# GUIDELINES FOR THE INTERNAL DEVELOPMENT OF A FINANCE SUBSIDIARY OF AN INDUSTRIAL CORPORATION

There are several keys to the successful internal development for a finance subsidiary of an industrial corporation. These are:

To clearly understand the role the subsidiary is to play within its corporate family. This role can be expected to undergo some changes over time, but can always be described in terms of the benefits the subsidiary is expected to produce.

To clearly understand what resources the subsidiary needs to fulfill its role.

To clearly understand the subsidiary's continuing corporate responsibilities and the constraints under which the subsidiary is to be developed and operated.

To have a realistic business approach that defines how the subsidiary is to satisfy its own needs in order to produce the benefits expected of it without violating the constraints on it.

## I. Potential Benefits of a Well Managed Finance Subsidiary of a Major Industrial Company

A leasing and equipment sales financing business developed to support the sales programs of affiliated manufacturing companies can provide, as well as derive, a number of attractive benefits, depending on how well it is managed. These may include:

a. For the Manufacturing Affiliates

1. Increased profit margins and increased rates of return on equity. Lease and equipment sales financing of customers' purchases may increase the number of units ordered from affiliated manufacturers because of the ready availability of financing, especially if the terms of this financing compare favorably with those available on the financing of the competitors' products. Floor planning by a finance affiliate may also increase the manufacturers' independent dealers in maintaining levels of inventory that promote sales. In other words, by offering such financing, a finance company may provide its affiliated manufacturers with a competitive advantage. Increases in the number of units ordered and manufactured in a given year will reduce the manufacturers' overhead burden rates, thereby increasing their profit margins.

2. A powerful tool for strengthening existing customer relationships and for developing new ones. When making "financed-sales", manufacturers are in effect closing two deals with their customers. In addition to selling a product, they are providing a service (e.g., financing) that customers will associate in a favorable way with the product they are acquiring and with the manufacturer who made it.

   Competitively priced financing offered in support of manufacturing sales will be most beneficial if the process of arranging and administering the financing can be kept simple. ***The close affiliation between manufacturers and a related finance company can make this simplification practical and effective.***

3. With lease financing, a presence in some control over the aftermarket of the manufacturers' products. This is especially true if operating leases are involved. If so, there are usually very definite, if sometimes indirect, relationships between the profit margins of the manufacturers and the lessor. These relationships can be very important to the nature of the interaction of the businesses and the profit potential of each, and must be clearly understood if the leasing business is to be managed in a fashion that is supportive of the manufacturing business.

4. An important signal to the market place that the manufacturers stand behind their products and believe in their continuing market value.

   This can be a significant benefit for a manufacturing business that makes technologically advanced and/or high value products.

b. For the Parent Company

1. A more rapid and stable turnover of equity.

   A finance company typically enjoys a more rapid turnover of equity than a manufacturing business. This reduces the amount of new equity that must be obtained to support a given level of business, thereby increasing a company's rate of return on equity. A finance company is particularly useful in this regard because its investment opportunities are generally available in a fairly continuous stream of relatively small units. This is especially so if the company writes a mix of tax-intensive and non-tax-intensive business. If a finance company is properly managed, it has more than the usual degree of flexibility in determining the type and level of its capital expenditures from year to year. Proper utilization of this flexibility may have a stabilizing effect on the redeployment of equity.

2. More efficient use of tax benefits.

   An efficient use of tax benefits may serve to reduce taxes and increase returns on equity. Properly managed, a finance business can make it possible for a corporation to manage its tax liability. This may provide the parent company with a competitive advantage.

3. A dampening of cycles in revenues and profits.

   The initiation of sales financing, i.e., the new sales finance business, is cyclical and usually synchronous with overall levels of economic activity and, therefore, is not counter-cyclical to most manufacturing businesses. An existing portfolio of finance contracts, however, is largely non-cyclical. Contracts in place usually provide predictable revenues and profits for several years to come. This may serve to dampen the impact of the cyclicality of the revenues and profits realized by most manufacturing businesses.

4. A significant source of income.

   A well-managed finance company can be highly profitable.

c. For the Finance Company Itself:

1. A reliable source of new business.

   If the finance company's prices are competitive, it can expect to finance a significant share of its affiliated manufacturer's sales.

2. A source of taxable income.

To be competitive in the leasing business, a finance company must have a source of taxable income that will ensure the utilization of tax benefits as it generates them. A profitable parent company's tax liability can provide these essential resources over the long term if it is not squandered by a poorly managed finance company.

