Helping to dress the shop-window boosts sales for vendors and funders alike

Displaying assets in showrooms—be they cars or industrial equipment—is an essential sales-aid for many manufacturers and dealers. Financing the assets, however, can be a major drain on cash-flow. LEASING*Life Editor* ***Vic Lock*** *found that the leasing industry can provide a cost-effective solution, not only to financing the stock but also its sale to an end user.*

Elsewhere in this report

Law	22
VAT	24
Systems	24

"Be careful with the jargon," warned an industry observer, "inventory finance and stock finance (SF) mean different things to different people and the term 'asset finance' can be quite confusing." The warning was soon appreciated. It is important to distinguish between "inventory finance" schemes through which factoring companies advance funds against anticipated sales receivables on the one hand and dealer, floor-plan or SF, largely provided by leasing companies, on the other. This report focuses on the rationale and the mechanics of the latter.

SF's roots are in the car, commercial vehicle and agricultural sectors. Over recent years, however, it has broadened into many other asset classes—both business and consumer related—and there are indications that more lessors are entering the market.

SF is now available against a vast array of assets but is sometimes relatively asset specific in terms of the funding source. For example, Barclays Asset Finance (BAssF) provides facilities against agricultural assets through its Claas vendor-finance relationship and Close Asset Finance (CAF) focuses on machine tools and printing presses through specific asset-finance divisions. On a wider basis, Capital Bank Motor (CBM) funds against cars, commercial vehicles, caravans, etc, while another Bank of Scotland (BoS) Business Banking (BB) division is preparing to broaden the HBOS offering; Lloyds Bank subsidiary Black Horse (BH) concentrates on cars, caravans, motor homes and motor cycles; Haydock Finance (HF) is primarily involved in the car and light commercial sector; while Lombard is one of the few lessors currently to assess the viability of any asset type.

Lenders' security

The benefits to equipment manufacturers and dealers in their equipment are clear. SF provides an additional line of credit to dealers and, quite possibly, from a source unrelated to their bankers. Les Porter, the director at CAF responsible for engineering finance, explained that banks have become increasingly reticent to provide overdraft facilities against equipment held by dealers following the *Brumark* case *(see page 22)*. The case raised a number of "asset security" issues which, added to the economic circumstances in which some dealers find themselves (especially dealers in secondhand equipment), makes the banks reluctant lenders.

CBM's manager of dealer administration David Knighton, who has worked in SF for 30 years, added: "unit funding has seen a resurgence against overdraft facilities in recent years". He explained that while a fixed or floating charge may be taken over unit-funded assets—as would typically be the case in a current account or overdraft-type facility—CBM's SF security is really in holding title [ownership] in the asset.

For lessors, asset ownership and security are second nature. Some take and retain title in assets covered by SF facilities on a legal document specially drawn-up for the purpose; others use a document more akin to a hire-purchase (HP) contract or conditional-sale agreement. Either way, most will monitor the assets covered by the SF advance. In order to reinforce their security and guard against fraud, funders will audit the assets on a regular basis—often monthly but sometimes weekly or every few months—and where vendor relationships apply there may be an audit trail from the manufacturer through to the funding source.

Steve Worrall, operations director at HF, added another dimension. "We would consider stock-finance facilities on buses, coaches and road haulage vehicles," he explained, "but we prefer cars as they are much easier to identify, easier to dispose of and obtaining good title is so much easier." While funders will register the assets subject to SF with either HPI or Experian, secondhand cars are generally perceived as lower risk because of the number of ownership checks available and the relatively lower exposure against each unit. "Nine or 10 coaches may require a £1m credit facility," said Worrall, "that adds up to a whole lot of motor cars."

That said, Knighton stressed that SF can be provided against any asset with a unique and identifiable serial number. BoS Equipment Finance (BoSEF), which generates all its lease and hire-purchase business through brokers is, for example, preparing to offer SF facilities in conjunction with one or two manufacturers in the office equipment sector. BoSEF managing director Phil Ross explained that the SF initiative had been driven by brokers. "They put forward a very persuasive argument that the provision of dealer funding in the OE sector would ultimately lead to more equipment finance business," said Ross.

Knighton enlarged: "SF has clear advantages for manufacturers in the office equipment sector. It enables them to put more stock into dealers and it is not unusual for manufacturers to carry some or all of the interest charges for a period." It is understood that BoS Asset Finance is planning to mirror the BoSEF initiative across its business focus groups including engineering, printing and construction.

