Module # 3 – Component # 2

"How to analyse a car rental company"

This component focuses on the basics of the car rental industry. We look at the fundamentals of the industry, the economics, the risks and the financial equation that investors can expect to find in a typical car rental business.

This is one component in the Investor Campus series of "How to analyse …" In this series, over 50 individual industries are covered. It also assumed that the reader has the base knowledge to analyse a generic company.

Objectives

To identify the profit drivers behind this industry, the business model, risks and critical success factors.

Expected Outcomes:

? To understand the economic and financial fundamentals of the industry.
? To understand the key issues and profit drivers in this industry.
? To be able to review a typical company within this sector and compare it meaningfully to global norms.
? To be able to identify warning signals and opportunities in a typical company in this sector.
? To be equipped to conduct an interview with management of a company in this industry.
? To understand a recipe to analyse a company in this sector.

Car rental summary table	
Key ratios to assess a car rental business	• **ROCE:** an indication of the operational competence of the business. • **ROE:** combines operational performance with gearing level. • **Debt to equity ratio:** Indication of financial leverage and risk. • **Interest cover:** An indication of financial risk. • **Operating margin and ROS:** Ability to generate accounting profit.
The basics of the business	Car rental companies rent vehicles to corporate and leisure travellers. The majority of revenue is derived from rental payments. The major constituents of cost are Depreciation (+/-30%), Salaries (+/-25%) and Interest (+/-15%).
The profit drivers of the industry	• **Economic growth**, • The number of **car rental days**, • Revenue per rental day – **pricing** of rental transactions, • The **volume** (i.e. number of rental transactions), • The **utilization** of the rental fleet.
Economic fundamentals	The car rental industry is a **global and regional business**. It is a **long term growth** industry, although within that growth it can be **cyclical and seasonal**. It is sensitive to **interest rates** and **inflation**. **Large players** who have the balance sheet or backing to finance the cycle of car acquisitions dominate the car rental industry.
Financial fundamentals	The key to a successful car rental company is effective **current asset management**. This is because the majority of assets in a car rental company are the cars that it rents. Assuming that a company is profitable; **the higher the gearing of a car rental company, the higher the return on equity**. Gearing in the US can be as high as 8:1.
Accounting issues	The **depreciation rate and method** and the accounting for **repurchase programmes** are the key accounting issues to understand.
How to identify a winner in the industry	Because of the balance sheet issues, size is important. A company with the **optimal amount of gearing** will benefit in the right interest rate environment, especially if it has **established favourable lending arrangements**. The right mix between corporate and leisure travel is also essential. The **management and track record** of a company is extremely important. In order to succeed a company needs a unique combination of **management**, **vision**, **brand presence** and complete **commitment to superior service**. A **reliable outlet to resell cars** that are not under repurchase agreements is also important.
Risks and warning signals	• Continued **declines in revenue**. • **Significant consecutive decreases in rental days**, **revenue per rental days or utilisation rate**. An utilisation rate of 65% and below is a sign of badly run business. • Bad cash flow management in terms of receivables. • Excessive gearing in the wrong interest rate environment. • The **wrong mix** of fleet or reliance on only one manufacturer to supply vehicles. • **Significant drop in air travel.** • A troubled **used car market** environment. • Excessive general **overhead cost** structure. • A cancellation or non-renewal of concessions from airport locations.
Appropriate valuation methods	• **P/E multiple**. • **Net asset value**. Car rental companies can trade at a *significant* premium to net asset value. This is because effective use of leverage against the assets can result in shareholders getting a return on their funds well above the industrial average. • **Cash flow** valuation ratios. • **Avoid the EV/EBITDA ratio.**

1. What is car rental?

Car rental is the hiring of a motor vehicle from one party to another party. Rentals are generally made on a daily, weekly or monthly basis. The car rental business is usually associated with a car that is hired for a period of 12 months or less. "Rental" of cars for a longer period is commonly referred to as **leasing.**

The car rental industry is comprised of two principal markets: ***general use*** (including airport and local market facilities) and ***insurance replacement.*** General use companies serving airport and local markets accounted for approximately 73% of rental revenue in the United States in 2001, while the insurance replacement segment accounted for approximately 27% of rental revenue.

General use locations rent vehicles primarily to business and leisure travellers, while insurance replacement facilities rent primarily to individuals who have lost the use of their vehicles because of accidents, theft or breakdowns. In addition to vehicle rental revenue, the industry derives significant revenue from the sale of related products such as ***liability insurance*** and ***loss damage waivers***.

