Changing Lanes and Shifting Gears

The Case of Duncton Plc

Case study
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This case was written by Dr Graham Miller and Cinla Akinci, University of Surrey and Dr Philip Walsh, Ryerson University. It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was made possible by the co-operation of Peter Minter, Duncton Plc.

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Changing Lanes and Shifting Gears: The Case of Duncton Plc

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Introduction

Peter Minter, Managing Director of Duncton PLC, had just got off of the phone with Duncton's bank. While the company had experienced double-digit growth over the past 4 years under his leadership, and was now a significant provider of sub-prime vehicle financing in the UK, he was facing the need to refinance the company as their lender had just provided notice that it would no longer be able to provide financing for Duncton's fleet of vehicles. Peter realized that he was going to have to quickly arrange for a meeting with the three other owners of Duncton to discuss this change of events. While the decision by the bank was not a reflection on Duncton, Peter was still disappointed with the bank's decision, but he also realized that it had come at a time when the owners of the company had been considering an appropriate exit strategy. Peter decided that before he would meet with them, he needed to reflect on the appropriate future strategy for Duncton PLC.

Duncton Plc

Background

Duncton is a provider of sub-prime vehicle financing in the UK. Established in 1992, it lends money to people who would like to borrow money to buy cars, but who are unable to receive credit from mainstream banks and credit companies because of an impaired credit history. For lending money to those who cannot receive credit from traditional sources, Duncton charges a premium. Duncton focuses on lending money to finance the purchase of higher-value cars.

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[1] *Dr. Graham Miller, Ms Cinla Akinci and Dr Philip Walsh prepared this case with the generous co-operation of Mr Peter Minter, Duncton PLC. The case should serve as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.*

Duncton was created by one of the current owners: an experienced car dealer who decided to provide vehicle financing for his customers as a result of an increased demand for dealer financing at his auto dealerships. For the past 15 years (See Appendix A – Duncton Timeline), Duncton's business model has focused on establishing an asset base, the value of which was primarily the trade value of the vehicle, and on restricting the initial financing of that vehicle to less than 95% of the trade value of the vehicle (See Appendix B – Duncton's Business Model).

Duncton's senior management team has more than 30 years experience in the vehicle finance industry (See Appendix C – Duncton's Founders and Management) and is led by the Managing Director, Peter Minter. Peter has a background in finance and business development. He is supported by Duncton's Finance Director, Tony Gourlay, who also has significant fleet and banking experience, and by Neil Eustace, Head of Sales and Marketing, who has held key roles within the area of consumer marketing.

Management currently emphasizes the importance of operations and collections. As at December 2006, Duncton had a fleet of 2,304 vehicles (adjusted book value of £29 million), with an average annual growth in fleet size of 17% since 2001. This growth has been achieved profitably with pro forma pre-tax profits of £279,000 in fiscal 2005 and £579,000 in fiscal 2006 (subject to audit), with pre-tax profits of £708,000 forecast in fiscal 2007. While Duncton's size is small relative to its competition, Management sees as assets their smaller size and their experienced management, allowing the firm to be more nimble and responsive to changes affecting the industry.

Duncton's Business Operations

To generate customers, Duncton relies on a wide network of industry brokers (approximately 650 broker relationships), dealers and vehicle manufacturers. The sales team responsible for establishing and managing these relationships is measured and rewarded on the net present value of each customer contract developed.

The use of the Internet has not played a large role in Duncton's business. The primary reason for this is the concern on the part of Duncton's management that the use of the Internet for the purpose of screening potential customers denies the subtlety and nuance of an experienced underwriter, lacks quality assurance and does not have proper controls in determining whether the potential customer warrants pursuing. Further development of an appropriate platform for pre-qualification of customers that incorporates Duncton's financing rules is seen as having some potential for sales growth and a key investment to be funded from any additional financing raised by the company.

The underwriting process is overseen by the Managing Director and is broken into three key areas:

> **Lease Value:** Vehicle value through the life of the agreement is less than the trade value of the vehicle as there is typically a large initial payment that ensures the loan amount is less than the trade value of the vehicle and that the customer is financially committed to the contract.

Traceability of Vehicle: The location of both the vehicle and the customer is monitored through a series of checks, including electoral roll, personal visits, electronic in-car trackers (the only company in the industry to use them), and ID verification.

Credit Risk Management: A customer's credit position is verified through the use of credit reports, references, employment records, and bank statements.

