Changing Lanes and Shifting Gears: The Case of Duncton Plc

Dr. Graham Miller
Faculty of Management and Law, University of Surrey, U.K.

Cinla Akinci
Faculty of Management and Law, University of Surrey, U.K.

Dr. Philip Walsh
Ted Rogers School of Management, Ryerson University, Canada

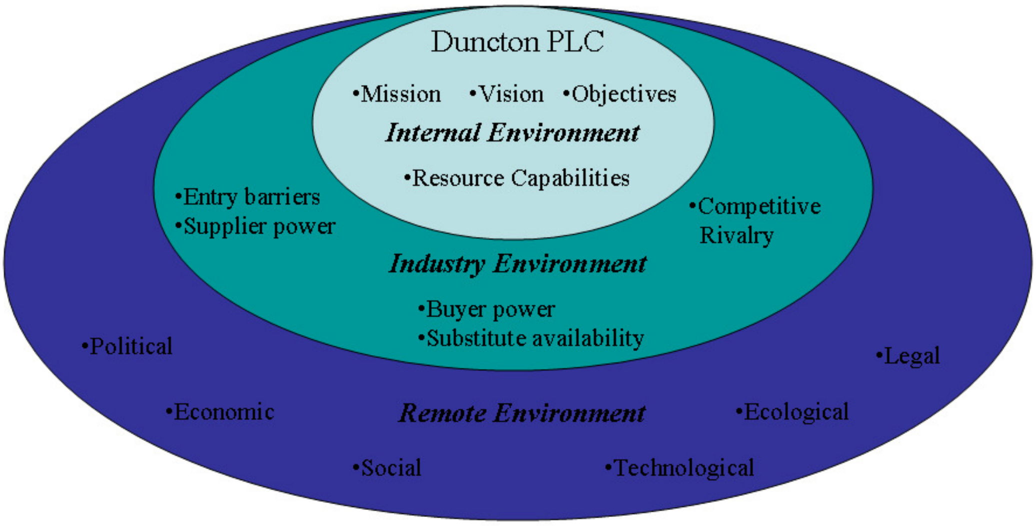
Teaching Notes

The Duncton PLC case study is ideal for final year undergraduate management students and MBA students. The case addresses a real life situation whereby a small- to medium-sized enterprise is dealing with its owner's determination as to what the appropriate next step might be in growing the company, while at the same time addressing the appropriate exit strategy for the owners over that same period. A common dilemma for owners and managers of small- and medium-sized enterprises, the students will find that they need to address the environments, both externally and internally, that the company and its owners face. The case involves discussion of the sub-prime market for lending, a contemporary topic for business students.

The traditional strategic framework (See Figure 1) that students should be encouraged to use will allow them to consider the following issues that arise in the case and must be addressed by the company's owners:

1. Is the remote environment in which Duncton finds itself changing for the better or worse in regards to the sub-prime vehicle financing business?
2. Is the UK sub-prime vehicle lending industry attractive for participants, and what might the key success factors be for industry competitors?
3. What is the long-term prospects for Duncton in this industry and what strengths and weaknesses does the company currently have that may or may not result in its future success?
4. For the owners, what are the implications of the previously listed issues to their ability to determine and implement an acceptable exit strategy, and what might that exit strategy be?

Figure 1: Strategic Analysis Framework (Walsh 2007)



Is the remote environment in which Duncton finds itself changing for the better or worse in regards to the sub-prime vehicle financing business?

Political and Legal

The new Consumer Credit Act will tighten the lending criteria making it likely that more borrowers will fail by existing assessment tools. This would push a growing number of would-be consumers from the mainstream market into the sub-prime market. However, if the aim of the legislation is to ensure consumers do not borrow beyond their means, then it would seem reasonable to expect some additional legislation to prevent consumers simply moving to alternative sources of funding. However, the effect of this increase in regulation will be additional work and an additional fee charged to consumers to compensate for this extra work. This will enable Duncton to charge higher fees in keeping with its competitors, and if Duncton is able to manage its costs, then the potential exists for higher margins.