Deals on wheels

Many car dealers were thrown into disarray in May when it was announced that First National Motor Finance would cease writing new business. Both regional players such as HF and national funders such as BH were anticipating a surge in business as dealers sought new stocking lines. Jon Tilney—senior manager, dealer credit at BH—explained the different credit issues between franchised and non-franchised dealers.

BH has franchised relationships with car manufacturers such as Suzuki, Mitsubishi, Proton, Hyundai, Morgan and Lotus. It also provides SF on used cars through independent dealers and car supermarkets. "Where we have a joint venture with a manufacturer," Tilney explained, "we get closely involved with the vendors, their business plans, sales targets, strategic market positions, etc, and typically fund the stock of the whole franchised network."

Independent dealers come in for closer scrutiny at a local-management level. Here, the financial risk profile of the dealership is analysed through the normal credit checks and business-plan assessments. No matter the nature of the equipment covered, it is unlikely that an advance will be made without the provision of three years' bank accounts, and often other guarantees from the borrower.

CBM runs similar checks in its motor and caravan business where independent dealers are concerned but also has joint ventures with manufacture's, some going back many decades. "As well as playing a significant role in the sales cycle by providing a better spread of stock for immediate sale," Knighton stressed, "SF also helps manufacturers to control the timing of the distribution of their stock." This, ➲

he explained, can be particularly important when a manufacturer is preparing for a specific marketing campaign, new product launch, etc.

The *quid pro quo*

"At the end of the day it is all about enhancing dealer cash-flow," said John Kneller—sales director, industrial equipment programmes at BAssF. "Stock finance has long been considered the Cinderella at the ball but for us it is an integral part to offering vendor finance programmes where the preservation of a relationship between a manufacturer and a lessor is jointly beneficial." Not all SF facilities are vendor related, however, or directly linked to manufacturers or to business end-users.

Not unnaturally SF facilities do not come without a *quid pro quo*—the providers of such funds anticipate a reasonable level of finance business to flow from the arrangement as equipment is "sold" out of stock to either businesses or consumers. More often than not, this would mean the provision of a lease or HP facility to support the sale.

Porter said: "we look to support machine-tool manufacturers through the provision of stock finance but we do not see it as a profit centre; we provide the facility in anticipation of dealer co-operation at the sales-finance end. "Outside of its wheeled-asset business, Worrall confirmed: "we would fund other stock assets, but would expect that dealers reciprocate with a reasonable level of new-finance opportunities."

In the car sector, the funder/dealer relationship tends to be much more formalised. Tilney explained that SF is provided on an interest-rate sliding-scale basis. If a dealer generates, say, £2-4m of retail paper for BH, an interest rate of finance house base rate (FHBR) plus 4% would apply; if the new-finance band is £6-8m, the dealer would pay only FHBR plus 2%. "The retail paper and interest rate are closely monitored," Tilney confirmed, "and adjusted on a monthly basis."

The BH charging policy is typical of the sector. "Our stock-finance advances are clearly linked to the retail business we receive from dealers," said Knighton. "Our interest rates are matched to the level of retail paper generated." In the case of the motor and caravan trade, this would relate to finance business flowing back to CBM or, on commercial equipment, to equipment-finance transactions referred to other relevant BoSBB divisions.

Documentation issues for lenders and for borrowers

By Yasmin Dossabhoy, afl Solicitors

Stocking-finance arrangements can provide clear benefits to dealers, financiers and manufacturers. However, there are various forms that these facilities can take.

Stocking loans

As the name suggests, the purpose of stocking loans is to finance the dealer's purchase of stock. Generally, the credit provided under stocking-loan agreements is of a revolving nature (similar to an overdraft facility). The agreement will specify the credit limit (or the manner in which it will be identified), up to which the dealer may borrow from the financier, with interest charged usually being either at a fixed rate on the balance outstanding from time to time, or a sliding scale charge linked to the level of retail support introduced by the dealer to the financier. The agreement will also state when the monies are repayable (e.g. upon demand made at any time by the financier, or upon the happening of defined events of default). It is common for financiers to take security over the stock and proceeds of sale as security for the dealer's obligations to them.

Fixed or floating charge on stock?

While in theory it is possible to have a fixed charge on stock, in practice, particularly where there are significant volumes of equipment, this can be difficult. To have a fixed charge, the financier must have control of the assets subject to it (e.g. requiring the dealer to obtain the prior approval of the financier to every sale).

With a floating charge, until the occurrence of certain events (when the floating charge "crystallises"), the dealer can manage and dispose of the relevant assets in the ordinary course of business.

