Opportunities for Action in Industrial Goods

Treasure Chest or Time Bomb?
Reevaluating Your Financing Sub

The Boston Consulting Group
Over the past several decades, many industrial companies have provided credit to their customers through wholly owned financing subsidiaries, often with impressive results. Companies such as Boeing and Bombardier, Ford and GM, John Deere and Caterpillar have expanded their financing subsidiaries to the point where some have even surpassed their parent companies in terms of both growth and absolute earnings. By the end of 2001, the financing subs of nonfinancial companies accounted for nearly 30 percent of the approximately $4 trillion in loans and leases in the United States alone. And from 1993 to 2002, industrial companies (excluding automotive companies) with well-developed financing subsidiaries significantly outperformed their industry peers in terms of shareholder value creation.

Despite this positive track record, continuing to own a financing subsidiary may no longer make strategic sense for many industrial companies. The traditional advantages of do-it-yourself financing have largely become obsolete, and the costs and risks of ownership now often outweigh the benefits. Even a financing sub that is currently profitable can swiftly become a drain on the parent company’s resources. A downturn in the subsidiary’s performance can quickly undermine the parent’s credit rating and diminish its access to capital—thus further raising the cost of financing the subsidiary and triggering a negative spiral. Although the financing subsidiaries of some companies, such as Caterpillar, Harley-Davidson, and John Deere, have continued to make healthy contributions to their parents’ coffers throughout the downturn, many subs have become financial burdens.
This danger can be hard for some companies to face, because they tend to see these units as their crown jewels. Moreover, many industries consider providing credit to customers a competitive necessity. And in fact, owning a financing sub may still make strategic sense in some cases. Usually, however, companies may do far better to offer credit by partnering with banks or other financial institutions. The question is, what strategy makes most sense for your company?

To answer that question, it will be helpful first to review how shifts in the economic and industrial landscape have redistributed competitive advantage among participants in the credit extension business. Against this background, you can assess where your competitive advantage or disadvantage may lie. Then you can determine whether and how your own financing subsidiary is creating value—and whether it makes sense to continue to own the financing function or to outsource it.

**The New Competitive Terrain for Financing**

Traditionally, industrial companies have had many compelling reasons to extend credit to customers. By bundling financing with their products, they have expanded their markets, made their products more attractive, and increased their customers’ loyalty. They have also managed to make themselves look a lot bigger. For many companies, in-house financing has become a major source of growth in earnings; the spectacular success of GE Capital is a notable example. This opportunity for growth has been particularly welcome for industrial companies, whose core markets have been expanding at lackluster rates, if at all. And finally, by offering financing, companies have gained flexibility in their strategic approaches to sales and pricing.
However, beneath the surface of this successful performance, which was fueled in part by a booming economy, a number of issues were developing. Today, some of the reasons for extending in-house credit that originally looked so persuasive are open to question. In the new competitive environment, bigger is not always better; EPS growth does not always create lasting value; and, in terms of who owns the credit function, the home court advantage may no longer hold.

Bigger is not always better. In many cases, the debt that fueled the growth of in-house financing has transformed the traditionally conservative capital structures of industrial companies into highly leveraged balance sheets resembling those of banks or other financial institutions—but without their sophisticated risk-management systems. Hence the economic downturn caught financing subsidiaries and their corporate parents largely unprepared. With balance sheets already strained and operating cash flows deteriorating, most companies were not in a position to afford mounting credit losses.

As the parent companies were forced to provide credit support to their financing subs, their own credit ratings suffered, thus increasing their cost of capital and depressing their share prices. A number of companies have had to sink large amounts of money into formerly high-performing subs, in some cases winding down credit operations or exiting the business altogether. The much-publicized case of the auto industry—in which the zero-financing fight has reduced some leading companies' de facto credit ratings to below investment-grade level—may be atypical, but it can serve as a warning to other sectors.

EPS growth does not always create lasting value. Earnings per share—the measure by which many
financing subs have achieved stellar performance—can be illusory, because standard accounting practices generally fail to reflect the second-order costs of extending credit. For instance, in calculating the cost of subsidized credit, you must take into account not only the difference between present values of the payment streams at market rates and at subsidized interest rates but also the impact of the loan on the company’s immediate cash flow. When customers accept credit, the subsidiary typically must seek funds in the capital markets, further increasing its leverage and thus contributing to deterioration of the credit ratings of both the subsidiary and the parent company. As the company's credit rating goes down, its cost of borrowing goes up—and so does the real cost of the customer’s below-market-rate loan. With margins already razor thin, any increase in cost can easily transform an expected profit into an actual loss—especially if the credit product has various options built into it (as do leases, for instance).

The home court advantage may no longer hold. In some areas of the credit extension business, industrial companies and their wholly owned subs still have competitive advantage over financial institutions. In others, however, the advantage has migrated to the traditional lenders. Drivers of value creation in this business include access to cheap capital; the ability to assess credit risk, process loans, and manage operations; and skill at sales and marketing. In which of these areas does your company have a solid competitive advantage over a bank or another financial institution?

Access to Cheap Capital. In the past, many manufacturing companies had very strong credit ratings compared with financial institutions. Those ratings were founded on solid profits, relatively conservative balance sheets, and substantial long-term assets. As a
result, the companies could borrow capital at very low
cost—an advantage they were able to share with their
financing subsidiaries. Unfortunately, for many indus-
trial companies, this advantage no longer exists. Can
you compete long-term with Citigroup or MBNA in
borrowing? If not, perhaps you should seriously con-
sider outsourcing your capital-raising function.

