ELFA) in the U.S.A. provide insight into the world of captives.

Weighted-Average Spread (%)[1]

	Captives	Banks	Independents
Pre-tax yield	4.28	4.51	7.74
Average cost of funds	2.24	2.00	3.10
Pre-tax spread	**2.04**	**2.51**	**4.64**

Captives, almost invariably, have the lowest spread. The reason is obvious, as their prime motivation is to sell equipment and they have every incentive to do so at rates which are lower than their competitors.

Applications Approved[2]

	Captives	Banks	Independents
Percentage approved	87.9%	70.9%	68.8%

Captives have the built-in incentive to approve more credit applications for lease financing than their competitors; once again, to meet their principal objective to sell equipment.

Portfolio Analysis[3]

	Captives	Banks	Independents
Current	94.6%	98.9%	98.5%
Delinquent	5.4%	1.1%	1.5%
	100%	**100%**	**100%**

[1, 2, 3] 2018 Survey of Equipment Finance Activity – SEFA, Equipment Leasing and Finance Association (ELFA)

Based on the fact that captives are more liberal in their lending practices, it is not surprising that the receivables they carry have a much higher delinquency rate as compared to their competitors.

The statistics, provided above, clearly demonstrate that captives use leasing as a means to achieve incremental sales.

Lessor's Point of View

Lessors should strive to enter into formal vendor leasing programs for obvious reasons; they offer numerous benefits to the lessor. Lessors should convince vendors of the benefits such programs offer to the vendor; going one step beyond, they should try to convince a vendor not to form a captive subsidiary owing to the disadvantages pointed out earlier.

SIGNIFICANCE OF VENDOR PROGRAMS TO LESSORS

As stated earlier in this publication, the U.S.A. equipment finance and leasing industry is fortunate that its trade association, ELFA, compiles detailed statistics in a host of areas including sources of origination. Some significant statistics follow:

New Business Volume by Origination Channel and by Type of Organization[4]

	Captives	Banks	Independents
Vendor	—	35%	26%
Captive	98%	—	6%
Direct	2%	50%	48%
Third-parties	0%	15%	20%
	100%	**100%**	**100%**

It can be seen that both banks and pure independents heavily rely on vendors as a source of originations.

[4] 2018 Survey of Equipment Finance Activity – SEFA, Equipment Leasing and Finance Association (ELFA)

New Business Volume by Origination Channel and Market Segment[5]

	Small-Ticket	Middle-Ticket	Large-Ticket
Vendor	31%	24%	11%
Captive	54%	21%	24%
Direct	7%	41%	57%
Third-parties	8%	14%	8%
	100%	**100%**	**100%**

Vendor origination is more pervasive in the small and middle-ticket markets. This makes good sense, as transactions, particularly in the small-ticket market, are more homogeneous. Homogeneous transactions lead to standardized operating procedures, which in turn lead to smoother and more efficient processing of transactions. Response time can be faster, causing the vendor's customers to be served better.

New Business Volume by Origination Channel and Organization Size[6]

	Under $50 million	$50 - $250 million	$250 million - $1 billion	Over $1 billion
Vendor	4%	20%	16%	25%
Captive	31%	19%	26%	32%
Direct	37%	34%	37%	34%
Third-parties	28%	27%	21%	9%
	100%	**100%**	**100%**	**100%**

The above statistics, again, make good sense. Smaller, boutique-like leasing companies rely more on their direct salesforce and third parties than the larger ones.

[5, 6] 2018 Survey of Equipment Finance Activity – SEFA, Equipment Leasing and Finance Association (ELFA)

Benefits to the Parties

Vendor leasing is a win-win-win as it offers a multiplicity of benefits to all three parties – the vendor, the lessor, and the lessee.

BENEFITS TO THE LESSOR

As evidenced in the statistics, vendor leasing programs are an important source of originations for good reason – they provide the lessor with a host of benefits. These are listed below.

New Delivery Channel

Originating transactions through vendor programs creates a new delivery channel for those lessors solely relying on their direct salesforce and/or third-parties to bring in new business.

Reliable Source of New Business

Vendors are in the business of selling equipment. The financing needed for this results in a steady and reliable source of new business volume for the lessor.