Customers of the general use vehicle rental companies include:

- **Business travellers** renting under negotiated contractual agreements between their **employers and the rental company**,
- **Business and leisure travellers** who make their reservations and may receive discounts through **travel, professional or other organizations**,
- **Smaller corporate accounts** that are provided with a rate and benefit package that does not require a contractual commitment and
- **Business and leisure travellers** with **no organizational or corporate affiliation programs**. Business travellers tend to utilize mid-week rentals of shorter duration, while leisure travellers have greater utilization over weekends and tend to rent cars for longer periods.

Rental companies in the insurance replacement market enter into contracts primarily with insurance companies, automobile dealers and repair shops to provide cars to their customers whose vehicles are damaged or stolen or are being repaired. Compared with the general use market, the insurance replacement market is characterized by longer rental periods, lower daily rates and the utilization of older and less expensive vehicles.

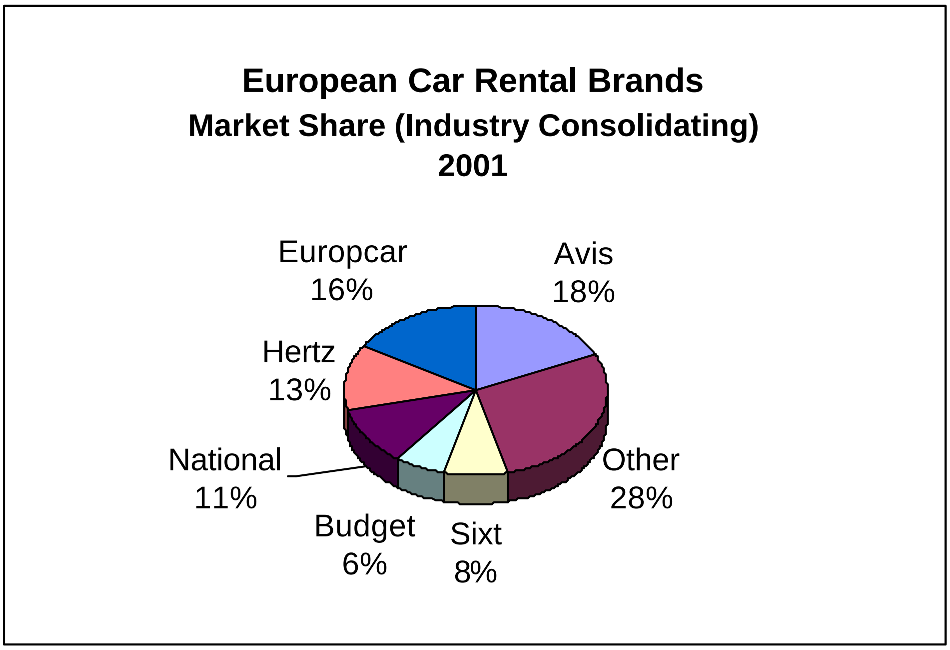
2. <u>The car rental industry – a short overview</u>

Industry players

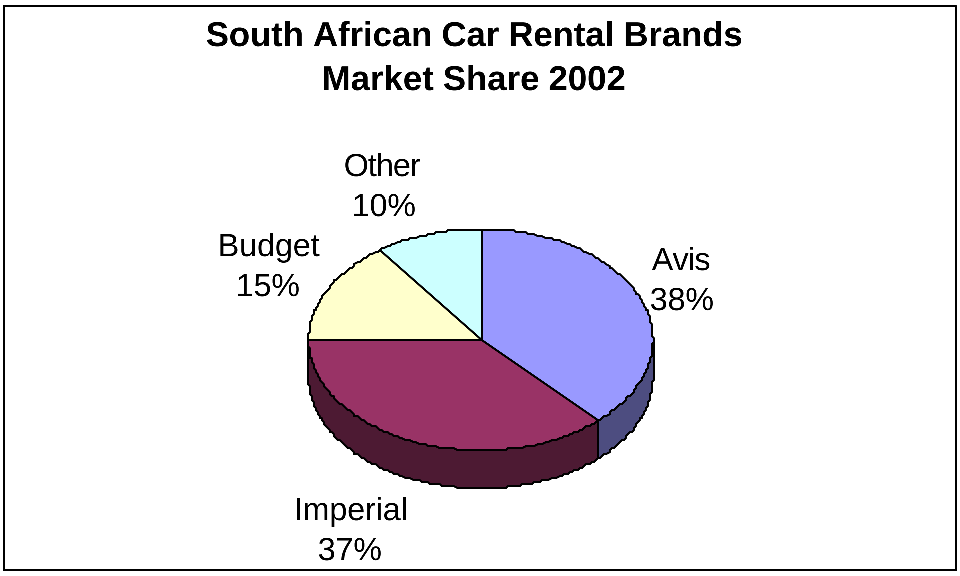
The car rental industry is dominated by a few major global players. Among them are **Avis, Hertz, Budget** and **National Alamo**. There are large regional players, but car rental companies typically prefer to trade under the brand of a global player in order to capture a **proportionate share of incoming leisure travel.**

