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Knowledge Sharing

Question & Answer

What is Contract Hire & How is it calculated?

High level/ Independent response to industry questions.

For more detailed information & bespoke training

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Basics of Contract Hire - Finance Element

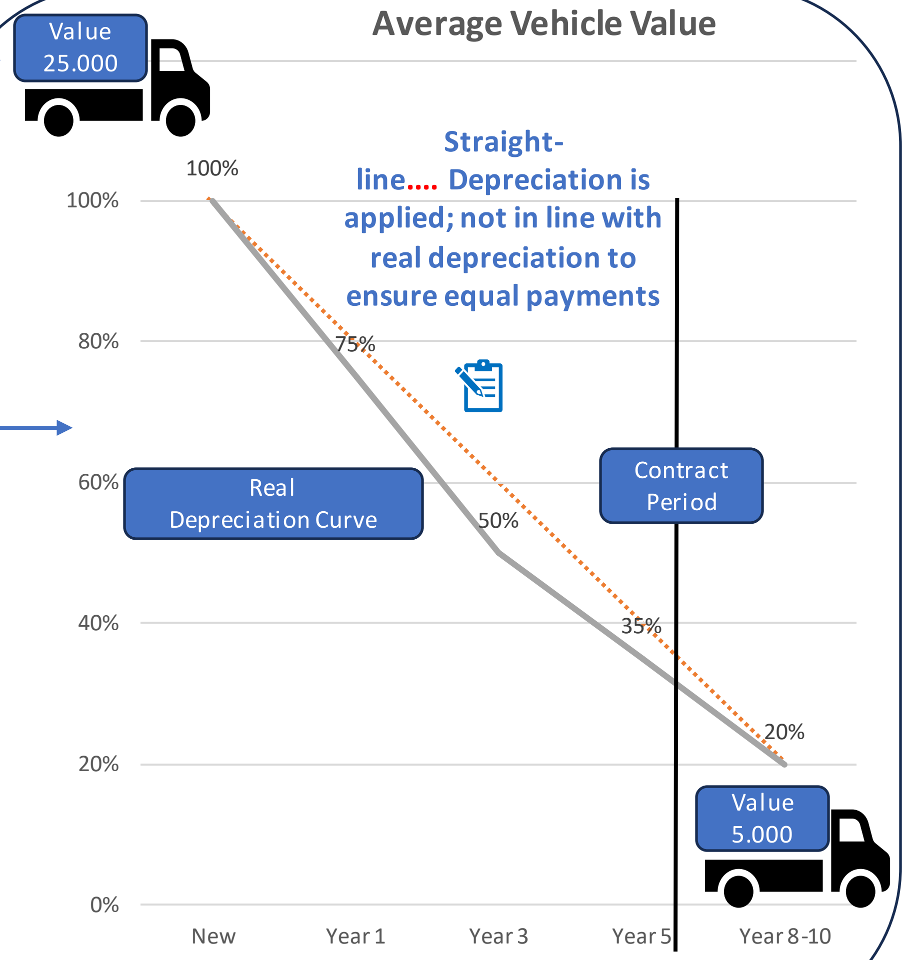
I don't want to spend my cash; what options are available to me?

Own the Asset ? Rent/Lease Asset

Options (Own the Asset)
- Outright Cash Purchase
- Contract Purchase – Up Front /End of Term Balloon

Options (Rent/Lease Asset)
- Flexible/Long Term Rental
- Contract Hire/ Operating Lease

This series only considers Contract Hire



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	Example
Leasing Company/Bank Pays the Dealer	25.000
Customer Determines Lease Period	5 Years
Leasing Company/Bank Predicts the Value of the Vehicle at chosen replacement (60 Months) & contracted mileage (100.000) based on historical sales data (Residual Value)	8.750
Leasing Company/Bank Straightline the depreciation over contract period to ensure equal monthly payments	25.000-8.750= 16.250/ 60 months = **270.83 per month**
Leasing Company/Bank set interest based on customer risk portfolio. Interest is charged on the full amount funded. In actual terms it is a 'declining' amount per month as the difference between the upfront investment and the residual is paid off. Rather than charging a different amount per month; the funder calculates the total interest (average investment)and then divides these into equal; monthly payments on a Straightline basis	25.000 + 8.750=33.750/2 = 16.875 (Average Investment) 16.875 x10%(Interest) /12 = **140.65 per month**
Customer pays 60 x monthly charge which equals depreciation + interest on depreciation	**270.83 + 140.65 per month = 411.48**

Question & Answer

Contract Hire
Who & What Determines the Depreciation?

