

Funding for early-stage asset finance organisations



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A guide for entrepreneurs and investors

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Foreword by Richard Carter, chief executive, Nostrum Group



Richard Carter,
chief executive,
Nostrum Group

This report follows on from our previous White Paper study Finding Funds for a Leasing Start-up published in conjunction with Asset Finance International a couple of years ago.

Since that report, those asset lenders who entered the market during the height of the recession have indeed succeeded in obtaining funding and in the majority of cases are thriving – but facing ongoing challenges.

There is no doubt that the availability of funding is increasing – albeit slowly – and also accompanied by increased innovation. Examples of this are the integrated wholesale funding business model of Conister Bank which is examined in some detail in this report, as are the various ingenious peer-to-peer lender models.

The UK financial services industry has always proved to be immensely innovative and we have no hesitation in predicting further innovation as well as the advent of more new-funding entrants over the coming year, which will serve to benefit start-ups and established lenders alike. One can even imagine the peer-to-peer model being adopted by existing lenders in a quest to augment their existing funding.

One clear message from the executives interviewed in this report is that, irrespective of the size of business and its funding aspirations, it is vitally important that the core business model is sound, scalable and profitable. Technology systems have a crucial part to play here, whether in allowing the lender to launch in a cost-effective manner, or having appropriate controls in place during the growth phase. A robust platform is essential to underpin the business, as is stressed by a number of the contributors.

Outsourcing non-core specialisms such as back-end technology is likely to impress a potential funding source. Although outsourcing the front-end solution is arguably less crucial for early-stage asset lenders than that of the administration operation, the benefit of importing a robust and industry-standard technology system from day one is highlighted in the report.

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The current funding situation

Overview

Finding start-up funding and renewing funding for expansion or restructuring of maturing debt presents a perennial challenge for new and early stage businesses. Although the funding gap has narrowed somewhat since the liquidity squeeze resulting from the global economic crisis, funders' investment criteria remain strict, and only those with a rock-solid business case and excellent credentials are likely to make the funding cut.

When the availability of funding dried up following the liquidity crisis, asset finance was particularly hard-hit, with funders pulling out of the market and a general lack of appetite for getting funding deals done. Independent asset finance companies in particular suffered as the investment tap was turned off – although bank-owned leasing subsidiaries had to fight internally for parent funding, at least they had parents with large balance sheets to call on.

The knock-on effects of that situation continue to be felt, with investors and lenders wary across the board; even established businesses are finding that they have to meet stringent investment criteria. In this climate, funding for new companies is a particularly exacting challenge. Many proposals fail to get off the ground due to a lack of interest, mainly from banks, which view financial services as a tough area to enter.

Start-up funding

There is no question that a new start-up faces significant obstacles in its search for funding. While equity is, some say, slightly more available than debt, both forms of finance are by no means easy to come by in the current climate. Despite this, there are ways that new start-ups in asset finance can get started – although the barriers to entry into the leasing market are higher now than they have been for some time.

Wholesale funding is not a real option as debt providers are looking for performance history and facilities tend to start at around £10-15m to make the facility worthwhile in terms of returns and costs to establish. A facility of this size would require a relatively fast route to market and thereby utilisation of the facility which may not be possible for start-ups.



Juan Kelly, managing Director, Conister Bank

But funding can be found. While the traditional banks may no longer be the first choice for funding, there are proactive lenders out there, such as Aldermore, Conister Bank and Shawbrook Bank. For example, Conister Bank's Integrated Wholesale Funding Agreement (IWFA) product requires very little equity and "can easily provide £10-12m in the first year, which is sufficient for most start-ups", according to Juan Kelly, Conister's MD. Established methods of finance such as debt and equity funding, securitisation, syndication and block discounting (for established companies) are still available, if you meet the criteria. Recent funding innovations include peer-to-peer lending, with companies like Funding Circle providing increasing volumes of person-to-business funding and others such as Zopa moving into the business funding arena.

Although demand for funding currently outstrips supply, arguably allowing some lenders to maintain healthy margins, others are pursuing growth strategies underpinned by lower cost funding. As a result, those lenders that can deliver their products with the lowest operating costs will continue to make the highest margins. Moreover, as funding costs and competition inevitably increase, these operators should be able to survive price compression without relinquishing significant margin. Technology will assist in maintaining the balance between low operating costs and margin.

The need to survive detailed due diligence was highlighted by a number of contributors in the earlier report – and is echoed here. However, risk in its broadest sense is increasingly important for funders as they continue to be vigilant for factors such as: How sustainable is the platform and what if the business fails and the portfolio needs to be collected out? As much as potential funders seek investment opportunities they also seek the contingency of an exit strategy.

The amount of regulation changes on the horizon facing UK lenders is daunting. Apart from the ongoing uncertainty regarding the way that leasing will be capitalised on balance sheets, the shift of regulation application from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA) is likely to mean greater scrutiny of consumer protection, promotion of competition and the protection of integrity in the financial system.

The FCA's initial focus is likely to be on the high-risk finance providers including debt management and high-cost credit – although there remains the uncertainty regarding in which direction the newly-formed regulator will act first. There is a definite case for lenders and service providers to join forces and work together towards preparing the industry for the impending regulatory changes. Having an established systems provider on hand to guide early-stage lenders through the regulatory minefield will be invaluable.

Richard Carter

Chief Executive - Nostrum Group

And brokers such as Shire Leasing and Kennet Equipment Finance that run their own book have the resources to provide a new funding source. The recent news of Shire Leasing being appointed as 'Master Broker' to a number of UK funders, opens up funding to a number of 'orphaned' brokers in the asset finance market that are too small to be attractive individually to funders, which should help those brokers and the SME market generally.

Another possible option is to seek funds on the basis of a joint venture, perhaps from overseas, i.e. from countries where the effects of the crash were not so drastic and funds are more readily available – an example of a new entrant established with a successful overseas organisation is MAXXIA, a joint venture with Australia's McMillan Shakespeare Group and the UK management team of Visper Asset Finance that was itself only recently established but had an experienced executive team and therefore the strength to attract investors.

Government finance might be another option: Credit Asset Management Ltd (CAML), a joint venture with the City of London Group plc set up in February 2011 that specialises in SME lending, was the only lesser to succeed in winning a grant from the UK government's Department of Business, Innovation & Skills.

Private investment may also be a route to consider. Private equity funders are around to fund on an equity basis, and they will do so on provision of an equity return or on the basis that they can leverage in the future. High net wealth individuals may be attracted to the higher returns currently available than through the equity or bond markets. HNW groups may be looking for a blended debt/equity return, and willing to fund 100% of the amount. This is usually for established businesses looking to grow, but could work for a start-up with credible management with a track record elsewhere. And a larger lender might be looking to partner with a niche specialist; here, partial shareholding might be a route, and as Bruce Nelson, director, Compass Business Finance says: "You need to think laterally when considering your options".

Funding for more established lessors

Looking further down the line, the question arises as to how easy it is for established lessors to source new funds for expansion or to renew debt facilities. The situation for established lessors has improved over the last 12–18 months, and continues to improve but it is still not easy. Companies need to consider a network of funders to source for finance, new alternative funders to the main banks. These are likely to have comprehensive due diligence requirements, which can add time and cost (costs which may need to be borne by the borrower, particularly if specialists are brought into the due diligence process – these should be factored in). Pricing and leverage ratios are improving, but neither are back to pre-2008 levels.

But industry views on this are confident overall; the opinion is that there is no lack of funds, but that those holding the purse strings will continue to be highly discerning. As Bruce Nelson put it: "There are no awards for bravery in the investor community."



Bill Dost, managing director, D&D Leasing

Bill Dost, managing director, D&D Leasing, concurred that well-run companies should have no funding problems. "Established lessors, who have shown a profitable portfolio that keeps its arrears and bad debts under control, should have no real trouble raising additional funding. As long as they can show that their business model is successful and that they have adequate distribution of funds, there really should be no issue raising funds."

But he cautioned: "It's important to keep a spread of funding sources and avoid reliance on any one source lest policies change, leaving a lessor stranded without adequate funds." And as Paul Brett, business development director of short-term asset finance provider borro, highlighted: "Existing lenders have access to numerous avenues to raise finance, from private funding to investment funds to banks; however, the skill is in obtaining funding at the right price to enable the business to lend competitively."

Mark Picken, managing director of Shire Leasing, also sounded a cautionary note, specifically concerning potential conflicts of interest between parents and subsidiaries: "The capital markets seem to have freed up and liquidity is much, much better. However, you only have to look at ING and more recently CIT pulling out of asset finance markets (the latter only Europe, not the UK) to see that parental interest in financing asset finance subsidiaries is not great." His view is that "The cash-hungry nature of asset finance is in direct competition with the bank parent trying to conserve cash and strengthen its balance sheet. Very few are looking to grow fast and would rather tread water, keeping a closer eye on risk and reward than on growth."