For the purposes of credit control, Duncton maintains a process of monitoring receipt of payment for every contract, with the Company having zero tolerance for non-payment. In circumstances where non-payment occurs, Duncton employs an in-house legal team to process claims, taking approximately six months from default to secure charging orders on properties owned by default customers where available. This internal group has a record of 79% collection record of debts secured by a charging order over the past two years. When a vehicle is returned to Duncton, an in-house disposals team is given the responsibility for ensuring the net disposal value of the vehicle is maximized. The use of in-house teams for these latter functions is different to other vehicle finance operations in the UK market as these other companies outsource a large proportion of these functions.

While Duncton provides only longer-term financing arrangements (3 to 5 years), Management has considered expanding its product range to include daily rentals for six-month periods for those customers who do not meet Duncton's credit requirements under its more traditional sub-prime financing arrangement.

Remote environment

At the time of writing, the UK economy is performing well with historically low levels of unemployment, low interest rates, and rising house prices. The average price of new and used cars is falling, leading to a decline in the size of the sub-prime finance market. Levels of mortgage arrears and repossessions of houses are low, as is the number of legal prosecutions (county court judgments) brought against individuals who have failed to meet debt repayments. However, in order to quell growing price inflation largely in the housing market, base interest rates have raised recently, which may begin to affect the affordability of personal debt repayment.

Despite the relatively benign economic environment, the number of personal bankruptcies has increased dramatically as people have taken on unsustainable levels of personal debt. The year 2004 saw a 31% rise in the number of people being declared insolvent over those declared insolvent in 2003, illustrating the change in social attitudes towards accepting what was once a social status with negative stigma. Personal indebtedness has raised to £1trillion with around 20% of this amount unsecured in the form of personal loans and credit cards. At the end of 2004, it was estimated that the average UK adult held over £4,000 of unsecured debt. These figures have been widely reported in the media, and the sub-prime market—particularly for credit cards—has received lots of negative publicity. In combination with the sub-prime mortgage problems facing the US, the image of sub-prime lending is not strong.

Frequently there is pressure for greater regulatory involvement in order to reduce the level of indebtedness of those with poor credit histories. Indeed, a tightening of lending criteria as required by the Consumer Credit Act will mean more rejected borrowers and so serve to increase the pool of people from which those in the sub-prime market can draw. However, a number of factors can influence the ability to attain 'prime' credit, such as whether the individual holds a bank account (which can be a time-consuming process for recent immigrants to the UK and of which there are an increasing number), or being self-employed and therefore without a regular and guaranteed income. Given the drive of the government to encourage more business start-ups, sub-prime lending can become an important element in operationalising a potential company. Similarly, the goal of reducing social exclusion has at its heart the need for individuals to be able to be mobile in order to take advantage of economic opportunities that present themselves. Sub-prime lending can offer those at the margins of society the chance to borrow money to buy a car, which will allow them to begin to work and so develop and strengthen their credit history.

The UK Sub-Prime Vehicle Finance Market

The UK vehicle finance market is divided into a prime lending segment (worth £9.5 billion) and the non-standard lending segment, which includes sub-prime vehicle lending (worth £2.6 billion)[2]. Datamonitor forecasts the growth of the sub-prime vehicle lending to be 8.4% per year until 2009 (£4 billion) and that the sub-prime market will represent 27.3% of the UK motor vehicle market, up from 21.8% in 2004 (See Appendix D – UK Vehicle Lending Growth). The non-standard motor vehicle finance market is dominated by used cars, with the dominant form (85%) of contract or agreement being hire purchase (lease to own). The sub-prime vehicle lending market is far more mature in the UK than in other European countries, although the sub-prime vehicle lending market is beginning in countries such as the Netherlands, Ireland and France.

The non-standard and sub-prime sector of the UK vehicle finance market has traditionally been, and continues to be, poorly serviced by the established lending community. The sub-prime vehicle financing industry can be divided into two broad segments:

1. Those individuals or companies with no or low funds and who are typically looking for a lower-value vehicle that conventional prime lenders will not lend against; and

2. Those who have funds, but whose credit rating is impaired in some way and therefore are unable to borrow from conventional prime lenders.