## II. Resources Essential to the Development of a Successful Finance Subsidiary of a Major Industrial Corporation

A number of basic resources are essential to the development of a finance subsidiary of a major industrial company if that subsidiary is to successfully support the sales efforts of its affiliated manufacturers over the long term. There are:

a. Independent Credit Worthiness and Diversification

If a lease and equipment sales finance affiliate is to offer services that truly benefit its affiliated manufacturers' customers and its independent vendors with financing rates that are competitive with those available on the products of competing manufacturers and from other sources, such as third party leasing and industrial finance companies, to provide competitive financing rates, a finance company must be able to borrow at advantageous rates. Satisfactory borrowings may be obtained in several forms and from several sources, but the appropriateness and availability of each depends on the particular circumstances of the finance company, which are often related to the stage of development in which a finance company finds itself.

A start-up or small finance company that offers financing only for the sales of affiliated manufacturers almost always requires parent company guarantees or keep-wells and is usually financed with lines of credit from banks. More often than not, the ability of such a finance company to grow and, therefore, its ability to continue to finance the sales of its affiliated manufacturers is soon limited to the growing magnitude of its parent company's guarantees and keep-alls, i.e., by the increasing size of the parent company's associated contingent liabilities. To grow beyond these limitations, a finance company must develop its own independent credit worthiness. In order to do this, the company generally must diversify and increase the size of its portfolio beyond that which would be required to finance its manufacturing affiliates' sales alone. This diversification usually must involve a greater variety of equipment, industries, and customers than those available from its affiliated manufacturers. This diversification must also begin well before the capacity of the parent company for financial support is exhausted. If this capacity is spent entirely in supporting the finance company's services of its manufacturing affiliates' sales, the finance company will never be able to effect the diversification it requires to independently obtain funds at favorable rates. Therefore, the finance company's usefulness to its parent and its affiliated manufacturers may soon expire. The orchestration of this transition in the financing of the finance company itself and its diversification requires careful planning and execution.

b. High Quality Personnel

As in the manufacturing business, to be competitive a finance company must develop and maintain efficient operations. The principal difference is that a finance company's production facilities are constructed almost entirely of people. As an efficient manufacturing facility often requires high quality and sometimes expensive machinery, an efficient finance operation requires high quality and sometimes expensive personnel. But in both instances, quality must pay for itself.

A relatively rigorous analysis can usually be performed to determine the value of the increased productivity that a high quality production machine promises and, therefore, what the machine will be worth in a particular environment. It is generally more difficult to quantify the potential incremental value of high quality finance company personnel. Fortunately, while the price of machine tools is generally determined and paid up front, the price of finance company personnel is paid out over time and may be adjusted in accordance with performance. Incentive compensation should be used by the finance company for its sales force and other key personnel to ensure that personnel costs are in accordance with value received.

As many a finance company has learned, the design of an efficacious incentive compensation program can not only be an important factor in determining the company's success, it can also be very difficult to do. This is especially true of the incentive program for the company's sales force. A large number of elements must be considered in evaluating any salesman's product and performance. In addition, the personal skills, characteristics and attitudes required of a salesman for success may vary considerably from market sector to market sector. This has the effect of making it much more difficult to devise a program that is equitable in all its components. In short, incentive compensation programs require careful planning and execution if they are to produce desired results at an appropriate cost.

c. Autonomy

If the finance subsidiary of an industrial company is to establish its own independent credit worthiness and attract high quality personnel, it must have autonomy. This is critically important with respect to the establishment of criteria for the selection of new business transaction in the development of strategy and in the development of organizational structure.

To achieve a satisfactory independent credit worthiness, a finance subsidiary of an industrial company that is to finance the sales of affiliated manufacturers generally must be able to convince its lenders that it has the authority to establish and execute its own criteria for selecting the new business it will write, including the ability to manage its portfolio additions to achieve proper balances of risk and return in its various business segments. It is not sufficient for the finance subsidiary to obtain recourse to its parent or affiliated manufacturer on credits that are unacceptable to it, for if the finance company does not have the right to reject such transactions, it may very well be overwhelmed by them and fail to achieve proper diversification. This is not to say that the parent company need be deprived of its right to control the development of its finance subsidiary to ensure that the subsidiary fulfills the important role of providing financing to its manufacturing affiliates. It does mean, however, that this control should be exercised by holding the finance subsidiary's management accountable for its performance against plan objectives that set targets for such financing rather than by direct manipulation of the subsidiary's criteria for selecting new business. This, of course, places the responsibility for devising criteria and business strategies that will satisfy the various needs of both lenders and affiliated manufacturers directly on the finance subsidiary's management team. It also requires that the parent prevent manufacturing affiliates from placing unrealistic demands on its finance subsidiary and that the parent give its finance subsidiary the authority to execute its chosen strategy. The orchestration of the whole process of establishing specific new business objectives, proper degrees of autonomy and necessary authority can be handled within the context of a good strategic planning function.