As an asset financier, Paul Tagg, director of block discount at Shawbrook Bank, thinks it is getting easier for established lessor to get funding, and observes that: "There have been a number of new entrants in the block discounting and wholesale sector."

How the industry views funding



Mark Picken, managing director, Shire Leasing

Overall, the belief is that there are more types of funding available now to the asset finance market than in recent years. Mark Picken noted: "There are bodies and individuals sitting on cash piles looking for better returns than the banks and general investment market will give them. Investors who had ignored the asset finance market now see the attraction. However, whether these investors are hedge funds, VCs, corporates or high net worth individuals, they are risk averse and expect very high returns. Nonetheless, these sources are investing and where practical remain a reasonable source of funds."

Whatever the source, lending criteria will be stringent, and newcomers will still find it tough. As Bill Dost observed: "Realistically speaking, there is not a lot of funding available for a 'new' leasing start-up unless there is a strong pedigree, business plan and funding already present. A new leasing company needs to enter the market with a strong measure of equity, a well-known management team and capital partners already in play. Once they have then created a book (or purchased a portfolio) additional funding can be sought."

The importance of the management team was also a prime consideration for Paul Tagg: "Funding new-start business is not our speciality but the most important credential for any new customer is 'who are the people involved?'. We would then take into consideration the level of their capital investment and what infrastructure in place. The minimum we would consider is £250,000 credit limit but can vary dependent on the above."

From the peer-to-peer lending perspective, Paul Brett would treat an approach from an asset finance company the same as any other: "In our experience the type of funding available is no different from any other start-up business; however, there may be options to partner with existing asset finance lenders by 'white labelling' their services, which would provide the necessary debt facility"

But Ratan Daryani, managing director, Rivers Leasing, found that he had to bootstrap his own venture: "When I started I could not find anyone to help provide finance, but admittedly I did not look too hard, assuming, based on my other business experience, that none would be available, bearing in mind the economic and financial climate in 2010. Rivers Leasing is funded from my own personal resources. I was able to attract block discount facilities after I had been successfully trading for a year."

Key factors in making a successful bid for funding

Getting the fundamentals right

There is no particular magic formula for obtaining asset finance start-up and early stage funding: the basic principles are the same as would apply to any other business. A start-up must assemble an excellent management team, with a strong and proven track record. There must be a bulletproof business plan that clearly identifies and quantifies the business opportunity, with a strong statement of intent, a comprehensive review of the market the start-up wishes to enter, and – just as important – sound financials and financial forecasts, with targets for new business volumes at certain milestones, set-up costs, anticipated margins, and so on. As Bill Dost points out, “The particular challenges for an asset finance start-up are no different than a start-up of any business that might require funding, except exacerbated.” However, there is more emphasis placed by investors on certain key aspects such as the management team, its track record and reputation, adequate capitalisation, market focus and robust operating systems.

It's not just about the plan, however; as Richard Carter, chief executive of Nostrum Group highlighted, systems and processes play their part too. “We've worked with a number of new-start businesses where funders have been extremely interested in the quality of management information that can be obtained directly from the core administration system. With an increased emphasis on risk management, we see this requirement increasing.”

What is also needed is a market willing to lend, and that at least is one area that has improved since 2009, when the market was actively in exit mode and those remaining had clearly defined parameters or restrictions on capital. There was then a distinct aversion to taking on additional risks, especially for new entrants focusing on small and new-start businesses, and thus funding lines had shrunk. As Bill Dost remarked: “Funding lines are now opening again; however, new entrants will still need to prove themselves.” Ratan Daryani backs that up: “If you can prove you have a viable business, people will always lend.”

Starting up a new asset finance company – Rivers Leasing

Rivers Leasing is an independent niche lease financing business based in London, providing finance on all types of assets, with the smallest lease values at £2,000 and the largest coming in at £50,000. Rivers Leasing is a principal lender (cash lessor) and provides finance from its own resources; it is not a broker. Its clients range from small sole traders and partnerships to large established listed companies; typically it operates in the SME sector.

Founder Ratan Daryani describes how he went about his successful business start-up.

AFI: *What made you decide to start in this field (post-recession, etc) at all?*

RD: I saw a large gap in the market and a large market in the gap for funding SMEs with the number of players in the market restricting lending and eventually declining, e.g. the withdrawal of ING.

AFI: *What was your business model for the start-up?*

RD: The model at start-up was and continues to be about focused lending – we offer one product (finance lease), one process, commercially sensible underwriting criteria with no real restrictions on asset class with a focus on the financial covenant of the lessee.

AFI: *How was finance arranged? How easy was it?*

RD: Initial finance for start-up was through own funds which has been supplemented after a year's trading by block discounting facilities. Obtaining block discounting facilities, although not that difficult to obtain, primarily due to the high level of personal funding injected into the business, has been slow in locking down.

AFI: *What were the risks and challenges then? Do you think the challenges have changed since?*

RD: I see the main risk as customer credit risk and believe that this will improve as the general economic climate recovers, so some years yet.

AFI: *What are the company's objectives now?*

RD: Our key objective is to continue to grow the business keeping the same model and accelerate our managed growth plan to achieve a target of a £5m lease book within the next months.

Due diligence

A critical part of the process is undertaking due diligence, both as a demonstrable part of the business plan, and for successful underwriting of business. Juan Kelly views it as essential to obtaining funding: "A 'suck it and see' approach is loaded with risk and unlikely to obtain funding. Funders want to know that lenders have the necessary expertise", while Ratan Daryani is unequivocal about its role in his business: "Rivers Leasing considers this to be absolutely paramount to the continued success of the business and as the company is funded primarily with my own money, I take this aspect of our business very seriously and am constantly reviewing alternative credit search systems and alternative sources of information for credit decisions." Paul Tagg also says that at Shawbrook it is: "Essential, and we base our credit decisions and ongoing monitoring around due diligence and research."

As a funder, credit assessment is fundamental to Funding Circle's business model; Laura McMullen, business development director said: "We use a significant amount of information to credit assess every business. We use credit reference agencies, data from Companies House and information provided by our customers to ensure that we have a full understanding of the business and the people behind it. We also have access to a huge amount of data on UK based businesses and their historic performance which we analyse and use in our credit assessment process."

Due diligence as part of your initial business planning is also fundamental for Bill Dost: "I'd say it's extremely important on the market and the area of the market you're looking to open up into. You need to know what the barriers to entry are. You need to understand what regulations exist and then where and who might provide funding. You also need to know what services and servicers you may need to approach, not just from banks, accountants, lawyers and software providers, but also what consultants you might engage and who you might need to engage for staffing and where you may want to locate your offices."

Tarun Mistry, partner, Grant Thornton UK LLP, offers the following recommendations regarding due diligence on new companies: "Performance is important; get as close as possible to the management team so you are comfortable they will perform. Understand the team and their systems, how the team works and the reliability and robustness of their business platform (is it outsourced or in-house?). What is their Plan B – how will the debt be repaid if it goes wrong? Use benchmarks – is this product being offered by another company; if so, how well are they doing? In cases where regulatory compliance is needed, how will management ensure loan agreements are enforceable?"

Strong reputation

There are high barriers to entry to the asset finance market with regards to reputation. Having a good reputation and respect in the market is very important. Anyone coming from outside the industry will, barring a miracle, find it impossible to get funders on board. Asset finance is an industry where establishing yourself can take years – it's a very protective industry. Realistically, only people with industry track records and the right profile to command respect from lenders will be able to make a success of a new company. The quality of the management team may well be the difference between success and failure.

D&D Leasing is an example of a foreign lessor that has succeeded in starting up an operation in the UK from scratch. In the case study below, founder Bill Dost explains how he did it.

Case study: Creating a reputation – D&D Leasing

Asset Finance International asked Bill Dost, managing director of D&D Leasing for his views on launching a new asset finance company. D&D Leasing is a general equipment funder, servicing the alternative funding market, and originated in Canada. It launched in the UK in 2009. D&D funds small business and entrepreneurs that require extra effort – what they call "story credit". The concept is low volume and higher rates for newer enterprises or exposure-type business under £50k.

AFI: What were the challenges of starting from scratch?

BD: I think the biggest challenges of starting from scratch are getting known in a market where you are unknown, and creating a trust factor where funders will be open to lending to you. Most funders want to see your model succeed, so that means you need to typically go through a cycle or at least a part of a cycle to see how your portfolio performs; this allows them to see how well your model and your adjudication procedures hold up over time. It also means that, unless you have access to a strong capital base that has allowed you to scale up quickly to significant volumes, most funding mechanisms will not be available to you for the initial stages of your leasing venture.