Accordingly, the sub-prime market is an attractive segment of the UK vehicle finance market because it attracts high margins resulting from the difference between the higher interest rates that customers are charged by sub-prime lenders and the lower financing charges that sub-prime lenders are able to receive from banks and conventional lenders (See Appendix E – Contribution Determination). For some sub-prime lenders, significant additional revenues are generated through insurance commissions and

[2] Datamonitor "UK Non-Standard Sub-Prime Consumer Credit" report May 2005

document fees. For many industry participants, these revenues can exceed the net margins generated by the interest charges after bad debt charges have been applied. The long-term nature of the lending contracts between the customer and the sub-prime lenders (3 to 5 years) results in significant penalties (and revenue to the lender) should a customer terminate a contract early.

Sub-prime lenders in the UK vehicle finance market typically access their funding from conventional prime lenders, such as banks and finance companies. The security for the conventional prime lenders is a combination of the vehicles themselves and the remaining assets of the sub-prime lender. For the sub-prime lender, the cost of financing these vehicles represents a significant portion of the costs of doing business as the business itself is capital intensive. As noted above, the sub-prime market still represents only a quarter of the total UK vehicle finance market and is a relatively minor financing market when considering the size of the UK property and commercial financing sector.

As most of the vehicles involved in the sub-prime market are used automobiles, the source of vehicles are those suppliers involved in the secondary market, such as used-car dealerships, car-rental agencies and prime-leasing companies. The UK used-car market is very competitive, with many choices of car brands and ages available. However, there is an obvious trend towards newer used cars as customers seek to change their cars more frequently.

The UK sub-prime vehicle financing market is characterized by a limited number of participants (12) with seven principle players, including Duncton. The market is highly segmented, without any dominant branding and with most participants focused either on higher credit-rated customers or lower-value vehicles. Appendix F provides an overview of their market positioning. In recent years, the industry has seen the entry of a number of players from the prime sector only to have them exit the market in a relatively short period. The failure of market participants to succeed in this industry is due in part to a combination of: high operating costs; an inability to collect on overdue payments; the need to securitize the assets so as to reduce provisions for bad debts; over-expansion leading to poor quality underwriting; and, an absence of the experience of working with the sub-prime lending market. Appendix G compares some key comparative characteristics of the industry and Appendix H compares Duncton's ability to collect payments with its industry competitors.

Duncton's Financial Position

Duncton has seen its pro forma pre-tax profit rise from £86,000 (1% margin) in fiscal 2004 to an estimated £579,000 (4.7% margin) in fiscal 2006. Duncton's management forecasts their pre-tax profit to grow by 36.1% per year to £1.46 million (6.2%) in fiscal 2009 based on continued forecast growth in loan origination of 21% per year. Duncton's management also predicts that their fleet financing facility requirement is going to grow to £52 million by the end of fiscal 2009. A comparative analysis of Duncton's financial position is shown in Appendix I.

Appendix A - History of Duncton PLC

Pre'92 — Lease Financing by Director 1 on ad-hoc basis through dealership

1992 — Establishment of Duncton as Finance provider on stand-alone basis. Directors 1 and 2 provide funding from personal equity

1994 — Director 3 joins management, buying into Duncton and serving as part-time CEO