Leverage Vendor's Salesforce

The lessor relies on the vendor's salesforce to refer business; or, as often is the case, applications for lease finance are originated online by the vendor's customers. The lessor's sales team has two tasks. One or two key individuals will liaise with the team leaders from the vendor's salesforce, and lessor sales personnel will close the transactions that are referred. The real leveraging comes from the fact the lessor does not have to solicit leads, an extremely time-consuming task.

In the small and micro-ticket markets, where transactions are generally homogeneous, online applications submitted with varied financial, trade, and other data save even more time from a credit approval point of view.

Lower Cost of Doing Business

Fewer sales personnel, standardized operational procedures, economies of scale in processing, and a simplified credit process lead to lower costs.

No Competition

Most vendor programs are exclusive and give the lessor the right of first refusal to finance the vendor's equipment. As such, once a vendor leasing program is in place, there is no competition in the vendor's equipment space unless the vendor's customers decide to shop around for financing.

Incremental Volume from Vendor's Customers

Over and beyond financing the vendor's equipment, the lessor gains from additional business volume that stems from customers seeking financing for other equipment.

Higher Profits

Point-of-sale financing is a tremendous benefit to the vendor's customers. It is service-based; as such, rates do not need to be as low as they are when lessors compete with other lessors on volume directly originated. Combined with incremental sales and lower costs, this leads to higher profits.

Risk Sharing with Vendor

As will be detailed later in this chapter, through a variety of arrangements with the vendor, the lessor is able to share varied risks with the vendor, much more so on operating leases.

SUMMARY OF BENEFITS TO THE LESSOR

Through the numerous benefits detailed above, the lessor is able to have increased and steady volume, lower costs, risk sharing, and higher profits! It is no wonder that in mature leasing economies – at least, in the U.S.A., as evidenced by the statistics, vendor-originated transactions are as commonplace as they are!

BENEFITS TO THE VENDOR

Just as much as the lessor benefits, so does the vendor.

Reliable Source of Financing

Alliances with financially stable and reliable lessors provide the vendor with a reliable source of financing.

No Carrying of Receivables

Equipment sales are facilitated without carrying any receivables associated with such sales. The attendant risk of default, subject to net loss pools, is borne by the lessor.

Better Cash Management

The vendor is generally paid when the customer signs the delivery and acceptance certificate or within a few days after this, depending on how the program agreement was negotiated between the two parties. This leads to improved cash flow, as the terms provided by the lessor are likely to be better than the trade terms offered to customers.

Increased Volume

As stated earlier in this chapter, sales-aid leasing, particularly via a formal vendor leasing program with a reliable leasing company, will lead to increased sales.

Higher Gross Profit Margins

Again, as was stated earlier, lease financing makes the purchase price less visible; and, it is a well-known fact that vendors are able to achieve a higher gross profit margin owing to preservation of the selling price.

Transaction Control

Asset life cycle management enables the vendor to avail of varied profit opportunities during the term of the lease as well as upon the termination of the lease.

Increased Customer Retention

Vendors maintain customer contact throughout the lease term and vendor leasing programs are service-based. Both of these lead to increased customer retention.

Increased Compensation to Sales Representatives

Due to increased sales, the vendor's salesforce is able to earn higher commissions leading to a more satisfied team with a lower turnover.

SUMMARY OF BENEFITS TO THE VENDOR

Through the numerous benefits detailed above, the vendor is able to increase sales, achieve higher gross profit, serve its customers well, and enable its salesforce to earn a higher level of compensation.

BENEFITS TO THE CUSTOMER

Customer benefits are listed below.

Point-of-Sale Financing

"On-the-spot" financing is seamless and convenient.

Competitive Rates

Though it was stated earlier that lessors may be able to command higher rates on vendor originated business, rates are still extremely competitive owing to the fierce competition in garnering vendor leasing programs.

SUMMARY OF BENEFITS TO THE CUSTOMER

The vendor's customers have ready access to financing at a reasonable cost, and are able to avail of a host of benefits the vendor provides through asset life cycle management.