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AFI: *What made you see it was a good idea and what was the initial scheme?*

BD: We decided to open up in the UK because we saw it as a growth market and a gateway into Europe, Eastern Europe and into Asia. The US wasn't a possibility at the time, so as a growth market the UK seemed ideal – it was similar to Canada in that it had a similar legal system, a similar language, it too had a broker market and it was a much larger market than Canada. So for our purposes it was ideal. Our initial scheme in attending the market was no different than it was now – to fund the SME sector in the UK and to pick up exposure-type credits along the way.

AFI: *Who did you approach for funding?*

BD: In our initial stages of operation we did not approach anyone outside of personal contacts for funding. It was made clear to us from the outset that most institutions wouldn't be interested in funding a foreign leasing start-up. We came in with finance arranged and then went to the high net worth marketplace. The blockers, banks and institutions were not interested in our model at the start, due to not being proven in the UK and being a new start with no proven numbers.

AFI: *What were the risks and challenges?*

BD: Two risks and challenges: first, getting known by the community at large so that your value proposition can and will be used quickly. Second, scaling up fast enough with the right funding and transactions that you want in your portfolio.

AFI: *How did it go initially, and was there a breakthrough moment?*

BD: Our breakthrough was going through a full cycle of leases and showing how our portfolio performed and how our credit policies performed over a full business cycle. This proved our model and our ability to succeed in the marketplace. Once we had accomplished this, funders came alongside us to discuss opportunities. From there we were able to find the right companies that were in tune with our mind-set and our plans.

AFI: *How has the business expanded and what are its objectives and strategy now, particularly regarding niche markets?*

BD: We plan to continue to focus on what we do best, which is to fund entrepreneurs and small business. We fervently believe in a laser focus on our goals and our market niche. This means that often we have to say 'no' to transactions, or ideas that don't fit into what we are doing, but it also means that we can capitalise on everything that falls within our marketplace. We will continue to focus on our niche market and look for ways to innovate.

AFI: *Do you think the challenges (and risks) are less now for a prospective start-up, or different?*

BD: I think the challenges and risks for a new start-up are different. There is new regulation and there are more players entering every day. Compared to some markets there is a relatively low barrier to entry, but to other markets it's quite high. I think there is great opportunity for the right player(s) to enter the market if they know to a certainty what they are going to do and how they are going to go about doing it.

For a firm with an existing team simply starting something new, it would be easier than a brand new company coming in from outside. Either way, there is ample opportunity available; one just has to get through the barrier to entry, including the social barrier to entry as well, as you really must get to know people in the industry really well.

AFI: *Just how hard was it really, and would you do it again?*

BD: I would say it was really hard to start up, as we were doing it from scratch and didn't know anyone. We came to the market with a clear understanding of our offering and its potential, and we had to hold on to that understanding until we had built up enough of a book to attract attention from the institutions. I would definitely do it again and intend to do so in another market; however, I would learn from my mistakes and look to accelerate the time-line, but yes I would certainly do it again.

Finding a niche

Specialisation – finding a niche which a start-up thinks offers high potential – is crucial. The days when new leasing companies could compete with established players on cost to customers, thanks to an environment where credit was easy to come by, have gone. Quickly building a large client base through low prices is not an option for new start-ups. In order to differentiate themselves from the competition, they have to have a unique selling point – expertise or some other angle which established players do not currently offer. Niche businesses that have a value add which the funder cannot offer will do better. An example of this might be knowledge of the Scottish market, which can be a difficult area for funders to understand, as there is different legislation. Public sector or managed services could be other niches for new businesses to explore.

Small companies with something to offer – such as expertise in a certain line of business – can write their own business, then go and sell the receivables papers to bigger funders. This can be a good way for small companies to free up their capital and further invest in new business and a route to market for larger funders to acquire assets that would otherwise be unavailable to them.



Bruce Nelson, director,
Compass Business
Finance

Starting up in a niche market – Compass Business Finance

Compass Business Finance was founded in 2006 and is one of the few UK lessors to focus on renewable energy, in particular anaerobic digestion. Bruce Nelson, who leads the green energy side of the business, believes that "it will probably be one of the faster growing green technologies over the next few years." Nelson is optimistic that there will be significant change in the UK by 2015, with significant investments in technology and plant.

Bruce Nelson describes the particular challenges of operating in a niche market.

AFI: *What do you see as the prime differences (if any) to be aware of when starting up in a niche market? Are there specific hazards in, say, renewables as opposed to other niche areas?*

BN: Every market has its challenges. They are always changing/moving, so don't work in the past with a "because we've always done it that way" approach. If you're not up to speed with a market you'll attract bad debt. With renewables it's still a reasonably nascent market and therefore the historical data many would wish to understand isn't there. So education is required to build the confidence necessary for credit teams to progress funding requests. It's fair to say this doesn't happen overnight and rush things at your peril.

AFI: *Are there specialist funders?*

BN: I would have thought most lenders operate in specific sectors. Understanding the assets on which you're lending money has always been central to most of the asset finance sector.

Know your funder

Start-ups must take the preferences of different funders into account when deciding which organisations to approach. Funders hold the balance of power, so a prospective funding client should not be under the impression that it will be possible to persuade a funder to modify its criteria, as a general rule. Failure to investigate funder preferences prior to making a pitch risks wasting everyone's time, and burning bridges with that funder. Start-ups should pitch to funders already interested in their line of business. A small finance company would know who the larger players are, and would pitch to them. A start-up has to show in-depth understanding of the client base and its requirements. The funder will want to see proof of prudence, and past performance.

Getting that first relationship in place is crucial, as once you have a relationship with one bank, others will come on board more easily. Thinking long-term is vital; relationships must be structured to last.

Having a diversified funding base is also important. New companies should not put all their funding eggs in one basket; they should have a rock-solid relationship with their backers, but without being dependent on one funding source.

An innovative lending model for asset finance start-ups and intermediary lenders has been developed by Conister Bank – see below.

Viewpoint: A new lending model – Conister Bank

Conister Bank's managing director, Juan Kelly, gave his views to Asset Finance International on the current market for asset finance provision, particularly where start-ups and recent entrants are concerned.

Kelly began by giving his assessment of the current business model, stating: "Conister Bank's business model is different to other banks. I believe we are at a watershed moment in the UK banking sector. The current model is widely seen as having failed, and in the future there will be a new order."

Kelly continued with a description of how Conister Bank has developed its business model for funding. "We are pioneering a model where we allow our partners to originate and execute business in their markets. Conister Bank simply funds the underlying loans under what we call an Integrated Wholesale Funding Agreement (IWFA). This is much more accessible for start-ups, which will in my view play more of a role in the future of UK lending than they have done historically.

"The IWFA is effectively a hybrid between a blocking line and a term loan. Other banks lend in three main ways: brokered in; blocking; and term loans to intermediary lenders. Historically, if you were an intermediary lender (that is, a lender that does not have a banking licence and has to raise funding from other banks, e.g. D&D Leasing, 1PM, etc) you would have gone to either a big bank like RBS that would have lent you money on a wholesale basis to on-lend to your customers, or used the securitisation markets. Both these markets are effectively in hibernation. So if you are an intermediary lender you can either obtain funding via the blocking market or by using equity. Both are limited in availability and constrain growth.

"That's where the IWFA comes in. Intermediary lenders originate loans (directly or indirectly) and execute them (credit, admin, etc). We fund each loan individually and own the loan. You might say that sounds like blocking, and it is similar, but it has three important differences: 1) blocking requires equity to over-collateralise the loan, and this is a major growth constraint as equity is scarce and expensive; 2) average blocking lines for younger lenders are in the region of £1-3m, so you need several funders to scale up the loan book to, say, £10-20m, and beyond it becomes more difficult; 3) the IWFA can be used by start-ups and it is start-ups that often bring the new technology to lending."

Kelly concluded: "Our USP is that we are innovative. We look to design ourselves around our customers' needs rather than the other way around. We are the only bank in the UK to say we don't want to distribute or execute, we just want to fund. It sounds simple but it's not that easy for others to follow. Many larger banks are quite traditional and slow to change. The reason is that most banks have legacy distribution platforms and structures (e.g. branch networks, add-on products, staff). These are expensive and slow to unravel. But even new banks are following the old way. Take Metro Bank; it's a brand new bank starting with a clean sheet and given a fresh face, like being open seven days a week, but it's essentially still using an old business model. Of course, we don't believe IWFA's are the answer to everything and will continue to listen to what our customers want and find ways to service their requirements."

Outsourcing non-core activities

Once a start-up has assembled a credible and respected management team, identified its market and put together a business plan, the other aspects of running a business need to be considered, such as what software platform will be used, and where legal and accounting expertise should come from. Outsourcing non-core competency functions should be a serious consideration. Outsourcing can allow a start-up to focus on key tasks like new business development, knowing that the back-end processes and IT systems will deliver what it wants – as well as what its clients (and funders) want. Working with an outsourced back office provider with powerful systems can allow a start-up business to punch above its weight without requiring a significant financial investment. Not only does this help keep costs down and margins up, it ensures that investor equity is deployed where it is most needed – leveraging the funding facility.