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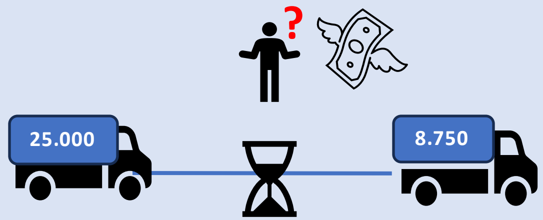

Why does financier set depreciation & how?

Who determines depreciation?

International Accounting Standard (IFRS) 16 defines **a** lease exists when a customer has the right to **control the use** of an identified asset **for a period of time**. An operating lease **does not transfer substantially all risks and rewards from owning the asset** (IFRS 16.62).

In simple terms = for an operating lease; the lessor (financier) must take the risk/reward of actual depreciation……There are profit sharing models available in the market on a pooled/ fleet basis.

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What is the financial impact?

Assume 10% interest; and in all cases the vehicle is contracted at 100k/60 months. Residuals shown are illustrative

Example

Capital	25.000	25.000	25.000
Residual	7.875	8.750	9.625
Depreciation	17.125	16.250	15.375
Period	60	60	60
Average Finance	16.438	16.875	17.313
Annual Interest	1.644	1.688	1.731
Monthly Interest	137	141	144
Total Depreciation	17.125	16.250	15.375
Monthly Depreciation	285	271	256
Total Rental/Month	**422**	**411**	**401**
Total Rental/ Term	25.344	24.688	24.031
Difference	656	Market Est.	-656

A 10% change in the residual value (the value the vehicle is estimated to sell for by the lessor) can make a circa 600euro difference to the ultimate rental payment per vehicle. The Residual Value determination is one of the key elements in setting competitive pricing by the lessor/financier

What Determines the Residual Value?

- **Contract Length/ Mileage & How Asset will be used; e.g. logistics = high level of wear & tear**
- **Date purchased & when available for sale – e.g. plate change (UK) & Warranty expiry**
- **Historical sales data on specific vehicle**
- **Total Current/ Market YTD sales data on vehicle**
- **Operational Risk & Commercial Appetite of funder**
- **Vehicle Assurance – e.g. if funder can ensure full maintenance history on sale**

Factors Influencing Real Sales Values/ Future Residual Values

- **Pace of technology changes – e.g. range extension on newer EV. Models**
- **Market perception on reliability and durability of the vehicle chosen**
- **Supply & Demand- e.g. supply shortage in 21'/22' and 23' chip shortage resulted in shortage & delay of new vehicles = shifting demand to 2nd hand/ increasing sales values**
- **Unexpected price changes. E.g. a recent price reduction on Tesla would have immediate impact on the residual value of older vehicles**
- **Inflation & Other Macro Factors. e.g during 2008 recession, new vhcl sales fell; increasing 2nd hand residuals as companies were encouraged to hold on to their vehicles longer**

Contract Hire

What should I expect when terminating Early or Exceeding mileage?

High level/ Independent response to industry questions.

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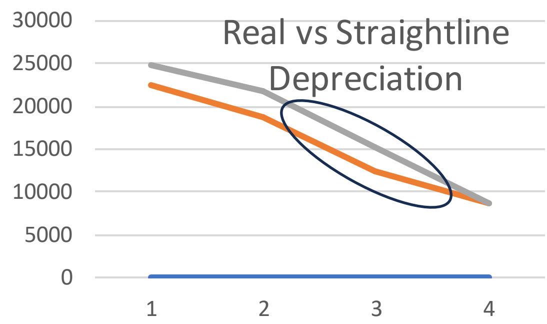
Basics of Contract Hire- What to expect in Early Termination/ Excess Mileage?

Is Contract Hire Flexible enough for my business, e.g. if I need to scale up or down my fleet?