The ability to take a fixed charge over book debts has been the subject of considerable attention. In *Re New Bullas Trading (1994)*, the Court of Appeal accepted that it was possible to have a fixed charge on book debts while they were uncollected and for the proceeds to be subject to a floating charge. However, the Privy Council in *Richard Dale Agnew and Anor v The Commissioner of the Inland Revenue and Another (2001)*, relating to the receivership of Brumark Investments Ltd, held that the borrower being able to collect and freely use the proceeds of book debts, was inconsistent with the nature of a fixed charge (the charge taking effect instead as a floating charge). While this was a New Zealand decision and is not binding on the English courts, it is nevertheless persuasive. This has caused many financiers to reconsider the security value of their charges on book debts.

Although giving flexibility to the dealer, one of the disadvantages to the financier is that, unlike a fixed charge, a floating charge is usually postponed to preferential creditors in a winding up or receivership of the company.

Unit stocking

Unit stocking facilities are an alternative to stocking loans. With these types of arrangement, the financier is the owner of the stock (or a buyer, hirer or consignee from the manufacturer). The dealer acquires its interest in the relevant equipment from the financier, rather than from the supplier. This interest will be under the consignment, conditional sale or hire-purchase agreement with the financier.

Conditional sale—one type of unit stocking facility is where the financier appoints the dealer to buy equipment as the financier's agent on the terms of the unit stocking agreement. The dealer also agrees to purchase from the financier each item of relevant equipment that the dealer purchases as its agent, the financier reserving title until payment. As with other conditional sale agreements, there are obligations on the dealer in relation to this equipment pending title passing to it (e.g. in relation to its condition and insurance).

Sub-consignment—another example is where the financier, with the agreement of the manufacturer, itself becomes consignee of the equipment (on a sale-or-return basis) and sub-consigns the equipment to the dealer.

Under any of these arrangements (including where the financier's interest is as chargee) auditing the stock will be important to the financier, particularly since it will not be able to assert its "security" interest against a buyer in the ordinary course of business, unless the buyer is aware that the disposition is in breach of the dealer's obligations to the financier. Therefore, the success of stocking-finance arrangements is very much dependent on co-operation among financiers, dealers and, in appropriate cases, manufacturers.

Additional benefits

While not all funders see their SF operations as profit centres in their own right, all agree that they are central to establishing business relationships. In some instances, the funder not only provides a funding line, but asset-management support as well. Keith Willard, a senior manager with Lombard Asset Management, explained: "our SF clients benefit from access to our dealer-based system. This enables them to, *inter alia*, identify the assets financed and monitor payment due dates and outstandings. The system is also a considerable aid to a dealer's stock-keeping functions."

Measures of SF offerings include the service levels provided, the interest rates charged, the commitment of the funder to co-operate at the point of sale and the lessor's knowledge of a particular asset sector and the rather intangible "relationship" factor. Where a funder's lease-finance business is focused on a particular asset, its sales force will be regularly calling on relevant dealers. "Under such circumstances," said Porter, "funders probably know stock-finance applicants very well and will offer the facility as part of a variety of financial products to support dealers' businesses." As CAF's machine-tool sales force has local underwriting authority, advances can be confirmed within two to three days.

Facility terms

The level of SF facilities may well be crucial to dealers. CAF's average advance on machine tools is in the £30,000 to £100,000 range; on printing presses (another CAF speciality) typical funding levels would range from £50,000 to £500,000. "As far as printing equipment is concerned," explained Murray Booker, managing director of CAF's print division, "the equipment is usually in a warehouse rather than a showroom and more often than not it is between purchase and sale. We are very reluctant to lend on a speculative basis. When we do the advance is usually 90% of trade value."

While some lessors provide SF on an asset- or transaction-specific basis, others take a far broader approach. Lombard, for example, looks to provide facilities on a revolving-credit basis on industrial equipment. "Typically, our SF advances are from £250,000 upwards," Willard explained, "with funding agreed under a single 'master' contract that allows for the possible seasonality of a dealer's business." BAssF also allows for the peaks and troughs in its core agricultural business where it provides advances of £5,000 to £150,000 per unit. Kneller confirmed: "the facilities are written on a dealer master agreement with credit limits agreed on a dealer-by-dealer basis".

Outside of the car and light-commercial sector—where credit is typically granted on terms ranging from 90 to 180 days—SF periods vary. For example, it is not atypical for CBM to provide terms on caravans of up to 365 days while CAF's machine-tool advances are made over periods of two to three years on a repayment basis of capital plus interest. Importantly, however, interest is only payable up to the day of settlement. Equipment dealers are advised to establish their position on settlement conditions before entering a transaction.