'Buying-in' specialist legal and accounting knowledge, for example, is likely to be more cost-effective for a new company than hiring in a full-time lawyer or accountant. If a particular structure is required for a particular area of business, it's advisable to buy the advice needed to set it up.

A plan to keep back office costs down while still providing an efficient and seamless service to clients could be an effective selling point on a business plan presented to funders. Outsourcing can provide cost-effective benefits in the form of scalability and processes where investors can see robust, well-used platforms – these provide reassurance in a downside scenario. Focusing on originating new business while outsourcing the 'heavy lifting' of administration to a trusted third party could well be a smart move, especially for fledgling businesses without large reserves of cash to spend on personnel, equipment and software.

However, if the business model relies on a special client service, certain differentiators should not be outsourced and need to be kept in-house, for example, distribution processes, customer contacts, underwriting, and processes involving asset redemption (i.e. where value and differentiation is added).

And outsourcing can also be viewed as a short-term option only, one that fails to build core competences into the organisation as it develops, thus depleting value in the longer term and running an inherent risk of loss of control within the organisation. There is also the risk inherent in partnering with another organisation, the operation of which cannot be controlled – a partner organisation's sudden business failure could prove disastrous. Potential third parties should therefore be chosen with the utmost care, and subject to due diligence.

Juan Kelly is one of those who advise caution: "Start-ups should try to retain as much in-house as possible, with the exception of IT which should be acquired off the shelf and outsourced." Mark Picken is also not a fan: "I see it as a short-term measure and a loss of control. In the short term it may help a start-up initially, but if it is serious about the market, its long-term strategy should be to originate, bill and collect its own portfolio. It depends on the overall strategy. If it wants a quick in and out, outsource it all after origination. If it wants to test the water and build knowledge, experience and reputation, then initial outsourcing is a less costly option. If it wants to build long-term value, keep as many of the systems and processes in-house as it can afford." And outsourcing is not an option for Laura McMullen: "We work closely with a panel of introducers and feel that outsourcing any of these functions would not work due to the high service levels that we seek to provide."

On the other hand, for Ratan Daryani, outsourcing was fundamental to his business start-up plan: "Outsourcing our lease management system and back office process has been essential to the Rivers Leasing business. This has allowed us to start up with industry recognised systems without the initial investment requirement, it has allowed us to utilise specialist and experienced staff without having to employ them directly and have them underutilised until we grow sufficiently to fully utilise their skills. Outsourcing has also been critical to our cash flow as the 'pay per lease' model of costing allows us to have professional systems and resources that match our cash flow and growth profile."

The most beneficial functions to outsource are from audit through to funding and portfolio management, including billing and collecting, as well as customer service, according to Bill Dost. "I think outsourcing back office functions for a start-up can be quite advantageous. Keeping overheads low will lead to profitability and having a backup servicer can bring a level of comfort to funders who may want to provide finance."

Paul Tagg also sees advantages, particularly in outsourced management systems: "Outsourcing has become more popular in recent years, particularly hosted management systems. For a start-up, it can provide an economic advantage whilst critical mass is being built."

And Paul Brett makes a valid point about exit clauses: "I am a fan of outsourcing as you can keep your costs low while growing your business. The important point to note here is that you ensure that your contract allows an exit, should you decide to take the function back in-house."

Viewpoint: Outsourcing can deliver what you – and your funders – want

By Richard Carter, chief executive, Nostrum Group



Richard Carter, chief executive,
Nostrum Group

Writing a comprehensive business plan and securing funding is a big challenge for any entrepreneur. On top of that, the organisation will need to define and implement its back-end processes and IT systems if it is to present a credible case to potential funders – another substantial and challenging task. This is where many fledgling businesses turn to outsourcers. Outsourcing allows you to focus your attention on key start-up tasks like writing a plan and raising funds, knowing that your back-end processes and IT systems will deliver what you – and your funders – want.

Since funders are not short of options as to where they invest, they need to be sure the organisations they back are able to combine the highest return with the lowest risk. Outsourcing can help achieve that risk/return balance. It is often more cost-effective than in-house provisioning, especially in a business's early stages; for example, if you only need a quarter of a person to do a specific task, you can buy in that quarter's worth of expertise without having to pay for the three-quarters you don't yet need. Outsourcing also helps with the management of risk; with dozens of people on the Nostrum team, we have a depth of experience in systems and back office that a new start-up is unlikely to be able to match.

Outsourcing can also deal with issues of scale. A start-up has the benefit of all of the outsourcer's experience on tap immediately, so if the business start-up grows quickly it has access to that knowledge without having to wait for the recruitment process to bear fruit. Outsourcers can scale up the services they provide to a start-up as rapidly as required. The costs for outsourced processing and systems are scalable and linked to the number of transactions carried out, which offers a clear benefit for a new company. In the typical business, adding an extra member of staff means you need more resources to allow that new employee to do his or her job, but if processes are outsourced, that extra cost is covered by the pricing, so it is a pure pay-as-you-go solution.

Speed to market is another area in which outsourcing can add value. We can provide all back office systems and processing infrastructure very quickly. If a client is looking to launch a new product, we can react fast, taking systems and back office off the critical path for a company launch or a new product launch, helping the client to exploit a market niche by rapidly putting the right systems with the appropriate capacity in place.

Outsourcing can also be a benefit to new companies regarding compliance. Although start-ups may have the advantage of flexibility, they still have to play by the same rules as everyone else. If there is a need for system and process changes due to legislative requirements, clients get them automatically from an outsourcer, which can also give clients advice on compliance. Often, start-ups are created by business development experts whose main focus is, understandably, more on the particular niche they wish to operate in, be it a particular vendor, partner, product or distributor. An outsourcer can make sure that all of the essential bits at the back end are in place and up to speed so they can focus on what they are best at. As an outsourcer and software supplier, Nostrum is continually investing in research and development, so our clients get the benefit.

Industry views on key funding issues

Key issues for potential funders are summed up by Bruce Nelson as: "Who's in the team. What reputation/experience do they have and can these be verified. On what markets will they focus, or will they be general non-specialist funders. Who will drive the credit policy and will their reputation be intact following the recent troubled years. Compliance will have its place; AML, CCA regulation changes, data protection. They must also ensure they have adequate capital, as cash flow is critical for any lender, and as experienced by many a few years ago, can be the downfall of profitable companies if loosely managed."

Matching your requirements to the right potential investor is also important for Mark Picken: "The challenge is having the right scale and there is no universally right scale. At one end, investors will want to invest large amounts of capital and seek control. At the other, the investment may be relatively modest and is being offered to augment the current poor returns in the deposit markets. Generally, the issue is that new investors want low risk and high returns. Nice work if you can get it! What is clear is investors need to trust the management team and be convinced they are knowledgeable and experienced. Shire's unique role as a Master Broker in the UK is largely predicated on the management team's experience and proven systems and processes that have weathered the recent credit storm."

Paul Brett sees the main challenge as obtaining a longer-term debt facility to enable the business to lend: "Many start-ups initially use equity to finance deals but ultimately a competitive wholesale debt line facility has to be obtained", while Bill Dost also identifies the need for demonstrably robust business fundamentals: "Keeping a low overhead and profitability and often seeing how a lease portfolio has performed will also assist in attaining funding. A robust legacy system or one that is outsourced is fundamental to provide auditability and performance reporting to a potential funder."



Paul Tagg, director,
Shawbrook Bank

Paul Tagg provides the asset financier's point of view: "As a start-up there is no track record, leaving lenders to rely on due diligence of the business and management and, as block discounting usually advances up to 80% of the customer net lend, the asset lender would have to be able to provide the 20% equity on each deal; this is the main challenge for the asset financier. The increase in regulation also means that a new entrant would need to cover these aspects. Fortunately, there are professional firms out there that can cover this, but obviously at a cost."

Tarun Mistry also highlights lack of track record as a primary issue: "The first challenge for a start-up is lack of portfolio history: the start-up needs to prove it can make the returns. How solid is demand for the product – will volume assumptions be met? What platform will be used – if it fails, how will a funder get their investment back? Can the start-up show it can provide leverage going forward – is there a financial buffer to keep the company viable without having to rely on the debt funder for support if projections are not met?"

On the downside, both Juan Kelly and Ratan Daryani believe that obtaining funding is a steep uphill battle. Kelly puts it plainly: "Many funders won't lend to a start-up and this is unlikely to change in the next two or three years", while Daryani says: "In my experience you need to go from start-up to being a viable business before you can obtain any further funding."

From the horses' mouth: top advice from the industry experts

Bruce Nelson, director, Compass Business Finance

Have a clear vision of your project. Ensure you have a strong team, robust policies and have others stress/sanity check your model.

