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SELECTED ASPECTS OF HIGH RESIDUAL VALUE IN CAR LEASING CONTRACTS

1. High residual value car leasing

As practiced in United States in a high residual value car leasing contracts, lessee returns the vehicle at the end of the lease[1]. A lessee is responsible for a proper estimation of the residual value only partially. It means that a lessee may be charged for an excess mileage and excess wear-and-tear and personal property taxes, late charges, etc. High residual value contract may be an attractive financing possibility for many types of companies. For example corporations previously financing cars or trucks using credits or standard leasing (with low residual value) had to pay much of an attention, when leasing contract ends. Using high residual value agreements, where is no obligation to be an owner, when leasing contract finishes, corporation may transfer the risk of residual value estimation differences to the producer or lessor. Such kind of the leasing agreement might be defined as the usage of an asset (similar in some aspects to rental) rather than their financing. In some industries or areas of activity it is possible to find high residual value leasing more attractive than others. Frequent car changes, relatively short usage periods (two or three years), high mileage there are indicators determining decisions to use such kind of leasing.

How could leasing companies provide high residual value leasing contracts for their customers? On one hand a customer may be proposed leasing company financing and their residual value risk protection. On the other hand manufacturer may participate in the process of purchase, financing and residual value protection. In both cases the result of the residual value contract may by to generate long term relation between a lessor and lessee (optionally producer) basing on the frequent changes of an asset or group of assets being an object of leasing agreement. Second case may be recognized as vendor leasing program, where an important role in the area of purchase pricing and future residual value guaranteeing is on the producers side. In some cases the contract may be prepared by an independent lessor. And in some a lessor may depend directly on the product producer, where the producer is an owner of leasing company – a captive leasing company.

In both cases seem exist advantages and disadvantages. Integrity may determine to choose a concrete producer product. Independence may differ this way, that the lesseee may choose wider range of assets.

Important role in the decision making process, regarding the choice of asset in the leasing contract, has the information asymmetry between the manufac-

[1] http://www.federalreserve.com, 31 of May 2006.

turer or lessor and the lessee. Both the asset producer and lessor (even the independent one) are on different positions, estimating the residual value. However it seems that manufacturer-owned lessors has a better position in this process, because such company, preparing the estimation, may base on better knowledge or guarantees and other support (e.g. sales provision, which may cover a lost risk in some part), what is the closer relation consequence. In the high residual value leasing sector it may be one of the most important factor, critical in the automotive sector, where the relations between producer. and lessor base on the agreements or direct ownership relations. Hypothetically it is possible to imagine that for example automotive producers are better in estimating residual value than lessors, but lessors depending on producers are on similar position as concrete producer.

2. Producer's cooperation

It is common on the financial market, that the manufacturer decides to cooperate with a leasing company or prepare a program providing leasing for its customers using producers-owned leasing company. What may be the reason of doing it than? It is possible to imagine that the customer may only demand for a financing of an asset. But in some cases a producer manufacturer may lose the customer if the leasing company can not provide a leasing contract basing on the producers conditions. In some cases it may even happen that the customer will be proposed not only a service for a producer's asset, but even an alternative. The alternative in this case mean, that customer will be proposed a leasing for an alternative asset – the asset produced by the competitor. Avoiding such situations, the producer may find necessary to provide leasing for the customer, cooperating with the proven partner. Than the producer does not have to worry about the loss of customer. The lease contract may be signed before the customer might change their mind or decide to choose a competition.

In the area of car full service leasing contracts it is possible to imagine, that the producer is not only interested in asset sales. From the profitability point of view producer's future relations with the customer (or leasing company) may be as much important as sales or even more. Producer can expect other benefits through a cooperation leasing program (close relation between lessor and a producer of an asset). Coordinating a process of financing (leasing), the producer is holding the relation with the customer through the long period. It does not only allow to control future equipment needs of the customer, but also it enables to make profit form a sales of spare parts, servicing in the after sales area. And of course it makes probable sales for future leasing contracts with existing customer[2].

It is also possible to construct a leasing contract this way, that the customer has an obligation to inform a lessor (if the lessor is cooperation with a producer, than the information flows to a producer) of their future asset needs, regarding next financing. When the lessee nears the end of leasing period informs the lessor of the future purchase needs. Such relation entails a possible producer's proposal for a customer, built on the knowledge of the long term relation, in the area of an asset purchase, service and residual value correct estimation.

Bundling the relation with leasing company, the produces may achieve another purpose. The level of contract complication seem to be higher in the situation where lease does not know the exact purchase price of an asset. This can be made in the sales price route of negotiations. Hypothetically the manufacturer may be able to propose bigger discount cooperating with a lessor, this way being more competitive. It is also possible, because a manufacturer may count on future profits from future after sales services of an asset, particularly offering full-service leasing contracts. This is why full service leasing contracts may complicate recognition of real sales price and other leasing conditions unusually difficult for the lessee.