WIN-WIN-WIN

As stated at the onset, vendor leasing programs are a win-win-win as seen by the multiplicity of benefits received by the vendor, the lessor, and the customer.

Selecting the Right Vendor

A formal vendor leasing program, as was just detailed, can lead to a multiplicity of benefits to the lessor. The benefits are contingent on the lessor entering into an alliance with vendors who possess certain desired qualities.

Given the significance of vendor originations, and the initial amount a lessor has to invest to kickstart the program, it behooves lessors to enter into alliances with the right vendors.

DESIRED VENDOR QUALITIES

The qualities a lessor would seek include:

- Acceptable attitude toward leasing
- Top management buy-in and cooperation
- Good past experience with lessors
- Reputation in the marketplace
- Good quality products and services
- Strong marketing capabilities
- Strong remarketing capabilities
- Financial stability and sales growth
- Reasonable gross profit margin

The above qualities are indicative of a vendor worth considering as a partner.

APPROPRIATE DUE DILIGENCE

Prior to entering into an alliance, a lessor should do the needed due diligence to gain an in-depth understanding of the vendor. The items a lessor would look into have to do with the vendor itself, its salesforce, and its customers.

Vendor-Based

The items to be reviewed would include:

- Organization structure
- Time in business
- Geographic operating area

- Product lines
- Volume
- Market share
- Percentage of volume financed
- Transaction size
- Service department
- Operations structure

The above due diligence would provide the lessor with the insight needed to gauge if the vendor's structure, products, volume, and other items could lead to a profitable partnership.

Vendor's Salesforce

A well-managed and motivated salesforce is critical to assure a smooth flow of business to the lessor. Items to review would include:

- Structure
- Tenure of sales team
- Turnover
- Experience
- Compensation

The compensation aspect needs to be looked at to understand the split between base compensation and incentive compensation, so as to gauge the degree of financial motivation the sales team has.

Vendor's Customers

With respect to the vendor's customers, the lessor would review:

- Profile
- Geographical diversification
- Credit profile
- Inclination to finance

Interviewing key customers would provide the lessor with a better understanding as to their needs, the risk inherent based on credit profile, the possibility of incremental sales if on-the-spot lease financing were to be provided; and, the potential for lease financing of their general equipment needs.

Responsibilities of Parties

To have the program benefit the two parties as much as possible, both the lessor and the vendor have to fulfill varied responsibilities.

LESSOR RESPONSIBILITIES

The lessor's responsibilities include:

- Provide training
- Perform the needed credit due diligence of transactions
- Fund transactions
- Service customers at inception, duration, and termination
- Submit periodic reports

Training the vendor's sales team, the ones who are in contact with the customers, is critical. The vendor's sales personnel need to fully understand all the benefits that leasing offers, such that sales are not lost as on-the-spot financing is introduced; and, that incremental sales can be generated owing to the availability of lease finance.

Besides the above responsibilities, it would make sense for the lessor to provide additional support to the vendor with items such as custom designed lease applications and certain custom designed marketing materials detailing varied lease options.

VENDOR RESPONSIBILITIES

The vendor's responsibilities include:

- Refer and/or provide transactions
- Submit periodic pipeline and other reports
- Assign relationship manager(s)
- Provide needed support at inception, duration, and termination.

Elements of the Agreement

For the arrangement to be a true partnership, it makes good sense that the term of the agreement not be too short or too long – one year being too short, perhaps three being too long. A two-year term with mutually acceptable renewals is perhaps the most sensible duration.

A management committee needs to be set up. The committee should have equal representation and should meet periodically to discuss how the program is doing and how it can be continually improved. Both parties should appoint designated program managers and dedicated client service teams.

A healthy partnership would also allow the two parties to have audit rights to all financial and operational materials related to the program.

PROGRAM-RELATED ITEMS

The items that need to be negotiated in the formal agreement include:

- Term
- Exclusivity – with announcements to customers and dealers
- Credit parameters
- Right of first refusal
- Funding cycle time
- Origination of transactions
- Documentation
- Management committee
- Equipment title and warranties
- Loss pools
- Termination provisions
- Continuing responsibilities post termination

Some of the above items warrant a further explanation.