Mark Picken, managing director, Shire Leasing

Pick your asset sector carefully, match a funder to it carefully, and go from there. Starting out as a general asset funder is hard today and investors will be nervous unless you can demonstrate a track record that means you can manage the risks.

Ratan Daryani, managing director, Rivers Leasing

The best advice I was given, about a year after starting, was to implement an industry recognised lease management system and move away from spreadsheets.

Bill Dost, managing director, D&D Leasing

If one is looking to 'fund' a leasing start-up, I'd say first look for an existing platform you could purchase; failing that, look to tie into a smaller leasing company that may want an outside funder.

If you are looking to start a new leasing company, ensure you come in with enough funding capital and working capital. Ensure your management team has a solid pedigree and know your model and work your model.

Juan Kelly, managing director, Conister Bank

- a) Have a full and realistic business plan with a detailed financial model.
- b) Keep costs as low as possible. Don't over-engineer.
- c) Raise enough equity to get the business to a breakeven loan book size.
- d) Utilise a funding model that uses as little equity as possible so you don't miss out on rapid growth opportunities.

Tarun Mistry, partner, Grant Thornton UK LLP

- Make sure you have sufficient equity in place to cover for unplanned events.
- It will probably take longer than you think to raise the equity and debt – this should be factored in.
- Consider the option of going live with your own equity backing, to prove the model before going to a debt provider (who will then be more receptive to your proposal).
- Get your platform sorted – reliable, robust, demonstrable, with management skill-sets needed to fill key criteria (operational, underwriting, distribution).
- Have a thoroughly prepared and comprehensive business plan, so that you can answer all the questions that will be put to you. A quality, reliable and flexible financial model is vital.
- Have a corporate structure that gives funders adequate security. You need to be able to demonstrate how security is covered if an outsourcing model is adopted.

Paul Brett, business development director, borro

The golden rule of any start-up is to keep your costs under control and track every enquiry and transaction back to the marketing strategy. Remember, marketing without measurement is madness!

Tim Tainty, managing director, Kennet Equipment Leasing

Build a reputation on thoroughness, commercial acumen and sensible decisions.

Paul Tagg, director of block discount, Shawbrook Bank

From the funder's point of view – know who your customer is; always obtain references on key personnel. Where appropriate take a collegiate approach with other funders in reference to the professionalism and reputation of management. Audit the company in depth prior to lending and continue monitoring.

Peter de Rousset-Hall, independent consultant

On starting up outside the UK, my belief is that most UK companies that have little or no experience of operating outside of the island tend to be very naive when doing so. They assume that because most EU businessmen speak English they must operate to a UK style of culture and practice. This is rarely the case. If you are looking to do business abroad, be aware of different business customs, practices and regulation.

The role of secondary funding markets

Block discounting and securitisation are the two main sources of secondary market funding. Syndication is generally only available for larger transactions in excess of £50m (club basis) or £100m for syndication, so is not really a viable option for start-ups or early-stage operations.

Block discounting

Block discounting is a tried and tested funding source within the asset finance industry. The funding method lost some of its usefulness when there was a super-abundance of debt funding prior to the credit crunch, but is now coming back as a mainstay of the industry.

A typical block discount facility is started by a lessor approaching a block discountor and offering to generate new business, while being in possession of enough equity to finance some of the equity costs, usually around 20%. The block discountor will advance a fixed percentage of the cost of the asset, typically around 80–85%, while the leasing company puts in the rest. The block discountor will make its margin, so when the lessor is able to lease out an asset at whatever the market rate happens to be, the lessor will be left with a margin which needs to be sufficient to cover its fixed and variable operating costs, bad debt provisions, and, hopefully, a profit. The block discountor takes a charge over the receivables generated through the lease contract, allowing it to collect out on the asset if anything goes wrong. Current players in the block discounting market include Aldermore, Hitachi Capital, Shawbrook and Siemens.

The credit philosophy behind block discounting is extremely similar to that behind securitisation. Block discounting tends to be a single investor execution. Because it is bilateral between the block discountor and the lessor, there is usually no need to bring in outside parties such as ratings agencies and investment banks, as would be the case for securitisation. This drastically lowers the cost of execution.

Block discounting is the easiest way of accessing the market for a new start-up. It is possible to get funding from block discountors to set up a business, although usually block discounting is a step after the initial financing has been put in place, as a track record of writing deals. For small ticket deals, block discounting makes a lot of sense. However, a good track record is key and the consensus is that if a new company has a very experienced management team, it will receive

recognition of that and there is no reason why facilities should not be provided. However, for a new start-up with no previous experience, block discounting will not be of use, as there will be no track record, no underwriting examples, and no history of reliable operating systems.

And Tarun Mistry advises: "In the past it was quite normal to use block discounting to leverage up, which could be done with relatively small amounts. That option is still there, the appetite is there and increasing, but a block discountor needs to know who's involved, if the underlying assets are of good quality, and be comfortable with the management team and platform etc – which can be an issue for start-ups."



Tarun Mistry, partner,
Grant Thornton

Securitisation

The securitisation market closed significantly post 2008 but has opened up in more recent years for assets that are well understood and have performed relatively well over the period.

The key to asset finance securitisations is the ability to predict accurately the future value and future income of a portfolio, and to prove it. Most major asset classes have been securitised: cars, aircraft, ships, plant and equipment, as well as intangibles such as software licences, but these can be much more difficult. The main ingredient is a high degree of predictability of performance in a wide range of economic scenarios.

The problem with securitisation is simple – in its full version, it is massively systems- and analysis-intensive. At the end of the process, after the lessor has met the ratings agencies and undergone a full analysis of the deal and stress testing, the lessor knows far more about his or her own business than is sometimes comfortable. For a start-up, unless they have incredibly well-developed infrastructure and the proven capability to provide servicing, securitisation won't be an option on the table. It's not for the faint-hearted – you need to know your business inside-out and be able to prove it. Anyone without at least a three-year track record is looking for disappointment, and first-rate systems and back-up are needed. But securitisation alone can never be a viable alternative to working capital, only an addition to it.

New start-ups face an obvious barrier when it comes to securitisation: a substantial portfolio is required (from £50m upwards, £100m being standard) with some kind of performance record to offer security to investors. But new companies should not discount this route entirely, and it could be a relevant route for established companies looking to raise funding for a new niche subsidiary. Longer leases look to be better suited to securitisation, but investors then also have to wait longer for a return. The average lease term of around three to four years is the most effective securitisation term. Independent leasing companies should look at achieving gearing ratios of around three to one (prior to the crash, ratios could be up to 10 to one). A new company should use low gearing ratios to build a portfolio that can be packaged for securitisation when the portfolio is mature, after around three to four years.

Accessing securitisation is not easy, particularly in the SME sector; it's all about good documentation, auditable procedures, and being able to answer any and all questions that a funder might raise. Due diligence is detailed and quality management information is critical throughout the process. You have to be able to cut the book in every way imaginable and give good data on any particular tranche. Consistency is also important: a securitisation needs a level of scale and consistency regarding the asset, product offering, process, documentation, etc, so participants know it will perform in a known way.

How the industry views the secondary funding markets

Bill Dost believes that these markets are an extremely important but under-utilised area of the UK marketplace. "Many funders traditionally keep their secondary funding deals under wraps, so having a clear understanding of the size of this market is extremely difficult. I can say that if we want the leasing industry to grow, a fully functioning and active secondary market like that in the US is extremely important."

In the opinion of Bruce Nelson, "Block discounting is often for those who can demonstrate a good track record, effectively recourse to an acceptable balance sheet. Although I'm sure some in this sector would consider parties with a sound reputation and where there's sensible 'skin in the game'." He sees block discounting as a very versatile product if used judiciously, and well suited to building an initial lending portfolio. "There's definitely an opportunity, although I'm not sure the funders use the secondary markets as much as they could. But the movement of experienced people from company to company in recent years may assist this sector to develop in the future. Knowing with whom you're dealing and how they operate is critical."

Juan Kelly noted that: "The blocking market is fairly buoyant for established players but term facilities are difficult to obtain", while Paul Brett commented that: "Since the credit crunch, secondary markets such as syndication and securitisation have been very difficult to come by. My understanding is that these markets are slowly beginning to reopen."

As director of block discount at Shawbrook, Paul Tagg's views are particularly relevant: "There will always be a need for businesses taken to the next step in development. However, the clearing banks are not in the market and funding is difficult to arrange in the securitisation and syndication sector and almost impossible at £50m or below."

Other sources of funding

Funding for Lending

Following lobbying from the FLA the UK government initiative, the Funding for Lending Scheme has been extended to permit participating banks to lend to non-bank finance companies for onward lending to SMEs. Credit Asset Management Ltd (CAML) has so far been the only start-up lessor to succeed in winning funds from the scheme, but there is clear potential to increase the availability funds for asset finance.