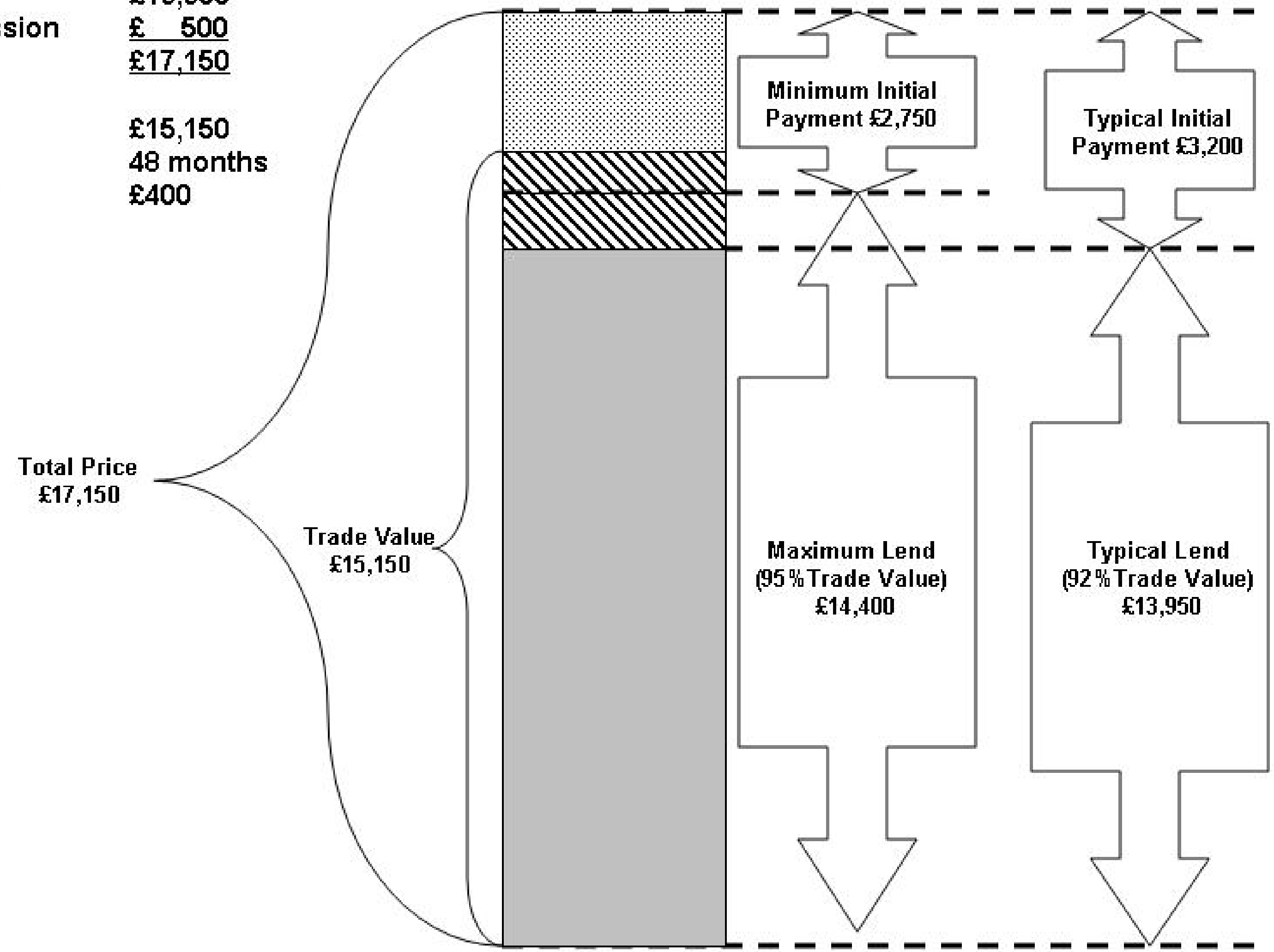
1995-2001 — Organic growth to 1,000 car fleet with financing from third parties on small bi-lateral basis

2002-2003 — Professional management team recruited at Managing Director, Finance Director and Sales Manager level. Business Model refined to allow for fleet financing by bank

2003-2006 — Core systems developed to provide for expansion of fleet to over 2,000 vehicles and staff of 37

Appendix B – Duncton Plc Business Model

Retail Price	£16,650
Broker Commission	£ 500
Total Price	£17,150
Trade Value	£15,150
Contract Term	48 months
Monthly Rental	£400



Appendix C – Duncton PLC Founders and Management

Founders:

Director 1
Originally a wholesale motor dealer in specialist cars and an adviser to vehicle valuation organizations, he is a former founder of a retail finance company, a vehicle service company owner, and a Director of a vehicle contract-hire company.

Director 2
A chartered accountant and venture capitalist, he has more than 20 years experience in corporate turn-arounds and corporate acquisitions and divestitures.

Director 3
Former strategy consultant and senior executive, he has held executive and non-executive chairmanships with a number of companies, including a sub-prime mortgage company.

Founders Ownership of Duncton PLC	% of Equity
Director 1	27
Director 2	36
Director 3	34

Senior Management Team:

Peter Minter, Managing Director
Joined Duncton in 2002 with strategic objective to grow the business organically into the leading sub-prime vehicle finance business. A civil engineer with an MBA, Peter has experience in the international industrial consultancy field, and for the past 18 years has held increasingly more-senior positions in the vehicle leasing and finance industry. He has been involved in a number of start-up ventures related to the leasing industry.

Tony Gourlay, Finance Director
Joined Duncton in 2004 and is responsible for the finance, accounts, tax and IT functions of the company. A mechanical engineer and qualified charter accountant, he has spent 21 years in a variety of senior group finance roles, including 10 years as the finance director of the largest vehicle leasing and finance company in Europe.

Neil Eustace, Head of Sales and Marketing
Joined Duncton in 2005 after 20 years of key roles in sales and marketing with organizations, including Canon UK and Chubb.