Exclusivity and the right of first refusal go hand in hand. The lessor should strive to be the exclusive source for financing all of the equipment sales made by the vendor. This does not mean the lessor is obliged to finance all transactions as some, or many, may not meet the credit guidelines agreed to between the lessor and the vendor.

The credit guidelines are just a guide; they set the broad range of parameters within which acceptable transactions are to fall. They will include items such as the minimum number of years the customer has been in business and an acceptable range for certain financial ratios, such as the gearing ratio and the current ratio. Given that arriving at credit decisions entails a combination between an art and a science, the lessor should be given program discretion to accept or decline at its sole discretion. This is where the right of first refusal comes into play.

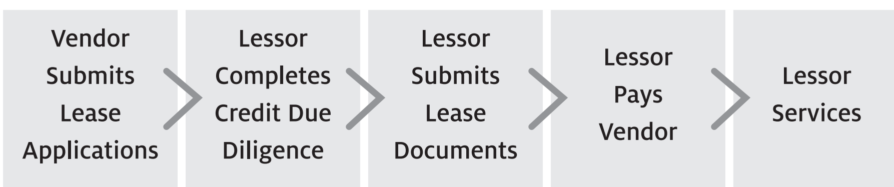
If the lessor decides to decline the transaction, such decision needs to be communicated promptly to the vendor and the customer so that the customer can shop for financing elsewhere. The right of first refusal essentially gives the lessor so many business days to decide whether to accept or decline. This vastly mitigates the possibility of a lost sale as the customer could then get financing elsewhere, or the vendor itself may decide to finance the sale.

The funding cycle time has to do with the number of business days the lessor has from the time the lessee signs the delivery and acceptance certificate to the time the disbursement is made to the vendor.

Loss pools will be discussed later.

Program Process

The process is best diagrammed.



The transaction flow is not much different than for those transactions originated directly except for the fact that the vendor refers or submits the lease financing application.

Program Risks

Besides the normal risks such as the credit risk, asset risk, and the occasional risk of fraud, the unique risk involved in vendor leasing programs has to do with vendor performance risk.

VENDOR PERFORMANCE RISK

Vendor programs offer a mechanism to originate incremental volume for both the lessor and the vendor. However, the insertion of a vendor into a lease transaction can create complications. While the lease agreement is bound to have a "hell or high water" clause, preventing the lessee from stopping payments or canceling the agreement, it will not prevent the lessee from holding up payment for non-performance on the part of the vendor. This almost always has to do with maintenance.

It is imperative to conduct the appropriate due diligence of a vendor prior to entering into a formal vendor leasing program. Vendor due diligence was detailed earlier in this chapter.

RISK MITIGATION

The three risks stated above, credit risk, asset risk, and vendor performance risk, can all be mitigated.

Credit Risk Mitigation

The mitigants include:

- Acceptance criteria
- Lessor right to decline
- Repurchase or buy-back
- Net loss pools

The credit acceptance guidelines and the lessor's right to decline transactions work as the first buffer against credit risk. However, in many a vendor program, the vendor and the lessor arrive at an understanding for the lessor to arrive at looser credit acceptance guidelines. Such an arrangement, all other things being equal, leads to enhanced equipment sales for the vendor as customers who otherwise would not qualify for lease financing are able to avail of such. There are two mitigants to the higher risk that stems from looser credit guidelines, vendor repurchase or buy-back and net loss pools.

The repurchase or buy-back arrangement is one where the vendor agrees to buy back the equipment at a stipulated value in the event of a lessee default.

NET LOSS POOLS

Net loss pools derive their name from the fact that like type transactions in terms of asset type, transaction size and customer demographics are placed into a pool.

The vendor and the lessor agree on a loss reserve percentage which is escrowed into an agreed upon bank account. As an example, on a $10,000 transaction with a two percent agreed upon reserve, the lessor will pay the vendor $9,800 and deposit $200 into the escrow account. This is similarly done for all transactions that fit the pool parameters. The accumulated reserve is then used to reimburse the lessor upon delinquencies.