Economic

As interest rates rise, so repayment of loans becomes less affordable, and bankruptcies, insolvencies and repossessions will increase. This state serves to add customers into Duncton's market. Such customers may once again fail to maintain their repayments and Duncton may face a rise in early termination of the contracts themselves. But, if properly managed, profit can still be derived from the deal.

Conversely, in a flourishing overall market, where interest rates are low and employment high, more customers will qualify for mainstream sources of lending, denying Duncton of a customer base, but making the circumstances for repayment easier for any customers who do not qualify for mainstream lending.

Social
The emphasis on innovation and small business start-ups should continue to see a rise in the number of self-employed in the UK. Such businesses will suffer from lack of credit histories at the beginning, and so potentially be suited to receiving funds from Duncton.

Technological
Two key strengths work against the Internet offering opportunities for Duncton. The first strength lies in the skill of its underwriters and their ability to discern a potentially good customer from one with a high risk. The Internet offers the potential to Duncton to automate more of the process of underwriting and so speed the decision-making process. But such an automated system of underwriting would fail to take advantage of the subtle skills possessed by staff at Duncton. The second strength the company enjoys is its relationship with its brokers, who bring the business to Duncton rather than to competitors. The strength of this relationship is exemplified by the way in which its brokers are considered as the customers of the company rather than considering the customer to be the person who actually buys the car. An Internet interface would allow the purchaser of the car to contact Duncton directly, and so remove the need to pay commission to the brokers. However, with no commission paid, the brokers would have no incentive to direct business to Duncton, and a currently valuable distribution channel would be threatened.

Ecological
While there is an ambition to direct more traffic away from the roads and towards rail, this remains a long-term ambition and not one likely to affect Duncton for the foreseeable future. Any pressure to reduce carbon emissions is likely to be manifest in different types of cars being sold, using different fuels rather than any large-scale modal change.

Is the UK sub-prime vehicle lending industry attractive for participants, and what might the key success factors be for industry competitors?

The application of a strategic framework derived from Porter's five forces model and shown in Teaching Notes – Appendix A dealing with the analysis of the UK Sub-prime vehicle lending industry, provides some answers to the question of industry attractiveness. Students should attempt to answer these questions themselves and then determine whether they consider this industry attractive for participants. Our analysis would indicate that the industry is moderately unfavourable, but students may approach the Bargaining Power of Suppliers without considering the power of the lenders of capital to the sub-prime industry participants and the effect it has on balancing out what would appear to be a lack of power on the part of used-vehicle suppliers. As a result, students would see the Bargaining Power of Suppliers being favourable to the industry as opposed to moderate and this might lead them to see the industry as moderately favourable or even favourable.

In terms of key success factors, teachers may wish to provide students with a framework for comparing the core competencies (key success factors) required by participants in the industry (See Teaching Notes – Appendix B), without the key success factors, weightings, ratings, or scores. While this framework can be expanded to compare industry participants individually, the data acquired in researching this industry provided only a comparison between Duncton PLC and an aggregate of competitors within the industry.

The case study provides students with a summary of these industry characteristics (See Case Study-Appendix G) as well as some discussion within the case itself. Using this framework, students can attempt to identify what the key success factors are in this industry, consider the relative competitive strength between Duncton and its industry competitors in employing these key success factors and to determine what the importance weighting of these factors should be. This latter part of the process should allow for considerable discourse on the part of the students as the case does not attempt to address the element of importance weighting. Our analysis has chosen to rate the industry strength at 5 for each of the factors, as the data provided in the case allows for determining the industry average, and to determine Duncton's rating by relating Duncton's ranking in that data to the industry average.