Contract Hire is a **fixed period & mileage contract.** Due to the funder applying straight-line in their depreciation & interest calculations. There will always be discrepancy in real value to net book value until the full term is reached



Basee on campaign Example

What should I expect in terms of excess mileage, e.g. I have contracted for 5 years; `100.000k; however some of my fleet is averaging 30.000km per year/ which means ill exceed contract mileage by 50,000km on these vehicle?

What can I expect to pay if I need to terminate early

Example on the right is a **worst case** scenario & highlights the need for care when selecting a solution, term and funding partner

The premium funders offer a more equitable settlement, in the next part of this series we will dive into solutions that reduce customer risk and unnecessary costs.

Estimated Worst Impact of Early Termination

Time	Min Residual	Max Residual	Average Depreciation	Est. Real Value	Contract Hire Depreciated Value	Depreciation Shortfall/Not Charged if Terminated Early	Interest Shortfall- Contracted Interest not charged at early termination date
New (Not Driven)	100%	100%	100%	25000	25000		
Day 1-30	85%	95%	90%	22500	24729	2229	8082
Year 1	65%	85%	75%	18750	21750	3000	6576
Year 3	40%	60%	50%	12500	15250	2750	3288
Year 5	30%	40%	35%	8750	8750	0	0

25.000

8.750

Most funders will provide you with an under/ excess mileage table as per below example

Pence Per Mile	
Total Depreciation	16.250
Kilometers	100.000
Rate per kilometer contracted	0,16
Reduction if under mileage	0.16
Penalty if over mileage	0.16

On the finance element; the over and under rate should in theory be charged as the same rate. However, certain age factors (e.g. warranty expiring), could impact value – penalty tables might therefore be tiered

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Question & Answer

Contract Hire

Summary of Risks + Solutions to Reduce Risk

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Basics of Contract Hire- Summary of Benefits & Risks

Leasing/ Contract Hire is widely adopted for the following benefits:

- Free's up operating cash- allows business to spend operating cash on profit making endeavours
- Fixed Price and Fixed Term – No surprises
- No Risk on Resale Value
- Leveraging Funders Purchase Power & Technical Skills & Management Systems

…..there are risks that need to be carefully considered

	Factor	Risk to Customer	Solution to Reduce Risk
	Excess Mileage/ Over Contracted Mileage	End of Contract Re-Charge	- Regular Contract Re-Schedule - Pooled Re-schedule (+/-) - Equitable +/- Policy
	Excessive Damage/ Maintenance History not Captured	Re-Charges from Funder	- Maintenance Included in Lease - Fixed Damage Re-charge incorporated in lease - Profit Share at sale
	Sale below Residual Value- External market factors	**None – Funder takes Risk**	- Pooled Profit Share
	Sale above Residual Value/ Income Potential	**No risk** – Customer loses ability to benefit from market increases; i.e. low supply could result in higher sales than Residual Value	- Pooled Profit Share
	Staff Movements/ Reduction in Fleet Required	Early Termination Charges/ Cost of Contract Transfers	- Contract Novations/ - Equitable Early Termination Settlement Policy - 2nd Hand Lease

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How to Mitigate Risks- Contract Hire **(Excess Mileage)**

Even a small excess; (in the below example) can result in a substantial charge at end of contract = not budgeted for.
NB. Most Lenders will only charge excess if >10% above contract

	Contracted KM	Actual KM	Excess KM	Excess Charge @16ppm
Year 1	20.000	21.000	1.000	163
Year 2	20.000	22.000	2.000	325
Year 3	20.000	21.900	1.900	309
Year 4	20.000	20.500	500	81
Year 5	20.000	22.000	2.000	325
Total	100.000	107.400	7.400	1.203

Contracted Residual 8750

As soon as you notice that a vehicle will exceed contracted mileage, contact the lender to re-schedule the contract based on actual mileage– this means the lender will calculate a new Residual Value based on higher mileage & reflect the increased depreciation into future rentals; allowing you to budget effectively

	Annual Rental	Contracted KM	Actual KM	Excess KM	Excess Charge
Year 1	4.938	20.000	21.000	1.000	0
Year 2	4.938	20.000	22.000	2.000	0
Year 3	5.082	22.000	21.900	-100	0
Year 4	5.082	22.000	20.500	-1.500	0
Year 5	5.082	22.000	22.000	0	0
Total	25.122	106.000	107.400	1.400	0