Another aspect of the contractual relation between lessor and producer may let producer to hold a control over used asset market. Selling a product, producer loses possibility of the control the used good market and this may cause problems. Glass's Information Services informs that cars bought a year ago may loose even up to half of the purchase value[3].

Using leasing relations producer is allowed to avoid such situation. Leasing contract enables to have a control over the used goods market, especially used car market. Estimating a residual value for the end of lease period, the producer may point out which price is accepted by him, as a used market price. Lessee will return the used at the end of the contract at accepted by producer used market price. This is causing that a producer may set higher prices for used goods and the used goods market may be steered in the area of competitiveness of new offerings. Creating a lessor-producer leasing agreements it is possible to ensure that the producer will be able to control the market price of its own used goods through its guaranteed stock of finishing leasing contracts.

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[2] J. Wodaczek: Cross Border Leasing als innovatives Financierungsinstrument. Fachhochschule fur europaishe Wirtschaft und Unternehmensfurung, Wiedeń 2000, s. 26.

[3] J. A. Lee: Driving car costs down. CFO, May 2006, http://www.cfoweb.com.au, 23rd[h] May 2006.

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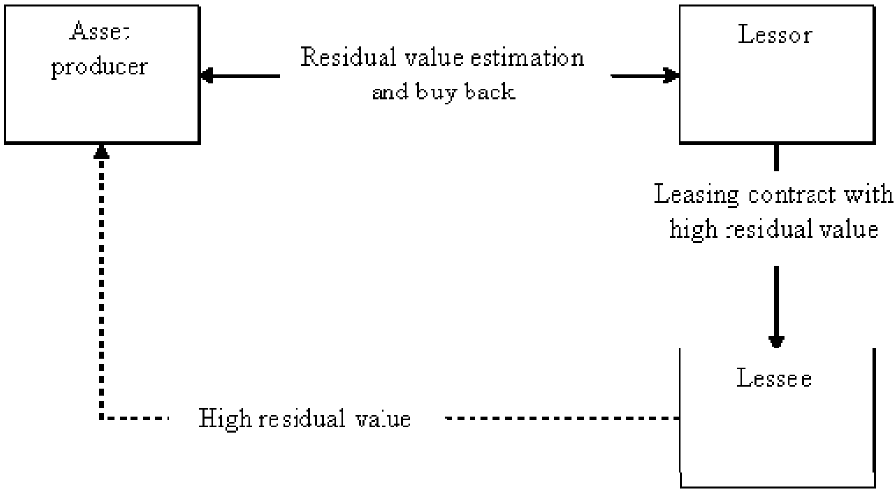

Figure 1. Role of producer in guaranteeing a residual value in the leasing contract
Source: Own study.

Cooperation with a leasing organization seem to motivated by the ability to predict the residual value of the leased assets. When residual value estimations are wrong it can lead to huge financial losses at the end of the leasing period. Examining the advantages of the leasing contract proposed by producer's leasing company it may be underlined expectations in the scope of product knowledge, and future changes and product novelties. One of the most important factors seems to be the information of product novelties and introduction terms. Fall of used equipment value is determined by new product introductions[4]. Basing on planned terms of leasing ends, producers can plan when they will introduce new products. They can also create product trend, product budget, including cost of competitiveness. Assuming that estimation of residual value is one of the main determinants in lessor profitability, it may determine a decision to use a producer's leasing company rather than an independent lessor in the leasing contracts.

Of course from the financial point of view a banker's lessor (bank is the owner of leasing company) holds similar advantages as the producer's one, e.g. diversification of risk, credit evaluation, experience in leasing, and organizational knowledge. But cooperating with banker's lessor the producer can not

[4] L. Pierce: Manufacturer Advantages in Residual Value Estimation. Innovation Seminar, 5 of December 2001, p. 8

influence on the residual value estimations as much as cooperating with the producer's lessor. Another positive aspect of the producer cooperation with its leasing company is that the producer may not be interested in informing a lessee of the real asset residual value estimated by the producer. The lower residual value determines a lessee to pay higher rates, but proposing high residual value in the leasing contract, determines a lessee to pay lower rates. Other costs of such operation may by amortized in the maintenance cost or provisions. If a producer owns a leasing company, high residual values may lead to bigger number of leases, but if the accurately accepted by producer residual value is low and shown in the leasing contract residual value is high, than it will most probably cover a risk of losses at the end of the leasing contract.