But industry opinion is divided on its effectiveness for start-ups, with Bill Dost noting, "For start-ups I'd say absolutely not. Funding for Lending has been keyed to support specific existing funders who fall within their remit. While there is the possibility that a new funder could come under the Funding for Lending banner and receive funding, it's highly unlikely due to the requirements of the program and the barriers to entry." Paul Brett concurs: "Funding for Lending is definitely making an impact; however, I believe that this impact is more keenly felt in existing businesses. That said, start-ups that raise significant capital may grow much more quickly using the facility."

FLS is seen as a mixed bag by others. Mark Picken noted that: "Some banks see it as an opportunity to lend, particularly if non-bank lenders offer them more capacity to do so. However, I have heard big banks say it makes no difference! FLS hasn't changed their credit appetite so why would it make them lend more?" Juan Kelly felt that perhaps the situation would improve with the Business Finance Partnership. On the other hand, Bruce Nelson is a supporter: "Funding for Lending has clearly made an impact on the market and when used judiciously has great value. It's probably one of the government schemes that's worked."

The FLA: lobbying government for change



Julian Rose, head of asset finance, Finance & Leasing Association

Julian Rose, head of asset finance at the Finance & Leasing Association, outlines how the FLA is working with government on new funding initiatives.

A growing number of investment firms are approaching the FLA to seek advice on how to invest in the asset finance market. We have met around half a dozen fund managers already this year. Our two Secondary Market conferences, held in 2010 and 2011, identified a number of factors that limit non-banks' ability to attract external investment. These factors frequently come up in discussion with the fund managers. These include lack of standardised terms for agreements and inadequate industry-wide data on loan-level performance. These are difficult issues to address as they require cooperation across the industry which is limited by competition law rules.

We have discussed this problem with HM Treasury (HMT), the Department for Business (BIS) and the European Investment Bank (EIB). The Government's Business Finance Partnership, together with the first round of the Business Bank's investment programme, were designed to help non-bank finance companies to obtain additional external investment. The Business Bank's proposed new sponsored leasing vehicle could fund up to around £400m of leases from multiple originators from 2014. The EIF's Structured Finance programme could also help non-banks to sell agreements to investors. Like any government interventions in the market, however, all of these schemes are at best temporary and partial fixes. The FLA's 2013 Operations Conference on 12 December will explore how the industry can find permanent solutions to address investors' needs.

We have also continued to lobby to ensure that banks can lend to non-bank asset finance businesses. Following our lobbying, the Funding for Lending Scheme was extended to permit participating banks to lend to non-bank finance companies for onward lending to SMEs. We are continuing to call for ring-fenced banks to be able to lend to non-bank finance companies, as the original proposals for banking reform would have precluded this. New lease accounting and capital requirements rules could also impact banks' ability to fund non-bank lessors.

Other funding routes

If traditional funding avenues prove difficult to access, there are a few other routes to market. One is the 'big brother' approach – a larger, established business that will allow a new start-up to leverage debt against its balance sheet. However, the start-up directors would have to give up a good degree of independence and a large share of the equity.

This 'piggybacking' on another company's balance sheet should reap rewards when approaching funders, as it will offer them a far higher degree of security. Once equity is in place, and more money is needed to finance the increasing deal flow, the organisation would then be able to approach the block discounting market, or some form of wholesale debt structure with its bank. Banks will still lend money provided there is a decent balance sheet or strong guarantees in place.

A previously popular option, particularly for staff made redundant, has been to set up as an independent broker, using their market knowledge and contact books to build new businesses for themselves, with the advantage that very little capital investment was required. But as margins available to lessors have become increasingly thinner, the broking route is now, if not impossible, then extremely difficult to establish. However, there is a small but growing trend among some established brokers towards running their own book, reflecting the attitude that, if the funders will not support them, then they might as well look to raise funds themselves.

Entrepreneurial dealers, with their command of the point of sale, are well-placed to set up and grow their own leasing book. As with other types of business, however, the lack of available funds can often cut off this route before it becomes an option.

Acquiring a banking licence may be beyond the ambitions of most new ventures, but that was the route taken by Aldermore Asset Finance, which decided that the only way to raise sufficient funding to support the operation was by way of raising deposits. It therefore acquired Ruffler Bank, an acquisition which also brought with it a small asset finance business.

Starting up as a broker/funder – Shire Leasing

Shire Leasing is the largest independent funding house in the UK for equipment finance and asset leasing. The flexibility it has as both a Master Broker and funder gives it a powerful position in the UK SME marketplace. It has a range of online services that includes an iPhone app which gives suppliers a decision in under six seconds, and its Esignatory service which accelerates the application process for both suppliers and customers by sending the whole document to the customer in PDF format for a legally binding electronic signature.

Managing director Mark Picken describes his business.

AFI: *What made you decide to run your own book?*

MP: It all started 19 years ago and has evolved from there. It makes sense to have a constant income stream rather than relying on new business commission each month. After the credit crunch those brokers without income other than new business commission were very badly hit. Those with portfolio income could keep the wolf from the door. It also allows us service level control for our vendors and direct hirers.

AFI: *Are there particular assets that you prefer to place on your own book? If so what are they?*

MP: No, we are a general asset funder. We do write deals with security instruments wrapped round them that are seen as too laborious for mainline funders to be interested in. If they are running a sausage factory it is impossible to make bespoke sausages on demand. Our innovative, entrepreneurial approach helps us win against their constrained, systemised demands.

AFI: *What was your business proposal to your funding sources?*

MP: History (23 years' trading), experienced management team, knowledge of the markets we were proposing, proven systems and processes, compliant and profitable. Our ability to achieve our Master Broker status with various funders was secured because of all the above.

AFI: *Where did the funding come from? How easy was it to find funders willing to lend?*

MP: The funding comes from various sources. We use block discounting, corporate investors, private investors, cash flow, and we hope to attract future investment from UK and foreign banks as well as maximising any opportunity that The Business Bank may offer. It is still relatively difficult to secure competitive funds, but if it wasn't everybody would be doing it. We have an expression in Shire that to secure future investor princes we have to kiss a lot of frogs!

Starting up as a broker/funder – Kennet Equipment Leasing

Kennet Equipment Leasing brokers finance for all types of equipment, with customers ranging from small sole traders to large multinationals. The last 12 months has seen Kennet launch a mobile leasing app, as well as the e-doc, which allows leasing agreements to be signed almost instantly. In addition, they now offer finance for equipment valued from £250 upwards as a new strategic market entry price point.

Managing director Tim Tainty outlines their experience.

AFI: *What made you decide to run your own book?*

TT: Whilst we already broker a lot of business finance, we are ultimately looking to establish ourselves as a credible broker/funder. Our own book will increase by £5m to £15m in the next year.

This growth in own book gives us the flexibility to place business in a funding portfolio that suits the business needs of the lessee – whether it is placed with us or another funder.

It goes without saying – it is a profitable part of the business, and allows us to put cash back into Kennet from shareholder investment and funder blocking lines.

Where we have defined dealer relationships we are also able to fund equipment acquisition rather than going to another funder, as there is already an established history with them.

AFI: *Are there particular assets that you prefer to place on your own book? If so, what are they?*

TT: No, we will consider each proposal on its own merits.

AFI: *Where did the funding come from? How easy was it to find funders willing to lend?*

TT: As our reputation grew in the market place we found and continue to find that funders are approaching us, so our access to funders is growing all the time.

Peer-to-peer lending organisations such as Funding Circle and Zopa and short-term asset finance provider borro are becoming more active business funders, side-stepping the banks and supporting the core of the UK economy. Peer-to-peer finance providers are defined by their Association as: "Platforms that facilitate funding via direct, one-to-one contracts between a single recipient and multiple providers of funds, where the majority of providers and borrowers are consumers or small businesses. Generally, funding is in the form of a simple loan, but other instruments may evolve over time."

Case study: Peer-to-peer lending: Funding Circle

A high-profile example of a successful launch of a company in the asset finance market has been Funding Circle, the peer-to-peer lender. In this case study, the company provides an insight into how it started and progressed.

Funding Circle is the world's first online marketplace where people directly lend to small businesses, sidestepping the banks and supporting the core of the UK economy. Small businesses borrow between £5,000 and £1m, while lenders are attracted by the prospect of high, stable returns for the long term.

The challenges of starting a peer-to-peer business lending operation

Small businesses employ 60% of the private sector workforce in the UK, which in turn supplies 50% of total GDP. According to HM Treasury, 92% of loans to these small businesses are funded by just five high street banks. It can take between 15-20 weeks to obtain a loan from one of these five banks. The opaque nature of this ecosystem means that these businesses are getting a raw deal. Combine this with the nation's general lack of trust and satisfaction in the banking system and dishearteningly low interest rates, and the potential for an alternative becomes increasingly apparent.