Appendix D – UK Vehicle Lending Market Gross Advances (£million) (2004 – 2009)

	2004	2005E	2006E	2007F	2008F	2009F	*Average Annual Growth Rate*
Total UK market	12,106	12,036	12,720	13,125	13,838	14,479	
annual growth	-	*-0.6%*	*5.70%*	*3.20%*	*5.40%*	*4.60%*	*3.60%*
Non-standard UK	2,642	2,992	3,170	3,321	3,614	3,954	
annual growth	-	*13.2%*	*5.9%*	*4.8%*	*8.8%*	*9.4%*	*8.4%*
% Non-standard share	**21.8%**	**24.9%**	**24.9%**	**25.3%**	**26.1%**	**27.3%**	

Source: Datamonitor

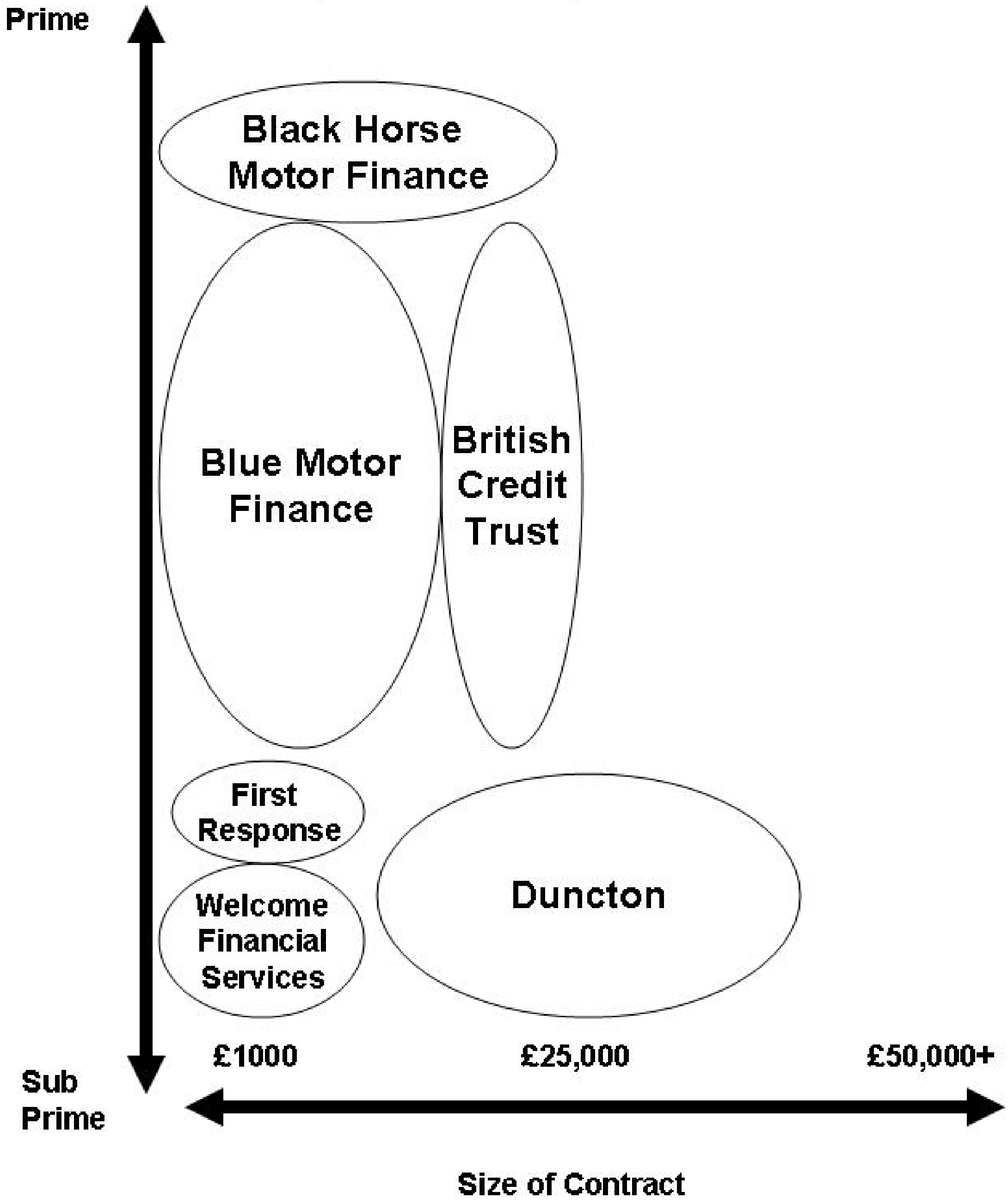
Appendix E – Contribution Determination for UK Sub-Prime Vehicle Financing Industry