The Ability to Assess Credit Risk, Process Loans, and
Manage Operations. Traditionally, manufacturers have
had a competitive advantage over banks in two areas:
being closer to their customers and having better
knowledge of their own products. These advantages
positioned companies to make better credit decisions
than banks. For example, 20 years ago in the automo-
tive industry, the person best positioned to make an
informed credit decision was the local dealer, who
knew the local customers, their employers, and the
overall state of the local economy better than anybody
else. These advantages are no longer with the dealer.
With the enormous amounts of transaction data read-
ily available in their databases, large banks can now
make credit decisions faster and more accurately. In
addition, they can almost always process loans and
manage operations more effectively than can the
financing subsidiaries of industrial companies (except
for several really big players). For most nonfinancial
companies in the developed world, competing with
banks is an uphill battle.

In terms of product knowledge, by contrast, some
manufacturing companies still have an advantage over
banks, particularly in categories such as highly special-
ized industrial products (including, for example,
chemical-processing and power-generating equip-
ment) and large vehicles. In these markets, manufac-
turers’ superior knowledge of the products’ econom-
ics and life cycles should enable them to price the
products and their financing better than anybody
else. These manufacturers are also in a strong position to evaluate the creditworthiness of likely buyers or lessors, whose fortunes are very much linked to the industries that the manufacturers serve and know well. Indeed, in these areas, manufacturers’ financing subsidiaries consistently realize lower credit losses than their banking counterparts. The challenge for these companies is to ensure that they continuously maintain and effectively leverage their advantage.

Skill at Sales and Marketing. Here your credit subsidiary probably has an advantage over a bank: the cost of customer acquisition is likely lower for you than for a financial institution that has never seen the customer before. But is it really necessary for you to own the whole operation to capitalize on this advantage? A fee-based arrangement in which you retain the relationship with the customer while a financial institution extends the credit may be more appropriate.

Does Owning a Sub Still Make Sense?

To answer this question, you will need to evaluate your financing sub’s performance in terms of actual value creation, rather than just accounting performance. The first step is to create complete clarity about the costs and benefits of each transaction “bundle” (the product together with its financing). An important benefit of creating clarity about the economics of these bundles is the opportunity to de-average your credit transactions. It makes sense to offer below-market credit if the profit margin on the product is high, as it is, for example, on high-end SUVs. It doesn’t make sense if the margin is low, as it is on many entry-level cars—or if the buyer is otherwise prepared to pay cash. By carefully tailoring incentives to specific products, regions, and customer
segments, financing companies can dramatically improve their performance.

Once you understand the real costs and benefits of each transaction bundle, you can determine whether the sub is genuinely profitable—even when the cost of the credit support provided by the parent is accounted for. It is important to keep in mind that most P&L entries are estimates at best. In the depreciation of leased products, for example, it is almost impossible to predict with any degree of accuracy what value will be realized in the secondary market when a leased car or plane is returned to the company at the end of the leasing period. At banks, it is common practice to reserve additional capital against uncertainty of this kind. Industrial companies would do well to follow the banks’ practice.

Profit is not, of course, the whole picture. What really matters is whether the subsidiary creates or destroys shareholder value. For the subsidiary to create value on a standalone basis, its returns must exceed its cost of capital—a much higher hurdle than just achieving profitability. Also, it is important to benchmark the sub’s value-creating performance against comparable financial companies, not against its industrial parent.

If, after completing this analysis, you discover that your financing subsidiary is not creating value on its own, this doesn’t necessarily mean that you should stop extending credit, because your subsidiary may be creating value elsewhere. For example, if extending credit allows you to sell your product at a very high markup, it may be worthwhile to do so, even at the cost of some loss of the subsidiary’s value. In a case of this kind, however, it is critical that you develop a clear view of what benefits the financing subsidiary conveys, and where and how they are realized.
The Strategic Challenge

Once you have fully understood your subsidiary’s current and anticipated contributions (or costs) to your corporate portfolio, you can assess the potential risks and benefits of continuing to own the sub. Clearly, there is no simple formula. In some cases, far from being panaceas, credit subs will cause their parents to hemorrhage money—and value. Nonetheless, in many industries, offering credit is simply an imperative. The key question is whether it makes sense to keep that operation in-house, shop it out, or share it. The strategy you choose should be the one that best allows you to minimize the risk, limit the drain on capital, and maintain the closest possible relationships with your customers. By thinking about these issues as early as possible, you can ensure that your credit operation creates value—and avoid painful surprises down the road.

Ari Axelrod
Mark Joiner
François Rouzaud

Ari Axelrod is a manager in the Boston office of The Boston Consulting Group. Mark Joiner is a senior vice president and director in BCG’s New York office and worldwide leader of the firm’s Corporate Development practice. François Rouzaud is a senior vice president and director in BCG’s Boston office and worldwide leader of the firm’s Industrial Goods practice.

You may contact the authors by e-mail at:
axelrod.ari@bcg.com
joiner.mark@bcg.com
rouzaud.francois@bcg.com

© The Boston Consulting Group, Inc. 2003. All rights reserved.
THE BOSTON CONSULTING GROUP

Amsterdam    Hong Kong    Paris
Athens       Houston      Rome
Atlanta      Istanbul     San Francisco
Auckland     Jakarta      Santiago
Bangkok      Kuala Lumpur São Paulo
Barcelona    Lisbon       Seoul
Beijing      London       Shanghai
Berlin       Los Angeles  Singapore
Boston       Madrid       Stockholm
Brussels     Melbourne    Stuttgart
Budapest     Mexico City  Sydney
Buenos Aires Miami       Taipei
Chicago      Milan       Tokyo
Cologne      Monterrey   Toronto
Copenhagen   Moscow      Vienna
Dallas       Mumbai      Warsaw
Düsseldorf   Munich      Washington
Frankfurt    New Delhi   Zürich
Hamburg      New York
Helsinki     Oslo