At Funding Circle, the team wanted to create a way of effectively bringing these two disaffected parties together and cut out banks. The business has grown to such an extent that now, alongside individual lenders, governments, councils, a university, and other businesses have an alternative means of lending directly to small businesses.

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The initial funding proposition

The concept Funding Circle was born in 2008, as the financial crisis began to take its grip on Britain. In summer 2009, the three co-founders Samir Desai, James Meekings and Andrew Mullinger left their day jobs to concentrate on turning their idea into a reality.

Initial investment of £720,000 came from friends and family. In March 2011 Index Ventures invested £2.5m. A year later, Index and the New-York-based venture capitalist firm, Union Square Ventures, combined to invest a total of £10m. This capital injection in combination with the creation of a high-profile board including Ed Wray (Co-founder, Betfair), Andrew Learoyd (ex MD, Goldman Sachs), Neil Rimer (Partner, Index Ventures) and Andrew Weissman (Union Square Ventures) meant that Funding Circle was able to quickly establish itself and attract businesses and lenders to participate.

In total, approximately £13m has been raised in funding, with additional contributions from a number of leading Angel investors.

Risks and challenges

Creating an online marketplace for businesses to borrow directly from British people had never been done before – there was no blueprint to follow. Now new businesses have a path to follow.

The challenges today are simply about raising awareness and making sure Funding Circle can help as many businesses as possible.

The breakthrough moment

Initially, Funding Circle promoted its innovative offering mainly through PR coverage and other marketing channels like direct mail, with additional support from business groups such as the Forum for Private Business.

£1m was lent in the first 10 weeks, which was a good indication that the business was popular with lenders and business owners. Since then, Funding Circle has trebled every year. In December 2012 the UK Government announced plans to lend £20m directly to businesses through Funding Circle. This was a watershed moment for the business and the wider peer-to-peer lending industry.

In total, Funding Circle has helped to facilitate more than £150m of lending in three years and is helping to lend £14m every month.

Expansion into new sectors

When Funding Circle launched, the limit for loans was £100,000. Over the last three years this has been increased to £1m. There has also been the introduction of new risk bands to help even more businesses, and recently Funding Circle started lending to sole-trader and small partnerships. However, the application process remains the same, in that businesses must be at least two years' old and with a minimum turnover of £100,000.

The challenges for a prospective lending start-up

The challenge for any new peer-to-peer business lender is to manage the supply and demand side of the businesses. Therefore it is important to have a regular stream of businesses that use the site. Funding Circle has helped 2,500 businesses to access finance during the last three years and on average 250 loans are listed every month. Lenders can be confident that they can get their money lent out and manage their risk by lending to lots of different businesses, while a business owner is confident their loan will be fully funded at a competitive rate.

Starting up a captive lessor



Alan Leesmith,
international director,
IAA-Advisory

Alan Leesmith, international director, IAA-Advisory examines the particular issues relating to starting up a captive lessor.

The question of including captive lessors in this report is one that raises the question as to whether it really has a place in such a guide. However, captives do start up and so the question still arises of how are they funded? It is unlikely to be by investors or entrepreneurs, except in a few peripheral cases which I shall refer to later.

The generally understood meaning of a captive is one which is owned by a parent company to which it provides a service. In this case we are talking about finance captives of equipment manufacturers, but it could equally refer to other services such as insurance. So the first question one should address is why equipment manufacturers decide to establish a captive in the first place. Those reasons are different to the rationale for setting up a pure finance company where 'lending' money, in one form or another, in order to make a profit is the primary objective. A manufacturer primarily establishes a captive for the benefits it can bring to him as a manufacturer, rather than as an investor. Those benefits are ones that help sell more product, maintain and secure the customer base, reduce discounting, provide more services and supplies and possibly control the second-hand market. Many manufacturers also see this as an opportunity to retain the profit that a third-party lessor would make on their business. A captive can also become a valuable company in its own right, thereby increasing shareholder value and returns.

Just like any other significant lessor, establishing a captive is an expensive business as all the necessary infrastructure needs to be put in place if the above objectives are to be met. So given these criteria for establishing a captive, it is not surprising that it is normally only the major global equipment providers that do this. Even then, because of the overheads involved, it is likely that they will only be established in markets where the parent has significant volumes to justify the costs.

A manufacturer's prime business is to manufacture and sell equipment, so the captive will only be formed if the manufacturer has sufficient cash resources or funding facilities available to it. A successful manufacturer will be able to raise funding more readily than a financial institution since it is producing tangible goods rather than the paper profits that banks and finance institutions make. Also manufacturers tend to be more successful at raising funds via bond issues and although their captives will frequently make such bond issues in their own name.

Managing a captive, as it is working within a manufacturer's sales culture, is a significantly different business to that of a traditional finance company working within the culture and criteria of a financial institution. For this very reason a number of captives came together to form their own trade association, The Captives Forum. This specifically looks at the challenges and issues faced by a captive in an equipment-driven culture. More details on the Captives Forum can be obtained from the author of this article, Alan Leesmith, who is the Secretary of the Forum. alan.leesmith@captivesforum.org

The minor exceptions that I referred to in the opening paragraph could be regional dealers who have traditionally used third-party lessors, but over decades have built up successful businesses and often have accumulated cash reserves. These companies frequently start taking some transactions onto their own books as they realise that this is a more profitable way of investing surplus cash than normal methods. In this way they slowly build up their own leasing portfolios and cement relationships with customers who they know well and understand the risks relating thereto. It is not unusual to see these dealers resort to funding via block discounting and similar routes, meaning that they become more of a hybrid than a true captive.

Appendix: Lease accounting: new rules are coming

Andy Thompson, Asset Finance International's legal and regulatory editor, looks at the likely effects of proposed changes to accounting procedure and highlights topics of particular interest for new entrants

The major regulatory challenge for the leasing industry in the coming years is one that will be almost global in scope. A new lease accounting standard is being proposed. Its heaviest impact will be on lessee rather than lessor accounting. However, new players entering the market as lessors will need to be aware of the changes, so that they can brief their future lessee customers on what to expect.

New entrants to the leasing market may operate under a variety of business models. However, even if the bulk of their contracts are to be funded by banks or other third parties, it is likely that new players will be introducing the business direct to lessees, and will therefore need to bring a high level of awareness about the coming changes in the lessee accounting framework.

The immediate effect of the change will be on international financial reporting standards (IFRS) and US generally accepted accounting principles (GAAP). National GAAP rules in many countries outside the US are likely to be brought into line with the change at some stage. For those lessees who are affected by it, the major likely change is that nearly all leases will give rise to assets and liabilities on their balance sheets.

The only exceptions to the new rule will be short-term leases that cannot continue for more than 12 months. The rules will apply to both equipment and property leases – but where equipment is concerned, the only exempted short-term contracts will be those like construction plant hire and vehicle daily rental.

Under current accounting rules in most countries, a key accounting distinction is drawn between what are called 'finance' and 'operating' leases. A finance lease (or a 'capital lease' as it is called in the US market) is one where most of the risks and rewards of ownership of the asset are transferred to the lessee. These are already on-balance-sheet to the lessee, while all other leases are classified as operating leases and are off-balance-sheet.

In most jurisdictions, for the lease to be classified as an operating lease there has to be a residual value (RV) risk to be borne by the lessor or supplier – and not guaranteed by the lessee – of at least 10% of the asset's value (when discounted to a present value (PV) at the start of the lease period).

The current finance/operating lease distinction is relevant to both lessee and lessor accounting. However, it is much more critical on the lessee side where it determines the question of balance sheet capitalisation. The lessor will of course always recognise a balance sheet asset of some sort, although the detailed accounting rules are different as between the two types of lease.

Under the current rules the underlying asset – i.e. the vehicles, plant or machinery (or real estate) subject to the lease – will appear on the balance sheet of either the lessee or the lessor, depending on whether it is a finance or operating lease. In the case of a finance lease, the lessor will recognise an associated financial asset, and not the underlying asset itself, on its balance sheet. Where the RV is underwritten by the equipment supplier or another type of third party who is not the lessor, a contract could well be an operating lease for the lessee but a finance lease for the lessor.

Under the proposed new rules, the lessee will recognise a 'right of use' (ROU) asset, and a corresponding liability for the lease rentals, based on the PV of the minimum lease payments. For a lease currently classified as a finance lease, the ROU asset will have much the same value as the underlying asset under current rules, but for current operating leases the ROU asset will be relatively smaller.

In the expense profile through the lease period in the profit and loss (P&L) account, nearly all equipment leases will be expensed on a front-loaded profile. This will match the current treatment of finance leases. However, it will differ sharply from the straight line expensing of current operating leases, so that the recognition of expense will become more accelerated in that type of contract.