Beware the VAT man

However the advances are made, care should be taken over the payment of VAT. "We do not propose to fund VAT for our car dealers," Knighton explained, "we fund on a unit basis with the funds advanced relating to the net trade value of a vehicle." CBM's dealers are encouraged to agree to adopt a self-billing invoice route sanctioned by Customs & Excise. A significant key to the VAT conundrum in the car sector is whether the units represent a taxable or exempt supply *(see page 24)*. ➲

Fraud prevention

Dealers should also be aware that the potential for fraud is never far from funders' minds, especially where secondhand equipment is involved. This can even dictate a lessor's geographical business area. "Given our north of England/Midlands focus," said Worrall, "it would just not make sense for us to visit a car dealer on the south coast on a monthly basis to check on two or three cars." At the other end of the scale, Lombard's 30 business centres mean that it can also provide SF facilities on a national basis. The more specialist SF providers can also do so through their sales-force networks.

SF funders look to counter fraud (and money laundering) at any level, but are particularly diligent over the possible double financing of the same stock or the sale of equipment "out of faith" (when the seller does not own the asset so has no right to sell it). "The potential for criminals to defraud SF providers is regrettably high," said Booker, "especially between stock checks. Funders' security checks may seem onerous, but dealers—especially those that trade equipment overseas—must understand their necessity."

VAT aspects can add taxing complexities

By Teresa Ahern, Director, Indirect Taxes, PricewaterhouseCoopers

VAT and stock finance are not always compatible bedfellows. The key issues are around whether or not the charges made by the lender are subject to VAT. If they are subject to VAT, when is that VAT due?

The automotive sector operates a number of different stocking plans. An example might involve a motor manufacturer, its distributor/importer company (D/Ico) and its captive finance company (Finco) selling cars to a dealer (D).

D is notified of its allocation of cars from the month's build in terms of models and mix and orders via D/Ico. Cars may arrive into the UK, or be built in the UK and may be delivered directly to D or "parked" in storage until release.

In this example the group operates a dealer stocking plan provided by Finco which pays D/Ico the wholesale price, plus VAT, when the cars leave the factory. Title thereby passes to finco.

Vehicles are then supplied to D by Finco under a consignment agreement, at the date of the vehicles first becoming available for delivery to D. The vehicles are purchased only at the point of adoption (when D pays Finco). The period of consignment can be anything from say 90 days to one year. During that period D can return the vehicles. Thus the terms of the agreement are sale or return (SoR).

Until the date of adoption D is charged a fee by Finco

Depending on the arrangements, these fees are given a variety of descriptions e.g. "admin" fee or management fee, or handling charge, stocking-fee charge, display

The systems approach to risk reduction and profit enhancement

By Tony Allen, Business Manager, APAK Group plc

Stock finance (wholesale finance) has traditionally been viewed by funders as a loss-leader, offered merely as a means to win or retain profitable retail finance paper. As such, obtaining budgets for staff and systems to support the offering has been a historic obstacle to the running of an efficient wholesale operation. The resulting need to provide a facility typically leads to a manually intensive and, hence, volume-limiting "spreadsheet-style" solution. Clearly, this is a self-perpetuating situation.

However, it has been proven that stock funding can return a lucrative profit to the funder whilst supporting the cash-flow needs of the dealer/retailer thereby gaining its loyalty when the time comes for writing the retail paper. Large dealer groups and manufacturers are in a strong position to demand stock funding as part of their deal with their finance partner and stocking is often a "must-have" in the financier's product portfolio.

Without sufficient automation, stock finance will almost certainly run at a loss as the overhead can be considerable. An efficient specialist stock-finance administration system can provide an efficient, low-risk, cost-effective solution to portfolio management. It makes it possible to move from the risky dealer loan to asset-based funding of each identifiable item. The financial support of higher-risk vendors can be minimised considerably by the identification of the assets against which the loan is made. This is inherent in retail finance but is often overlooked in stock funding. From the barely moveable printing press to most portable electronic equipment the asset that is funded may be identifiable and therefore redeemable.

High-risk dealers are a matter for credit control, and funding them is a known risk in the risk-and-reward scenario of lending. The combination of asset-based stock finance and real-time system reporting to support the monitoring of activity reduces the risk considerably.

Checks for clean title against the finance registers and full use of interfaces to manufacturer systems for product description and valuation, and upload and download between the stock finance system and vendor systems; retail finance systems; general ledger systems, etc, combine to minimise the risk of fraud. With a clear history of the funding of the asset and automated appropriation at the end of the funded period, it is easy for the vendor to manage stock and for the funder to be alert to any vendor activity anomalies that could cause concern.