Our choice of importance weighting is based on our interpretation of the data gathered during the research of this case study, and students may choose to employ different weightings. As indicated earlier, this process will result in considerable discussion amongst the students as they attempt to justify their recommendations of what are the key success factors of the industry and then their choice of importance weighting for each of these factors. Regardless of their choice of weightings, students should find that the competition is stronger in most key success factors and that the strength of Duncton in lower bad debt costs is offset by its high contract arrears.

What is the long-term prospects for Duncton in this industry, and what strengths and weaknesses does the company currently have that may or may not result in its future success?

The use of a SWOT model provides the student with the answers needed for this question. Teaching Notes – Appendix C is a list of key questions that students can attempt to answer using the information provided in the case. These questions deal with the strengths and weaknesses of Duncton and the opportunities and threats to which that Duncton is exposed.

In reviewing the case, the students will be able to identify that Duncton's strengths are its capability of adapting to environmental change because of its smaller size and experienced management. Another strength is the unique combination of experience in sub-prime finance, cars and banking that the owners and management possess. The historic performance of the company and its current financial strength are additional strengths. Students may also identify the use of electronic in-car tracking mechanisms as an innovative approach to providing a service in that it reduces the risk of vehicle loss.

Some weaknesses that can be identified include a small market share, no apparent competitive advantage and a limited usage of the Internet.

Opportunities for Duncton include the use of an Internet platform for customer acquisitions and the creation of a product that provides daily rental of cars for customers with no credit history for a limited period, at which point these customers can move up into a more conventional sub-prime arrangement after developing a credit history through their daily rental arrangement. Sub-prime vehicle lending is starting in other countries in Europe and this also presents an opportunity for Duncton.

Threats that Duncton face include the competitive strength and size of its competition and the future available capital for growth.

SWOT Analysis of Duncton PLC

Strengths	Weaknesses
•Ability to adapt to change •Management experience •Historical performance •Current financial strength	•Small market share •No apparent competitive advantage •Limited usage of the internet
Opportunities	**Threats**
•Use of the internet •Daily car rental •Expansion into Europe	•Size and strength of the Competition •Future ability to raise capital

Teaching Notes – Figure 5 provides the framework for comparing significant financial data for Duncton over the previous three years. Students should be asked to determine the key financial ratios to consider for this case study and then to discuss the implications of the results of a comparative review over the three-year period.

Students should note that Duncton PLC is a profitable company generating stable returns on capital employed and assets employed. The return on shareholder equity is extremely high reflecting the very high debt leverage employed by Duncton. While almost the entire debt of Duncton is covered by contract assets in the form of vehicles, any devaluation of vehicle values, increased financing costs, or non-payment by customers represents a substantial risk to the survival of the firm. Students may choose to explore various scenarios around the impact and the likelihood of the impact of these issues on the profitability of the firm, as well as benchmarking Duncton against larger publicly traded companies in the same industry or in sub-prime financing of consumer goods.

The major question arising from the financial analysis is whether the existing shareholders or future shareholders of Duncton should be accepting this level of return on capital employed relative to the risks associated with this industry.

For the owners, what are the implications of the previously listed issues to their ability to determine and implement an acceptable exit strategy, and what might that exit strategy be?

For Duncton's owners, they must contemplate whether the UK sub-prime car financing industry remains favourable for continued investment and growth. The remote environment analysis (PESTEL) suggests that the industry is not threatened by any major change driver and, if anything, the industry looks to be recession proof. The potential for the use of advancing technology in enhancing Internet sales/service and car tracking and retrievals provides additional support for this industry.

The industry itself may pose the greatest risk for Duncton's owners. Students may find, through the application of the Five Forces Model, that this industry is moderately favourable for investment, but the competitive strengths analysis will provide some concern about whether Duncton, in its current position, can maintain its profitability in the face of industry competition and the risk of losses related to increasing non-collectible arrears.

Students should point out that Duncton is still a niche player in this market and has been successful in sales growth and profitability even though its cost structure and arrears position are less competitive relative to its industry competitors. Future growth will result in increased exposure to competitive pressures and a need to continue lowering costs and arrears.