Re-scheduled Contracted Residual 7875

As per above example - Lender will include outstanding excess (Yr1 &Yr2) into the remaining lease instalments – allowing the customer to re-budget for the right monthly costs, without any excess at the end of the contract

Negotiate an Equitable under & over policy e.g. the same rate should apply for over and under mileage
Re-schedules done on a total/ pooled fleet – meaning only if the overall fleet is >10% of contracted mileage, a charge will be issued

Vehicle	Contracted KM	Actual KM Yr 1	Excess KM	Excess Rate	Excess Charge
1	20.000	19.800	-200	0,16	-32
2	20.000	20.500	500	0,16	81
3	20.000	16.800	-3.200	0,16	-520
4	20.000	21.600	1.600	0,16	260
5	20.000	17.600	-2.400	0,16	-390
6	20.000	22.100	2.100	0,16	341
7	20.000	19.800	-200	0,16	-33
8	20.000	21.000	1.000	0,16	163
9	20.000	20.500	500	0,16	81
10	20.000	24.200	4.200	0,16	683
11	20.000	19.980	-20	0,16	-3
12	20.000	19.800	-200	0,16	-33
13	20.000	27.000	7.000	0,16	1.138
14	20.000	15.000	-5.000	0,16	-813
15	20.000	17.000	-3.000	0,16	-488
Pooled	300.000	302.680	2.680	0,16	429

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How to Mitigate Risks- Contract Hire (Excessive Damage & Maintenance)

End of contract recharges allow the lender to charge for discrepancies to the contract, which will impact the sales price:-

If correctly applied; these charges should be the same as you would have incurred if you were to sell the vehicle yourself, i.e. the value you would lose at sale

The lessor will charge if:

1. Mileage exceeds 10% of contract
2. Maintenance History is not fully up to date & vehicle fully roadworthy
3. Damage to the vehicle exceeds agreed standards

To mitigate these un-budgeted charges the following options are available:

1. Maintenance included in lease/ rental (see next slide)
2. Regular re-scheduling (as per previous slide)
3. Regular vehicle inspections and repairs of minor damage prior to return- there are now great solutions available to estimate the damage prior to return.
4. Fixed damage re-charges can be negotiated up front; i.e. based on historical damage; the financier will increase the monthly rental to accommodate for charges at end of contract, allowing customer to budget up-front
5. Profit Share agreement with the funder

Example - Profit Share Offered	
Purchase Price	25,000
Residual Value	8,750
Financed Amount	16,250
Damage Re-Charge	879
Excess Mileage Charged	150
Sales Proceeds	8,450
Total Income/Loss by Lessor	9,479
Net Income/Loss to Lessor	729
Customer Profit Share @50%	365

Reputable funders offer a profit share to their large corporate customers with more than 10 vehicles terminating per year on a pooled basis; e.g. only if profit on all sales will there be a profit share;

This profit share in my view is the most equitable as it includes any re-charges as income; and then shares the overall net profit equitably with the customer as per above example

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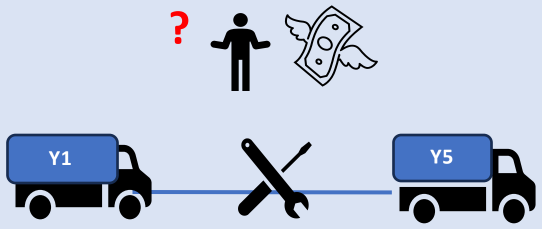
How to mitigate risks of contract hire: Maintenance



What is the best option on maintenance?

Maintenance of the vehicle equates to roughly 25-40% of the total operating costs; there are four options available to mitigate/ manage these costs. For this series; we only focus on Lessor Provided Maintenance

Solution	What's Included	What's not included
OEM Warranty	Component/Part Failure (limited)	Driver error; driver abuse; OEM standard services; movable parts
OEM/Dealer Service Plan	Standard Service Intervals, oil changes	Part Failure & Replacement costs (incl labour)
Budget & Pay Maintenance Self	Everything	Buying power; SLA's on service times; knowledge to verify
Lessor provided Maintenance Plan	Everything	Driver abuse; if proven Bespoke pricing based on your spend – lessors will charge the average costs they have incurred on this vehicle (historically)

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Fixed Maintenance Plans (all inclusive) have become popular as it includes more than warranty and service plans.