There is thus a necessity for financiers to offer a range of wholesale products to a relatively mature UK market, supported by a very functional, specialist system. Experience has shown that, with the primary driver being cost reduction, the financier's dilemma is transferred to the system provider, which is challenged with delivering a fully functional system that matches the financier's budgetary constraints.

Under this scenario the only means to overcome the financier's primary barrier to entry is to deliver a solution with minimal up-front costs along with a "pay-as-you-go" support-and-maintenance agreement that reflects the volume of business processed. Systems provided on an application service provision or bureau basis allow exactly this with costs deferred over an agreed contract term in order to match financier revenue.

Wholesale system functionality is paramount to supporting an evolving, competitive business area. Web access provides a cost-effective portal enabling vendors, field staff and stock auditor access to real-time wholesale data. Highly parameterised funding terms are paramount to the flexible support of multiple asset types with differing seasonal peaks, all within the same portfolio. There is no reason why agricultural equipment cannot be funded along with construction equipment, printing presses, consumables and "brown and white" goods. In the widest sense an asset could simply be an invoice where the assets making up the invoice are not tracked individually and where repayment profiles are agreed to follow the rate of retail sales.

The niche wholesale finance market, like all others, is an aggressively competitive business affected by the economic cycle. Effective automation and streamlining of business processes via a specialised system can mitigate risk, reduce overheads and thus optimise profitability. Following the recent round of consolidation of the larger financiers the opportunities for smaller, ambitious start-up organisations have never been better.

charge or interest (to name but a few.) The fee may be charged by reference to the wholesale price for each day the vehicle is on consignment. For VAT purposes in this example, the issue is whether Finco is making an exempt supply of credit or a taxable supply of "something" to D.

Taxable supply or exempt supply?

Customs may argue that as the charges are being made before the car has actually been appropriated, these represent exempt supplies of interest. The interest arises because Finco has paid D/Ico and as Finco has not been paid by D, it must have effectively provided a loan to D.

If the charges are exempt this can have significant partial exemption implications for finco depending on its partial exemption method. However, whilst Finco may make the charges by reference to the interest it is paying the manufacturer, it does not have to follow that the charges are interest on the "loan" effectively made to D.

One simple approach is that Finco is actually providing administration/management services to D. Thus the charges are subject to VAT. Alternatively, the charges may be akin to a lease charge. Finco owns assets, which it has put into the possession of D and for which it is making a "rental" charge (which it may seek to characterise as a flat fee or handling charge). Under this approach VAT would be due at the time each payment is received.

A further avenue to refute the exempt supply argument might be to consider the European Court of Justice (ECJ) case of *Muys' en De Winter's Bouw-en Aannemingsbedriff BV v Staatssecretaris van Financien* (Case C-281/91). The ECJ held that where a supplier authorises its customer to defer payment of the price in return for payment of interest, this is an exempt supply. However, where the supplier grants its customer deferral of the price in return for interest only until delivery, those payments are not consideration for the granting of credit, but are part of the consideration for the supply of the goods.

In a sale-or-return-of-goods scenario, the argument would be that there can be no granting of credit before the supply takes place because no debt has been created between Finco and D. Under the VAT rules relating to SoR (VATA s6 (2)(c)), the time of supply would be when it becomes certain that the supply has taken place, or if sooner, 12 months after the removal. Assuming an invoice is not issued until D appropriates the car, any intervening payments prior to the time of supply above, do not create a tax point. Thus any charges made become subject to VAT as being for something other than the vehicles and something other than credit.

In contrast to the SoR example, the stocking plan may involve the Finco raising a sales invoice to D at the point the vehicle is transferred to D. However, Finco may not make any charge other than a monthly stocking fee based on the outstanding daily amount of the vehicle value.

In some cases, capital may also be charged at this time. For VAT purposes the invoice has had the effect of selling the vehicle (assuming the contract is hire-purchase or similar) and VAT will be accounted for by Finco on the full value of the vehicle at that point. As a tax point has arisen the monthly charges (excluding any specifically relating to capital) can be construed as the consideration for an exempt grant of credit.

In all these situations, the wording of the contracts is crucial as to what is being supplied, by whom and when. That said, the words used in the contract may themselves not reflect what is happening for VAT purposes. Calling a charge "interest" will not always mean that this is what it is. Clearly, there are pitfalls in this whole area. But with careful planning and attention to detail, there are opportunities to avoid making exempt supplies which may make the arrangements more cost-effective.