The case began with the identification of the need by Duncton's management to replace their existing bank financing with alternative financing. Students should obviously identify this as paramount to any future objective of management. But in doing that, should Duncton's management be considering the kind of financing in light of Duncton's current strengths and weaknesses and Duncton's current capital structure? A key success factor is lower debt costs, and therefore the replacement financing should cost the same or lower than Duncton's current debt financing. The current high level of debt leverage may result in higher debt costs due to the identified industry risk. Any future exit strategy for the owners must consider the implications of the amount and cost of the new financing and whether or not additional equity financing is appropriate at this time. More importantly, students should identify that by continuing to lower costs and reduce contract arrears Duncton will improve future profitability and increase future return on capital employed. This would allow for a higher price for any equity financing or company sale should either choice of exit strategy be undertaken.

Appendix A - External Environment Analysis – Industry Environment

Porter's Five Forces Analysis

Overall Industry Rating	**Favourable**	**Moderate**	**Unfavourable**
Threat of New Entrants		***X***	
Bargaining Power of Buyers			***X***
Threat of Substitutes	***X***		
Bargaining Power of Suppliers		***X***	
Intensity of Rivalry Among Competitors			***X***

The industry is moderately unfavourable.

Each of these five forces can be measured by answering the following questions and summing the responses into yes (favourable) and no (unfavourable) categories.

I. Threat of New Entrants	Yes +		No -	Comments
1.Do large firms have cost or performance advantage in your segment of the industry?	X			While there is little in the case to substantiate this response, the fact that Duncton ranks near the bottom of the industry in profitability and in cost performance and also ranks near the bottom in market size suggests that the larger firms in the industry have a cost and performance advantage.
2. Are there any proprietory product differences in your industry?			X	Financing is a generalized product.
3. Are there any established brand identities in your industry?			X	There would appear to be no established brand identities as of yet in the market.
4. Do your customers incur any significant costs in switching suppliers?	X			As Duncton requires its customers to make substantial deposits and to incur penalties upon early termination of their contracts, this suggests that there are significant costs to switch.
5. Is a lot of capital needed to enter your industry?	X			This is a highly capital-intensive market due to the high cost of products (cars) being leased.
6. Is serviceable, used equipment expensive?	X			Most of Duncton's leased vehicles are used, but because of the "less than four years old" policy they are still quite expensive.
7. Does the newcomer to your industry face difficulty in accessing distribution channels?			X	Duncton uses a large number of brokers to access their customers, these brokers are generally not limited to any one supplier.
8. Does experience help you to continuously lower costs?	X			A large cost component is the bad debt issue in this business, and experience developed in the risk management area helps reduce this cost.
9. Does the newcomer have any problems in obtaining the necessary skilled people, materials, or suppliers?			X	The financing industry in the UK is very large and there is little specialization required to move from one sector to another, for example, home financing to car financing to equipment financing.
10. Does your product or service have any proprietary features that give you lower costs?			X	See comment 2 above.
11. Are there any licences, insurance or qualifications that are difficult to obtain?			X	It is not difficult to obtain business licences and there are moderate regulations in place to control the operation of consumer credit organizations.
12. Can the newcomer expect strong retaliation upon entering the market?			X	The market size is so large and fragmented that there is limited competitive rivalry.

