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Captive Finance: Gaining Competitive Advantage

Headline news can be a distraction. Evolving geopolitics and potentially disruptive economic and political outcomes block our field of vision from the deep connectivity of our world. Our technology, goods, and services are globally integrated on a massive scale. Everything, from children's toys to shampoo to bulldozers, is part of a global supply chain that links people and resources to produce outcomes that would be unachievable without cooperation.

Shining examples of the global economy are global automotive and equipment manufacturers—organizations like Hitachi, Ford, Volvo, and Daimler to name a few—that develop sophisticated machinery using cutting-edge techniques and market their products around the world. As is the case for nearly all exchanges of goods and services today, the final link between producer and customer (or manufacturer and business owner) is a financial transaction, specifically, a lease on equipment. These organizations manage regional leasing and finance offices that help businesses leverage equipment to improve their operations. Whether you are a farmer in Brazil, a mining company in Australia, or a commuter in London, leasing is an efficient method for acquiring a capital-intensive piece of equipment. These business units, often referred to as "captive finance," are strategically important and influential, contributing to a significant portion of the organization's overall profits and carrying some of their largest risks.

Global approaches to driving performance through people

So, what can captive finance firms do to win in today's deeply connected world? The answer is simple—drive performance through people. Regional offices must channel their company's vast resources into a local market. Everything from economic factors, such as commodity prices for agricultural businesses, to local labor force competitors, like banks and independent finance companies, must be understood globally and regionally. To win in a hyper-connected world and realize economies of scale, companies must spread best practices to regional offices and vice versa.

The following presents a case for thinking and acting globally, despite a myriad of distractions in today's headlines. Even for organizations of massive inventory and international supply chains, people are the greatest asset.

Five global truths about captive finance companies

1. **Large manufacturers must export to win:** Global manufacturers are concentrated in several large, developed economies, e.g., Germany, France, U.S., Japan. Major equipment manufacturing companies with the capacity

to design and export equipment require access to deep pools of engineering talent. Building this talent capacity requires a base of academic resources and a large, well-educated population. Emerging economies typically import advanced equipment to fuel growth. For these countries, it is more feasible to lease this capability via trade than for the country to build their own major manufacturing company. Given the tight margins of the manufacturing business in major economies, it will be difficult for emerging markets to develop their own capabilities profitably. As a result, the list of major, developed economies will remain short, while the list of emerging economies with a need for equipment will grow.

2. **Financial services skills are in demand:** As mentioned, the final link between the equipment user and the manufacturer is a financial transaction. This structure places the equipment leasing origination role in the position of addressing key questions regarding the equipment's specifications, useful life, maintenance costs, tax and accounting implications, and more. From the company's perspective, the leasing originator must have the skills to analyze the profitability of a prospective opportunity and interpret the credit risk exposure for the company in partnership with underwriting experts. Coupled with these fundamental tasks, a leasing originator must also navigate social, cultural, and language differences. Individuals who possess these skills will be in high demand, especially during periods of economic growth.
3. **Banks and captives compete for talent and business:** Leasing is an important component of a commercial lending business unit of a bank, offering an asset-backed financing alternative to cash-flow loans. Although the list of companies will vary by location, the nature of competitors, i.e., banks, captive finance, and independent companies, will carry consistent themes and principles across locations.
4. **Competition is a matrix of regional and global players:** Economic opportunity will help determine which companies compete in which geographies. Africa, the Middle East, and South America will need major equipment to access natural resources through mining. Construction equipment will be necessary for developing urban centers. No matter the equipment type or economic opportunity, far-reaching global firms will want close ties with their customers and entrepreneurial companies will likely try to steal market share from international companies, tugging at the perception that they do not have sufficient local insights. As a result, competition for talent and business will include both local and international companies.
5. **Sales producers respond to clear incentives:** We know that competitive compensation levels for a role vary by country. This reflects differences in the available talent pool, exchange rates, and the economic opportunities in each market. What is less universally accepted is that pay practices have commonality across borders. Sales individuals are motivated by incentives, such as closing more profitable transactions through negotiating higher yields or longer terms. The lessons of designing sales programs are not dependent on geography.

What should firms do to succeed in a global marketplace?

- **Conduct globally consistent studies:** It is common for captive finance companies to rely on locally sourced information as an exclusive source of insight. However, themes in business trends, such as technology changes, or human capital, like sales practices and performance management, can have consistent threads across geographies. Understanding the global view and implementing best practices locally sets an organization apart from competitors.
- **Define a firm-wide pay strategy:** What differentiates the employee experience from working at your captive finance company vs. a bank or an independent leasing company? Does the organization efficiently promote for top performers? Does the franchise drive organizational performance or does the individual? Answers to these questions and their application in terms of policy and programs, can divide or unite employees across geographies. It is therefore important that a clear talent strategy is reflected in your global pay strategy.
- **Plant effective incentive practices locally:** Adjusting for credit risk in sales originator compensation has become a standard practice in developed markets, but the adoption has been slower in emerging economies.

Firms are especially cautious when it comes to changing a historical practice. At a minimum, consider critiquing local and global incentive practices based on organizational feedback.

- **Develop a philosophy on peer groups / competition**: Franchise-driven companies, companies with a superior product and / or leading market share, rely less on individual performance to drive production. For these firms, pay and promotion programs should incorporate team contributions. For individually-driven companies without brand recognition, it's important to consider pay and promotion programs that reward top contributors meaningfully. Market data can provide a specific reference for creating pay opportunities that reflect your talent strategy.
- **Institutionalize global performance management:** The strategic priorities of a captive finance company should drive performance programs. For example, a firm entering a new market with limited market share or brand recognition should reward individual performance through competitive pay programs and promotional opportunities. A company with a dominant market position and a long-tail of residual customers should ensure performance management programs are equitable, but reward teamwork and collaboration. In both cases, market data and intelligence and can help pinpoint pay levels and practices that align with the organization's strategy.

Although we can certainly marvel at the progress of our spectacular global economy, real risks do remain. Credit portfolio deterioration in auto lending in the U.S. and FX volatility in emerging economies are representative examples of outcomes businesses must anticipate for the future. However, despite challenges, organizations can do more to channel their global reach and drive performance through people. In working with captive finance companies of manufacturing businesses, we see the need to create better, more harmonized pay practices and strategies across regions. The competitive forces involving equipment leasing roles, including competition with banks or the desired outcomes of sales producers, span borders. Regardless, a best-in-class organization will leverage data that has been assembled using a consistent methodology, which is enhanced by local partnerships, to find the highest common denominator between countries.

To learn more about McLagan's captive finance products and advisory services, please contact our team.

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