With respect to the matter of autonomy in the development of strategy and organizational structure, it is important to understand that the finance business is very different in many ways from most manufacturing businesses. In addition, the various business segments within the finance company must be allowed to develop strategies and an organizational structure that makes good business sense within the context of its own industry, even if these are somewhat different from corporate norms or from those of the finance company's

manufacturing affiliates. This often involves establishing plan objectives and performance measures that are quite different, as well as organizational reporting relationships and titles that would be unusual in a manufacturing business. Of course, it remains the responsibility of the finance subsidiary's management team to ensure that its strategic objectives are compatible with and supporting of those of its corporate parent, as well as its manufacturing affiliates.

## III. Continuing Corporate Responsibilities of A Finance Subsidiary of An Industrial Company and Constraints Under Which It Should be Developed and Operated

In developing its own business, staff and independent credit worthiness, a finance subsidiary of an industrial company also begins to take on a life of its own. This of course is essential if it is to maintain its ability to service its affiliated manufacturers' needs over the long term. Nevertheless, the finance company must be a responsible member of its corporate family. It should not take actions in pursuit of its own fortune that might be detrimental to its manufacturing affiliates, to other subsidiaries in its corporate family, or to its parent company. Even if it is well managed, a finance company may find it more difficult in practice than in the theory to meet these responsibilities while realizing its own potential for profitability and growth. ***Conflicts arise and compromises must be made that do not always perfectly reflect the preferences of either the finance company or its manufacturing affiliates.***

Some specific responsibilities and constraints that must be considered are:

a. Type of Equipment to Be Financed

One of the finance company's major responsibilities is to develop and implement strategies that will enable it to provide financing for the sales of its affiliated manufacturers in sufficient types and amounts and at competitive rates over the long term. It is a difficult task to manage a finance company's growth and development, including necessary transitions in financial structure and diversification, and at the same time to ensure that such financing is always available, but it can be done.

Also, the finance subsidiary should not provide financing that promotes the sales of manufacturers that compete directly with the finance company's affiliated manufacturers. This not only makes good business sense, but is important to the maintenance of good relations with these affiliates.

b. Levels of Investment

A Finance subsidiary should not undertake levels of investment that use capital needed by its affiliated manufacturers for research and development, modernization or growth.

c. Generation of Tax Benefits

A finance company should not generate more tax benefits than its consolidated parent can use currently. To do so would have the very destructive effect of making all the finance company's affiliates less competitive and could result in a significant reduction in its parent company's rate of return on equity. It may also seriously complicate its parent company's capital allocation process and performance standards for all subsidiaries. It is worth noting that it may be desirable for political reasons for a finance subsidiary's parent company to pay some taxes each year. This would mean that the finance company should limit its generation of tax benefits from year to year to amounts somewhat less than its parent company can use currently.

d. Relations with Affiliates

A finance company must maintain good relations with its manufacturing affiliates and other affiliated subsidiaries. This is a responsibility that is not only self evident, but is critical to the long-term success of the finance company. It is especially important for the finance subsidiary to establish and maintain a continuing dialogue with its affiliated manufacturers.

**IV. The primary objectives, responsibilities, constraints and derivative objectives of a finance subsidiary of an industrial corporation are:**

Primary Objectives -To provide sales financing for its affiliated manufacturers in types, amounts, and at rates that will provide these affiliates with a competitive advantage in order to:

- increase their profit margins and rates of return on equity.
- make the affiliated manufacturers' products and services affordable.
- strengthen their customer relationships.

To provide its parent company with a means of improving profitability by:

- increasing the rate and stability of equity turnover.
- generating tax benefits to be used currently, thereby increasing financial efficiency.
- dampening cycles in revenues and profits.
- contributing significant profits.

Responsibilities and Constraints

- To refrain from financing the sales of companies that competes directly with its affiliated manufacturers.
- To refrain from levels of investment that use capital needed by its affiliated manufacturers.
- To limit the generation of tax benefits in accordance with its parent company's ability or desire to use these currently.
- To maintain harmonious and productive relationships with affiliated subsidiaries.