In future lessee accounting for the ROU, the rules for deriving PVs for initial balance sheet recognition will be the same as for finance leases now. Lessees will be required to use the "implicit interest rate" in the lease to discount the lease payments where this is possible; however, they will otherwise be permitted to use their own incremental borrowing rates in the general credit market. Implicit rates are hardly ever documented on lease contracts. With the wider application of these rules in future, when all leases go on-balance-sheet, some lessees may be looking to their lessors for guidance on the implicit rates.

Many leases have renewal options for the lessee at the end of the contract period. Under the current version of the proposed rules, the standard-setters have gone for a solution that should minimise the compliance problems for lessees. In computing the PV at lease inception, renewal periods will be ignored except to the extent there is a "significant economic incentive" to renew.

It is likely that in practice this would catch only the renewal options on some current finance leases, where secondary rentals are reduced to a fraction of those in the primary period. In the case of newly capitalised operating leases, any renewal options are likely to be at relatively higher cost and so will not have to be accounted for until they are actually incurred.

Service-inclusive leases

Many of the operating leases that will come on to the lessee's balance sheet under the new rules will be service-inclusive contracts, like contract hire facilities in the vehicles sector. In these cases current accounting rules for the lessee are relatively simple. Both lease and service elements are off-balance-sheet, and are accounted for in the same way in the P&L account, normally on the basis of the documented rental and servicing costs.

In future, however, lessee accounting rules for these contracts will become much more complex. The servicing part of the contract will still not be capitalised, but the finance charges will be so.

The draft accounting standard lays down rules that should make it clear how these sharply differing forms of accounting treatment are to be applied to the two elements of this type of contract. In the great majority of cases across the leasing market, agreements are already documented in such a way that the split between finance and service charges will be clear to the lessee.

In some leasing market sectors where there are many service-inclusive contracts, notably reprographic equipment, the lease elements of most agreements are in reality finance leases under current rules. There may be some compliance issues at present, in that many lessees do not appreciate that the lease element should be subject to a finance/operating lease classification test and may therefore already need to be on-balance-sheet. In future, with all leases having to go on-balance-sheet and with clearly specified rules for splitting the accounting for lease and service elements, there will be less ambiguity on the correct treatment for those contracts.

With some deals in the large- and middle-ticket sectors, there are grey areas between service-inclusive leases and pure servicing contracts with no lease element. These also will bring more complexity when all leases have to go on-balance-sheet. The draft of the new accounting standard addresses this aspect. For both the putative lessees and lessors, it lays out a series of tests for determining whether a lease will have to be recognised within these contracts, based mainly on the extent to which the lessee has exclusive use and operating control of specific capital assets.

Lessor accounting

Under the proposed lessor accounting rules for equipment leases, lessors will potentially account for two distinct assets: the lease receivables, and a residual asset (RA) based on the RV. For present day finance leases there may in practice be no RA, and the valuation of the receivables may match that of the underlying asset.

For most types of equipment lease, including current operating leases, the lease receivables will be the main balance sheet item for the lessor and the RA (where relevant) will be relatively smaller. Proposed future accounting for the receivables will be essentially the same as for finance leases at present, giving a front-loaded income recognition profile through the lease period as a result of recognising finance charge income in the P&L account on an amortising asset.

The RA (if any) will initially be recognised as the PV of the expected RV at the end of the lease period. The PV discount applied to the RV will be unwound progressively through the lease period, and the resulting accretions of the RA will be recognised as income in the P&L.

For equipment leases that would now be classified as operating leases, the proposed change on the lessor side will be a mirror image of that on the lessee side. For in these cases lease income is currently recognised on a level profile, whereas in future it will become more accelerated.

Many potential start-up lessors will be existing equipment dealers or manufacturers, moving into the business of writing some leases on their own books. Their leasing activity would be a captive arm of their business as suppliers. For the captives the more important change in the lease accounting rules will be not in accounting for the lease as such, but in the ability to recognise a normal up-front selling profit on the equipment supply side of the business when products are sold on lease.

Currently, it is only on finance leases that a normal selling profit can be recognised by a captive leasing company (or its supplier parent) at lease inception. In the case of an operating lease, the asset has to be held in the books at its carrying value prior to realising a sale – i.e. at the cost of production for a manufacturer, or the wholesale buying price for a dealer. Only when the asset is disposed of, after the lease terminates, can any selling profit be taken into account.

Under the proposed rules, a selling profit at lease inception will be recognised in all cases, though it will not be the 100% recognition as under current finance leases unless there is zero RV. The proportion of selling profit for which recognition may have to be deferred to the end of the lease period will be the portion of the lessor's combined assets in the lease which is represented by RA rather than receivables.

Timing and transition

The new lease accounting standard is being jointly developed by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). This is part of a wider project to achieve convergence as between IFRS and US GAAP across all areas of accounting.

The project has been long delayed, and many changes have been made to an earlier exposure draft issued three years ago. The public comment period on the current draft expires in mid-September, and there will then be further re-deliberations by the Boards starting towards the end of this year.

If all goes according to plan, the standard setters may finalise the new rules towards the end of 2014. For listed public companies, the earliest possible effective date – i.e. the start date of accounting periods to which the new rules will fully apply – could be January 1 2017.

However, these companies will also have to produce comparative figures on the new basis for earlier periods while their main financial reports are still on the current basis. For these comparative purposes, the 'dates of initial application' could be for periods starting from as early as January 2015 for US-listed companies, or a year later for those in the EU and some other jurisdictions.

The great majority of lessees are of course unlisted SMEs. These will have rather longer to comply. In Europe, it is only listed companies who have to comply with IFRS under EU law. Others are subject to varying national GAAPs, although they can opt to adhere to IFRS instead. Some EU countries, including the UK, have national GAAPs which are kept close to IFRS, but there may be time lags before these countries' lease accounting rules are brought into line with the proposed IFRS change.

It is likely that for US unlisted companies, and also most of those fully subject to IFRS, the effective date of the new lease accounting rules will not be before January 2018.

The standard setters will require the new leasing rules to be applied to leases already running at the effective date, and not just those inception from that date. In the case of equipment leases now classed as operating leases, where the new rules will bring substantial changes, this will force quite complex retrospective adjustments to the accounting. That applies to both lessees and lessors, but it is likely that lessees will be relatively less well prepared for it.

The main transition proposal for operating leases on the lessee side is termed a 'modified retrospective approach'. It would avoid some of the worst conceivable consequences of retrospective application – such as an immediate up-front hit to the P&L account as a consequence of moving all running leases to a front-loaded expense basis, or restating past years' accounts right back to the earliest start dates of leases running at transition. It will nevertheless be quite challenging to apply, and many lessees may need some advice on it from their lessors.



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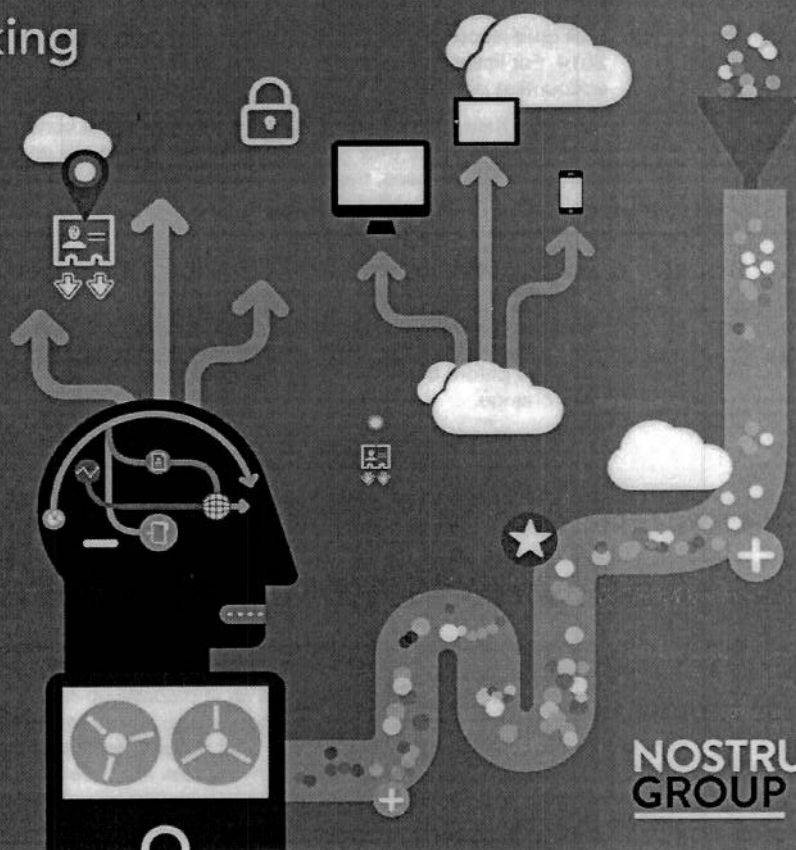
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