The large global players typically have franchise arrangements in smaller countries where local operators trade under their brands and pay a portion of revenues to the franchisor (**typically 5-10% of revenues**).

For example, market shares in Europe are as follows:



In a smaller country like South Africa, the market shares are as follows:



The US domestic general use car rental market includes several major companies, which operate airport and local market facilities. In addition, there are many smaller companies that operate primarily through non-airport locations. Most of the major car rental companies operate through a combination of corporate-owned and franchised locations.

There were significant changes in the ownership of domestic car rental companies in 1996 and 1997, as ownership of these companies has shifted in large part from the **major automobile manufacturers to independent ownership**.

While owned by the automobile manufacturers, car rental companies served as important outlets through which the manufacturers disposed of their vehicles, in a period when major labour contracts made it uneconomical for the manufacturers to limit their production of vehicles, even if they could not be sold through dealers.

There was an oversupply of cars in the rental industry during this period, with cars being available on favourable terms to many small local car rental operators, and the manufacturers did not commit sufficient resources to the development of the car rental systems. Following the ownership changes, however, the car rental companies have increasingly focused on their own profitability, although they continue to be parties to supply and repurchase agreements with the manufacturers.

Since the late 1980s, vehicle rental companies have acquired their fleet primarily pursuant to **repurchase programs** with automobile manufacturers. Under such programs, a car rental company agrees to purchase a specified minimum number of new vehicles at a specified price, and the manufacturer agrees to repurchase those vehicles from the car rental company at a future date (typically, 6-9 months after the purchase).

The repurchase price paid by the manufacturer is based upon the capitalized cost of the vehicles less an agreed-upon depreciation factor and, in certain cases, an adjustment for damage and excess mileage. These programs limit a car rental company's residual risk with respect to its fleet and enable the company to determine a substantial portion of its depreciation expense in advance.

While in the US, a large proportion of vehicles are usually purchased under repurchase agreements, in other countries cars purchased under repurchase agreements can be as low as 30%. The key determinant of whether a car rental company enters into repurchase agreements is whether the car rental company has an allied infrastructure through which to sell its cars at the end of the defined ownership period.

The total number of rental vehicles in service in the U.S. has been estimated at 1.7 million in 2001. The total revenue for the U.S. car rental industry has been estimated by industry sources at $18.7 billion in 2001, a decrease of 3.6% over 2000 revenue of $19.4 billion.

Factors driving historical growth

The factors driving historical industry growth include increases in **airline passenger traffic**, the trend toward **shorter, more frequent vacations** resulting from the number of households with two wage earners, the **demographic trend** toward older, **more affluent citizens** who travel more frequently and increased business travel. Car rental companies have also been able to increase the revenue they earn on their vehicles through the implementation of ***yield management systems*** similar to those utilized by the major airlines.

3. Recent developments in the industry

Due to the overall global economic conditions, the pricing and business travel environment continues to be under pressure when compared to prior years. In addition, following the events of **September 11, 2001**, there has been a significant decline in air travel and related car rentals at airports worldwide, particularly the U.S.

However it must be noted that countries that may be perceived as being a safer destination may indeed report an increase in leisure travellers and thus car rentals.

Due to the economic conditions and the competitive nature of the industry the major car rental companies have focused on:

- **Financial position,** creating an affordable and flexible capital structure,
- **Operations**, focusing on increasing productivity by developing and maintaining a more efficient business infrastructure which more fully utilises all the company's assets.
- **Customers**, strengthening of brand name and focusing growth on core areas
- **Employees,** continued focus on improved service.

A number of car rental companies have also developed their own internal outlets to resell their cars that they have bought and are not under repurchase agreements.

4. The profit drivers of the car rental industry

The key profit drivers of car rental companies are as follows:

- The growth of the **global economy**, and/or the **local economy** where relevant,
- The number of **car rental days**,
- Revenue per rental day – **pricing** of rental transactions,
- The **volume** (i.e. number of rental transactions)
- The **utilization** of the rental fleet.