Derivative Objectives (resources)

- To diversify its portfolio to ensure the development of the independent credit worthiness essential to meeting its primary objectives over the long term.
- To recruit high quality personnel and compensate them in accordance with performances.

To establish and exercise sufficient autonomy to:

- to ensure independent credit worthiness.
- to develop strategies, performance standards and measurements, and an organizational structure appropriate to its industry.

The objectives, responsibilities and constraints cited above are interrelated in a variety of ways. Some of these have the potential for producing conflict, even in a well managed finance company, and may become mutually exclusive in a poorly managed one. It is essential, therefore, for a well-managed finance company to develop the basic business approach that will prevent or, at the very least, minimize such conflict. Some important elements of such an approach are discussed below. These are presented using the various constraints cited above as points of reference.

Of key importance is the continuing profitability of the finance company itself. Such profitability is not only important to the establishment and maintenance of strong independent credit worthiness by the finance subsidiary, but it can also be a major source of new equity capital in the form of

retained earnings. A great many things affect the profitability of a finance company, but some factors are of primary importance. These include judicious and expert lines cited above, but involve many additional considerations as well, such as the establishment and implementation of appropriate criteria for the selection of new investment, and the maintenance of efficient operations. A finance company's success in these areas is greatly affected by the degree of autonomy it enjoys in the development and implementation of strategies, in the promulgation of procedures and guidelines, and in the recruitment of personnel and development of its organizational structure.

Another key factor is the maintenance by the finance subsidiary of a relatively steady rate of growth. A steady rate of growth facilitates portfolio planning and stabilized the generation and use of tax benefits as well as equity turnover, thereby increasing financial efficiency and improving the profitability of both the finance subsidiary and its parent. It also facilitates the staffing and organizational development of the finance company. In this regard, diversification is of considerable value because it provides some flexibility in the deployment of personnel, enabling the finance company to vary the amounts of new business it writes in its various market sectors from year to year. This, in turn, enhances the ability of the finance company to execute marketing and portfolio development strategies.

## V. Maintenance of Good Relations with Affiliated Manufacturers

What are the keys to development and maintenance of good relations between the personnel of a finance subsidiary and its affiliated manufacturers for whom the finance company provides sales financing?

The attitudes and demeanor of finance company personnel are one key to the maintenance of good relations. The personnel of a finance subsidiary of an industrial corporation must be made to understand that both the finance company and its employees are cast in a service role. This is true with respect to all customers and clients, but it is especially important that finance company personnel understand this and act accordingly when dealing with affiliated companies. A good finance company management team can and will make the service role part of the company's structure.

Another important factor is performance. A finance company must provide its manufacturing affiliates with good service. This is not to suggest that finance company personnel are to wait anxiously by the phone to respond instantly to every query or desire of its affiliated manufacturers. However, it does mean that the finance company must meet its commitments in a positive and timely way. Experienced managers will confirm that it is often more difficult for a finance subsidiary to develop a good service image among its own affiliates than with unrelated, third party customers and clients.

Mutual respect is another important element. In their joint effort to sell a manufacturer's product with financing, both the manufacturer and its affiliated finance company must bring something to the table. The manufacturer brings expertise concerning the equipment sold. The finance company must bring financing expertise. These respective abilities can be combined in a complimentary way that promotes success. If the finance company's representative in this effort cannot exercise the requisite financing expertise, he will contribute little to the sales effort, the finance company will fail to perform and its manufacturing affiliates will be justifiably disappointed. It is not uncommon for a newly formed finance affiliate of an industrial company to make the serious mistake of staffing its sales force with individuals who were previously employed by its manufacturing affiliates because of their familiarity with the equipment to be financed. As capable as these people may be, they seldom bring the requisite financing expertise to the sales negotiation process.

## VI. Closing Observations

The discussion above briefly presents in abstract form some important issues related to the internal development and growth of a finance subsidiary of an industrial company that is to finance the sales of affiliated manufacturing companies. Much is involved in the actual implementation of this approach that is not discussed. It is seldom possible, and may not even be desirable, for a finance company to possess at the outset all the "resources" described herein. In a very real sense, some of these may truly be derivative "objectives". But it must be emphasized that a finance company that fails to achieve these derivative objectives in due course will not be viable over the long term. In addition, a finance subsidiary also needs much more than an internal approach or strategy for development. It needs to develop and implement sound business and marketing strategies that govern how the company competes in its various markets, as well as strategies for the development of personnel, technical resources and so on.