Asset Risk Mitigation

In an earlier section in this chapter, it was noted that vendors often work with their lessor partners to mitigate the lessor's asset risk. The reason for risk-sharing, no different than with net loss pools, is to incentivize lessors to finance more equipment sales. The mitigants are listed below.

FIRST-NET LOSS RESIDUAL GUARANTY

This was explained in detail in Chapter Five.

REPURCHASE OR BUY-BACK AGREEMENTS

This is where the vendor agrees to buy back the equipment at a stipulated value at the end of the lease if the lessee decides to return the equipment.

BLIND DISCOUNTS

A residual guaranty could lead to issues having to do with revenue recognition. In lieu of such a guaranty, a vendor will give the lessor a discount on the selling price of the equipment. Conceptually, a discount is similar to a residual guaranty. This is illustrated below.

ILLUSTRATION

Equipment cost	$10,000
Residual value	$4,000

If the vendor were to provide a 25 percent first-net loss residual guaranty, or $1,000 in quantum, and if the vendor gauges that there is a 30 percent probability that it may suffer a $1,000 loss in fulfilling the guaranty, instead of giving the residual guaranty it could give a discount on the equipment cost.

The discount is arrived at as follows: 30 percent of the probable loss is $300. The vendor, using a certain hurdle rate, discounts the $300 to the inception of the lease. If the lease term is 36 months and the discount rate is 10 percent, the present value of $300 is $223. The calculation for this follows:

f		CLEAR REG
g		END
300	CHS	FV
36		n
10	g	12÷
PV		223

Giving a $223 discount on the purchase price is quantitatively the same as a 30% probability of suffering a $1,000 loss at the end of 36 months.

A discount will not create revenue recognition issues. Lastly, it is called a blind discount as the customer is unaware of the discount. The lessor either utilizes the discount to reduce the rental payments or uses it as a yield kicker.

VENDOR EQUITY INSERTION

A prudent approach used by a few lessors is one where the vendor is required to insert equity (cash) into the transaction. An illustration follows.

ILLUSTRATION

Equipment cost	$100,000
Residual value	$40,000
Residual guaranty	$10,000

In lieu of a fist net loss residual guaranty, the vendor invests the present value of such amount, adjusted by the probability of occurrence of the transaction. If the lease term is 36 months, and a hurdle rate of 10 percent is used, the present value of $10,000 is $7,417. If the probability of the loss is gauged to be 50 percent, the investment will be $3,708.50, $7,417 ÷ 2.

Upon sale of the equipment, the lessor will pay the vendor $100,000 and concurrently the vendor will pay the lessor $3,708.50. It is important that these two transactions are separated as the lessor will want the vendor to record the $3,708.50 as an investment, as opposed to a discount on the purchase price. At the end of the lease, the vendor is as motivated to recoup its investment plus interest at a minimum and maybe even record a gain if the residual is worth more than $40,000. If the lessor and vendor have entered into a remarketing agreement – see below, the vendor has every incentive to sell the equipment at the highest price possible.

REMARKETING AGREEMENT

Vendor remarketing agreements are extremely common. This type of an agreement is one where the vendor agrees to remarket the equipment either upon repossession if the lessee defaults or at the end of the lease term if the lessee has chosen to return the equipment. There are two types of remarketing agreements:

- Best efforts
- Priority

Lessors prefer a priority remarketing agreement, where the vendor agrees to remarket the equipment on a priority basis "as the next unit sold, as if from its own inventory, undertaking to sell the equipment as agent for the lessor utilizing sales efforts at least as great as efforts the vendor makes to sell similar equipment held for the vendor's own account."

Conclusion

Vendor leasing programs are indeed a win-win-win to vendors, lessors, and lessees! The programs constitute a significant source of new business volume for lessors. They also provide numerous benefits to all three parties. Lessors are encouraged to adopt the following strategy:

- With respect to vendors who already have a captive leasing arm, be it a department, division, or subsidiary — convince such vendors to diversify their risk by giving all or a large part of their future equipment sales to the lessor via a formal vendor leasing program.

- With respect to vendors who do not have a captive arm and who are simply referring equipment sales to a few lessors — convince such vendors to enter into a formal vendor leasing program.