The funder bases their pricing on the historical maintenance costs that the specific vehicle has incurred; added to that an inflationary percentage to ensure that they can offer a fixed price throughout the contract.

Maintenance Spend Trend		
	Range	
Year 1	8%	15%
Year 2	12%	18%
Year 3	17%	23%
Year 4	22%	28%
Year 5	25%	40%

Maintenance spend increases as the vehicle gets older. To allow for a fixed monthly price the lender simply divides total spend projection by the contract months; without interest.

Full Maintenance Fixed Price (example)		
Total Budget		6400
Contracted Months		60
Monthly Payment		107

If you don't have access to a qualified /technical procurement team, full Maintenace Plan is in my view the best option available to mitigate contract hire risks and unplanned costs. In most cases it includes the warranty; but the onus is on the provider to claim back on warranty claims.

Full maintenance plans brings the added advantage that the provider has to negotiate and manage the events, which is normally done by a team of qualified mechanics or an industry approved approval system

The key challenge with fixed maintenance plan is that you end up paying the industry average, instead of actual costs; which does not guarantee the lowest costs

Same as with the finance element, reputable lenders will offer a profit share on maintenance spend to their large corporates; e.g. they still take the risk, however if there was an under-spend on your specific fleet compared to the budget; they will share the cost savings on a agreed percentage.

How to Mitigate Risks- Contract Hire (Early Termination)

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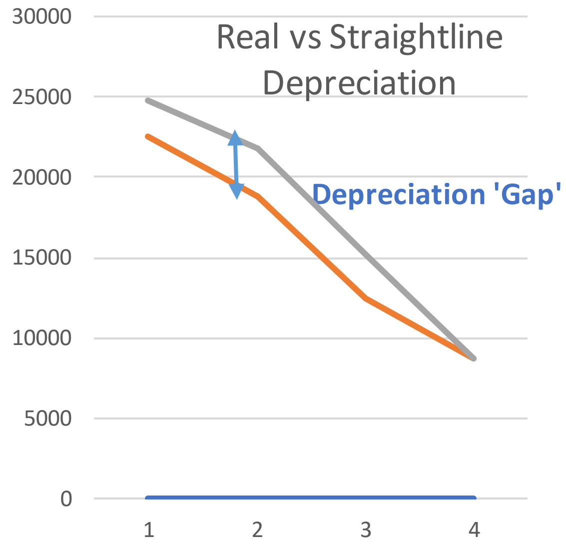

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Terminating a vehicle earlier than planned is costly, whether you own the asset, or lease the asset. This is due to the fact that most accounting principles dictate straight-line depreciation; which does not follow the natural depreciation of a vehicle; resulting in a loss compared to book value if sold earlier than originally planned, accounted for.

Actual Versus Accounting Depreciation

Time	Min Residual	Max Residual	Average Depreciation	Est. Real Value	Straight-Line Depreciation
New (Not Driven)	100%	100%	100%	25000	25000
Day 1-30	85%	95%	90%	22500	24729
Year 1	65%	85%	75%	18750	21750
Year 3	40%	60%	50%	12500	15250
Year 5	30%	40%	35%	8750	8750

Options available to mitigate the risk/ cost of early termination include the following:-

1. Funders are now offering Flexible Long term rentals; with a minimum rental of 3 months at highly competitive rates; if you are unsure about the use (new starter; new business unit etc) this option might appeal

2. Large corporates can negotiate a % of their fleet to be terminated without any charges- dependent on funder appetite & the vehicle – e.g. if the funder is confident they can re-lease (2nd hand lease) the vehicle; this negates the risk of loss at sale; therefore the waiver of an ET fee.

3. Negotiate an equitable termination fee- reputable funders will only look to recover the loss between their Net Book Value and the actual sales price. They will only charge once sold, which in many cases reduces the difference if the vehicle is sold higher than anticipated. Contracts should be carefully checked on this specific point; as there are companies charging full contract interest loss/ financial penalties

Question & Answer

Contract Hire
Conclusion

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Conclusion

Contract Hire remains the preferred funding option for fleets due to fixed pricing and financial/operational benefits

This visual representation highlights the risks in choosing Contract Hire as a funding option; and proves that these risks can be mitigated if your funder is prepared to work with your business.

Careful attention should be paid when selecting a funder.