II. Bargaining Power of Buyers	Yes +		No -	Comments
1. Is there a large number of buyers relative to the number of firms in the business?	**X**			The case identifies 13 companies actively involved in the UK sub-prime motor finance market, worth an estimated 3 billion British pounds and with approximately 600,000 customers.
2. Do you have a large number of customers, each with relatively small purchases?			**X**	While there are a large number of customers, their purchases are generally singular and relatively large purchases, i.e. vehicles.
3. Does the customer face any significant costs in switching suppliers?	**X**			As Duncton requires its customers to make substantial deposits and to incur penalties upon early termination of their contracts, this suggests that there are significant costs to switch.
4. Does the buyer need a lot of important information?			**X**	The buyer typically requires only the term of the lease, amount of deposit and monthly payments. They rely on the promotion of auto manufacturers and driving history to determine choice of vehicle.
5. Is the buyer aware of the need for additional information?			**X**	Information is contained within the contract, but the buyer typically does not seek additional information given their circumstances dealing with the supplier of last resort.
6. Is there anything that prevents your customer from taking your function in-house?	**X**			Customers are unable or unwilling to finance their acquisition themselves.
7. Are your customers highly sensitive to price?		**X**		Customers may be highly sensitive to price, but have no choice in the matter.
8. Is your product unique to some degree? Does it have accepted branding?			**X**	Sub-prime leasing is not unique and it would appear from the case to lack any examples of branding.
9. Are your customers' businesses profitable?			**X**	While the case does not provide any specifics, it can be generalized that, due to the nature of the need to seek sub-prime financing, the customers' businesses have yet to achieve a level of profitability to qualify them for prime financing.
10. Do you provide incentives to the decision makers?			**X**	There would appear to be no incentives provided by sub-prime vehicle lenders except in the form of competitive finance rates.

III. Threat of Substitutes	Yes +		No -	Comments
1. Substitutes have performance limitations that do not completely offset their lowest price, or their performance advantage is not justified by their higher price.	X			Customers cannot achieve prime financing as it requires too much credit worthiness and they cannot afford to buy a car outright.
2. The customer will incur costs in switching to a substitute.	X			**See Comments in Sections I.4 and II.3 above**
3. Your customer has no real substitute.	X			Generally customers have no choice in the matter; they must go into the sub-prime market in order to finance a vehicle.
4. Your customer is not likely to substitute.	X			During the term of their contract, they will most likely not substitute. However, upon the completion of the contract, they may have reached reasonable credit-worthiness to substitute with either prime financing or outright purchase.

IV. Bargaining Power of Suppliers	Yes +		No -	Comments
1. My inputs (materials, labour, services, etc.) are standard rather than unique or differentiated.	X			The business requires standardized products and services. The two principal suppliers to Duncton are in the areas of used vehicle supply and financing for the purchase of the used vehicles to sub-prime customers.
2. I can switch between suppliers quickly and cheaply.		X		The used-car market is very competitive with many choices of car brands available, but the financing used to purchase vehicles for sub-prime customers may need to be undertaken using fixed finance arrangements at lower interest rates but with early termination-cost provisions.
3. My suppliers would find it difficult to enter my business or my customers would find it difficult to perform my function in house.			X	Suppliers of vehicles would not find it difficult to supply directly to customers under sub-prime financing terms, nor would conventional financers should either wish to undertake the risk.
4. I can substitute inputs readily.		X		The used-car market is highly competitive, but financing for sub-prime lending at competitive rates is not readily available.
5. I have many potential suppliers.		X		See above comment.
6. My business is important to my suppliers.		X		The sub-prime finance market would appear to be a significant contributor to the sale of used vehicles, but in the case of Duncton, it was not important to its bank.
7. My cost of purchases has a significant influence on my overall costs.	X			Financing related to the acquisition of vehicles for leasing represents approximately 43% of the costs related to Duncton's business.

V. Rivalry Among Existing Competitors	Yes +		No -	Comments
1. The industry is growing rapidly.	X			The industry is forecasted to grow at an average 8.4% per year; over twice that of the total UK vehicle-lending market.
2. The industry is not cyclical with intermittent over-capacity.			X	The industry shows some cyclicity.
3. The fixed costs of the business are a relatively low portion of total costs.			X	For Duncton, fixed costs, such as payroll and overhead, represent approximately 50% of its cost structure.
4. There are significant product differences and brand identities among the competitors.			X	**See Comments in Sections I.2, II.8.**
5. The competitors are diversified rather than specialized.			X	Most of the competitors are involved particularly in the sub-prime vehicle-financing industry.
6. It would not be hard to get out of this business because there are no specialized skills or facilities or long-term contract commitments, etc.			X	On average, 4-year contracts with customers.
7. My customers would incur significant costs in switching to a competitor.	X			**See Comments in Sections I.4, II.3 and III.2 above.**
8. My product is complex and requires a detailed understanding on the part of my customer.			X	The product is simple: a car loan.
9. My competitors' businesses are all approximately the same size as mine.			X	Duncton is relatively small in comparison to some of the competitors.