A different situation exists when the vendor leasing program is provided by an independent leasing company, e.g. a bank owned lessor. The producer expecting higher sales has to overestimate residual values when informing the lessor. By setting optimistic residual values, producer can boost current sales income and postpone any loss until the end of the leasing contract[5]. In this case there is not so much space for possible cost of cooperation in the scope of residual value in the contract and the expected one on the market when leasing contract ends.

3. Full service car leasing

Car leasing is one of the most visible in its extensive growth in the automobile industry over the past years. For example in Poland around 50% of leased assets is represented by cars. The high residual value leasing defined by author as a full service operating lease[6]. In Poland, such services[7] are offered by several companies, e.g. DaimlerChrysler Fleet Management, Arval Service Lease, Master Lease, Lease Plan and others[8]. In proposed contracts, rates are calculated for less than a useful car life, mostly three or four years and fully maintained operating lease offers lessee not to take any residual value risk.

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5 M. Keller: Cahners Publishing Company Cahners Publishing Company, 1999, http://www.findarticles.com/p/articles/mi_m3012/is_12_179/ai_58398912/pg_2

6 J. Nowak: Procesy przemian i determinanty rozwoju przedsiębiorstw leasingowych w Polsce. In: Contemporary issues of finance, ranking and insurance in theory and practice. Part 2. Ed. K. Znaniecka. AE, Katowice 2006, p. 290.

7 Polish Society of Car Rental and Leasing, http://www.pzwlp.pl, 10 of June 2006.

8 M. Azembska: "Bank" 2005, No. 12, p. 31.

Between major players in the automobile leasing industry, there are mostly producer's lessors and bank ones. A basic problem on this market is that customers determinate more and more higher residual value contracts counting on the more and more competitive leasing rates, what may cause future problems for manufacturers or lessors, guaranteeing residual value.

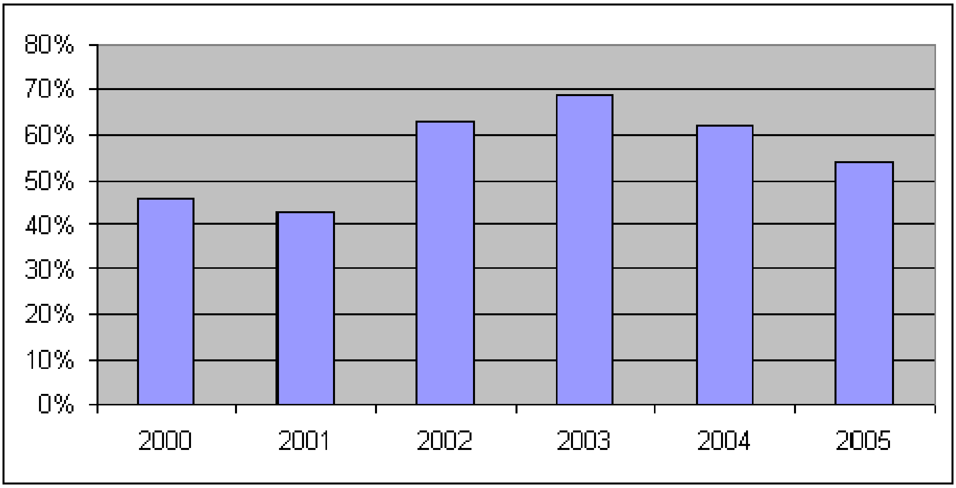

Figure 2. Market share car leasing/total leasing sector in Poland in 2000 to 2005 years
Source: Own study based on the information of Związek Przedsiębiorstw Leasingowych in Poland.

Predicting the trends on the car leasing market, and observing the past years of existence full service leasing and several years of leasing sector in Poland, it is possible to notice that operating lease with high residual value may develop, because of an option not to buy a car at the end of the contract. Combining it with the wold trend of residual value decrease it can be observed more lessee interest in high residual value car leasing contracts guaranteed by producer or lessor. There is opinion, that lower interest rates are more affordable than in the past years and it is an ideal time to free up capital[9].

Those lessors who had lower than normal residual values (higher leasing rates) will have to re-estimate the residual values, because of the competitiveness. The potential danger in this situation is that possible overestimation of the residual value may cause financial problems for the producers or lessor guaran-

[9] J.A. Lee: Driving car costs down. CFO, May 2006, http://www.cfoweb.com.au, 23rd[h] May 2006.

teeing a value at the end of the leasing contract. This can not happen when using low residual value.

Conclusion

A standard of cooperation between a lessor and producer depends on proper residual value estimation. Very important factor is realize a policy of competitiveness and a right steering of the used asset market. Requirements of the client determine higher and higher residual values to guarantee lower leasing rates in the term of leasing contract, but it is in opposite to the profit of producer or lessor companies, which guaranteeing the value of an asset at the end of the contract. Especially development of high residual value car leasing influences on the car market worldwide and this will probably affect in the near future on the leasing market in Poland.

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