Customer Interest	20.0%
Subsidies	0.0%
Commission (expensed)	-4.0%
Net Interest	16.0%
Cost of Money	-7.0%
Interest Margin	9.0%
Band Debt Charge	-7.0%
Gross Margin	2.0%
Other Income	
Document Fees	2.0%
Insurance Commission	2.5%
Other Fees	1.5%
Misc. income	1.0%
Total	7.0%

1. Source Duncton PLC

Appendix F– Overview of Duncton's Market Positioning vs. Competitors

(Source: Duncton Plc)



Appendix G – Duncton's Relative Competitive Position in the U.K. Sub-Prime Vehicle Lending Market (Industry average = 100%)

Derived from Sample of 7 Market Competitors[1]

>100=higher as compared to the industry average <100=lower as compared to the industry average	**Outstanding Contracts Total Value**	***Rank (n=7)***	**Operating Costs**	***Rank (n=7)***	**Related Other Income (i.e. Insurance)**	***Rank (n=6)***	**Cost of Borrowing**	***Rank (n=6)***	**Contract Arrears**	***Rank (n=7)***	**Bad Debt Provision**	***Rank (n=6)***
	3.5%	5.00	166%	6	68%	4	105%	5	217%	7	65%	2

1. Source Duncton PLC

Appendix H – Relative Comparison of Contract Arrears: Duncton vs. Industry[1]

Arrears-Industry Average Benchmark=1	**Industry**	**Duncton**
1-30 days	1	1.82
31-60 days	1	1.99
61-90 days	1	1.59
91-120 days	1	1.33
120 + days	1	3.57
Total	**1**	**2.62**

>1=higher number of contract arrears as compared to the industry average
<1=lower number of contract arrears as compared to the industry average

1. Source: Duncton PLC

Appendix I – Duncton PLC Comparative Financial Statements

Comparative Balance Sheet for Duncton PLC (FY04-FY06)

	Pro Forma Historical		
£000s	**FY04**	**FY05**	**FY06E**
Fixed Assets			
Contract assets[1]	21,052	25,252	29,641
Other fixed assets	389	338	312
Total Fixed Assets	21,441	25,590	29,953
Current Assets			
Trade debtors	1,426	2,819	3,563
Stock vehicles	64	126	170
Other assets & prepayments	878	858	975
Total Current Assets	2,368	3,803	4,708
Current Liabilities			
Trade creditors	(150)	(161)	(183)
Deferred tax	(262)	(259)	(259)
Overdraft	(196)	(994)	(735)
Fleet financing	(20,581)	(25,215)	(30,358)
Accruals & other liabilities	(305)	(337)	(608)
Total Current Liabilities	(21,494)	(26,966)	(32,143)
Net Assets	2,315	2,427	2,518
Loan stock/Mezzanine loans	1,019	1,067	1,120
Share capital	215	215	215
Profit and loss reserves	489	563	966
Revaluation reserve	592	584	219
Shareholders' Funds	2,315	2,429	2,520

1. Deferred income netted off fixed assets in pro forma balance sheet

Comparative Profit and Loss Account for Duncton PLC (FY04-FY06)

	Pro Forma Historical		
£000s	**FY04**	**FY05**	**FY06E**
Total Income	**8,921**	**11,148**	**12,311**
Gross Margin	**2,836**	**3,722**	**4,158**
Bank charges & fees	(113)	(112)	(64)
Bank interest	(1,119)	(1,500)	(1,778)
Loan stock interest	(43)	(48)	(53)
Mezzanine loan interest	(80)	(73)	(73)
Profit before overheads	**1,481**	**1,989**	**2,190**
Payroll Costs	(853)	(1,131)	(1,164)
Other Overheads	(647)	(678)	(806)
Transfer from revaluation reserve[1]	106	99	360
Pretax Profit	**87**	**279**	**580**
Tax	108	(205)	(96)
Profit after tax	**195**	**74**	**484**
Dividend	(125)	-	(80)
Transfer to P&L reserve	**70**	**74**	**404**

1. Transfer, for pro forma basis, from revaluation reserve in respect of former company-owned vehicles sold during the year