Appendix B – Core Competencies – Relative[1] Competitive Strength Analysis *(Rating out of 10)*

Key Success Factor/Competitive Strength Measure	Importance Weight [2]	Duncton		Competitor Average	
		Rating[3]	Score	Rating[4]	Score
Market Share	10%	1	0.1	5	0.5
Efficient Operations/ Lower Operating Costs	20%	1	0.2	5	1
Related Other Income (i.e. Insurance)	20%	4	0.8	5	1
Lower Cost of Borrowing	10%	4	0.4	5	0.5
Low Arrears/High Collections	20%	-3	-0.6	5	1
Asset Security (Bad Debt Provision)	20%	6	1.2	5	1
Totals of Ratings/Scores	**100%**		**2.1**		**5**

1. **See Case Study Appendix G.**
2. **Weighting of the importance of the competitive strength measures is based on interpretation of observations made in documents provided by Duncton PLC.**
3. **Duncton Rating determined by relating the difference in benchmarked performance in each strength measure between Duncton and the average of its competitors and is determined by the following formula:**
   Duncton Rating = Competitor Average Rating – (Competitor Average Rating x [absolute ∆ Duncton Measure and the Competitor Average Measure/Competitor Average Measure])
4. **Competitor Average Rating was determined to be 5, representing the appropriate average rating of all of the benchmarked competition assuming the best performing competitor in each measure is ranked at 10 and the worst performing competitor in each measure is ranked at 0.**
5. **The Score is determined by multiplying the rating by the importance weight assigned to each of the competitive strength measures.**

Appendix C – Internal Analysis – Financial

Key Financial Ratios	FY04	FY05	FY06E	Trend	Comments
Return on Capital Employed (EBITDA/Fleet Financing+Shareholders' Funds)	5.8%	6.9%	6.7%	↔	Stable – but is it large enough to justify the inherent risk in this business?
Return on Equity (EBITDA/Shareholders' Funds)	58%	79%	87%	↑	Very high and increasing reflecting the limited shareholder investment in the firm and the increasing return each year on ever-increasingly debt-leveraged assets.
Return on Assets (EBITDA/Fixed Assets)	6.2%	7.5%	7.3%	↔	Stable–but again, is it large enough to justify the inherent risk in this business?
Current Ratio[1]	2.59	2.17	2.64	↔	High ratio – but misleading as it allocates all of the unpaid monthly rental payments as accounts receivable, which may actually be interpreted as bad debt.
Contract Assets/Fleet Financing Ratio	1.02	1.00	0.98	↓	Decreasing – reflecting fewer assets to cover debt. Note also that the accounting of the Fleet Financing debt is deemed to be current, reflecting increased risk of recall.
Debt/Shareholders' Funds Ratio	8.89	10.38	12.05	↑	Increasing – reflecting higher debt to shareholder equity.
Debt[Fleet Financing-Contract Assets]/Shareholders' Funds Ratio	-0.20	-0.02	0.28	↑	Increasing – reflecting higher net debt to shareholder equity.
Trade Debtors/Contract Assets Ratio	0.07	0.11	0.12	↑	Increasing – accounts payable suggests increased risk in non-payment and bad debt.
Operating Costs and Overheads as a % of Gross Profits	101%	91%	90%	↓	Decreasing costs reflect more-efficient operating of company.

1. Excluding Fleet Financing from Current Liabilities