The volume of rental transactions is mainly a function of tourism and leisure on the one hand and corporate travel on the other. Leisure can be broken down into both internal and foreign leisure. This can be linked with the volume of air travel.

As the economy grows and corporate earnings increase, so companies are prepared to pay more on corporate travel while individuals spend more on leisure. As a result, volumes and rates may increase, but competitive pricing pressures are a permanent feature of the industry.

It is also important to look at the other indirect factors that influence the profit drivers. These include:

- Quality of **service**
- The **mix** between corporate and leisure travellers
- **Brand** presence
- Favourable / suitable **lending arrangements**.

From the point of view of the franchiser/licensor it is also relevant to assess the royalties/fees earned from the franchised operations, which can comprise a significant portion of revenues.

Significant changes in net cost of vehicles or in interest rates may also have a material effect on profitability and cash flows.

5. The economic fundamentals of the car rental industry

- The car rental industry is a **global and regional business**. Operations on the global scale are accomplished either through subsidiaries or franchised operations.

- It is a **growth industry.** Although global revenues declined in 2002, the car rental industry is still a long-term growth industry. This is driven by the fact that more people are able to fly and volumes are growing globally. This in turn positively impacts the car rental businesses.

- The industry is **seasonal.** The car rental business is subject to seasonal variations in customer demand, with the summer vacation period representing the peak season. The general seasonal variation in demand, along with more localized changes in demand at different locations causes the fleet size to vary over the course of the year.

- **The industry is cyclical by nature**. Downturns in the economy may cause businesses and private individuals to decrease their spending on corporate and leisure travel respectively, thus impacting car rentals.

- Due to the high gearing of car rental companies, the industry is **influenced by the interest rate environment** as well as the **inflation rate** of a particular country.

- **Large players** who have the balance sheet or backing to finance the cycle of car acquisitions dominate the car rental industry.

6. The financial fundamentals of the car rental industry

1. Current asset management

In contrast to a traditional industrial company, the key to a successful car rental company is effective **current asset management**. While a traditional industrial company typically has a large fixed asset base off which it must generate a return, most of the capital employed in a car rental company is tied up in current assets. **This is because the majority of assets in a car rental company are the cars that it rents to customers.**

The key factors impacting effective **current asset management** are:

- The price at which it **buys** cars,
- The price at which it **sells** cars,
- The **utilisation** of the cars, otherwise termed as **yield management**,
- The **optimal financing** of cars.

The price at which a car rental company buys and sells its vehicles is one of the keys to profitability. Probably more important is the utilisation of the assets i.e. the revenue that the company generates from the vehicle during the course of owning it.

The table below shows a typical asset equation for a car rental company:

	Purchase of vehicle	Depreciated value of vehicle 8 months later (assuming 25% depreciation rate)	Sale of vehicle after 8 months
Retail	US$100 000	n/a	US$70 000
Car rental	US$86 000	US$ 69 875	US$74 000

Due to their large purchasing power, car rental companies generally receive discounts on the cars that they purchase in bulk from the car manufacturers. Thus using a base of 100, car rental companies on average buy their cars at 86, a discount of around 14%. Within the year the car is sold around the 73-74 level and as it is sold within the year it is considered a current asset. Thus, for example, in the case above where the car costs $100 000 the ***actual asset cost*** to the company for the period that it owns the vehicle is $12 000, the difference between the cost of the car to the company and the price it sells it for (86 minus 74). This can obviously differ from period to period and from region to region.

The acquisition and disposal of cars have a significant impact on profitability. The major car rental companies acquire, subject to availability, a majority of their cars pursuant to various ***fleet repurchase programs*** established by automobile manufacturers.

The extent of repurchase agreements differs markedly from company to company depending on their infrastructure to resell vehicles. Because of the history of car rental companies in the US (ownership by automobile manufacturers), many car rental companies have **as much as 100%** of their vehicles on repurchase agreements. In smaller territories car rental companies often sell the vehicles themselves and have **as little as 30%** of their car purchases on repurchase agreements.

Under these programs, automobile manufacturers agree to repurchase cars at a specified price during established repurchase periods, subject to certain car conditions and mileage requirements.

Repurchase prices under the repurchase programs are based on either:

- A **predetermined percentage** of original car cost and the month in which the car is returned or,
- The original capitalization cost less a **set daily depreciation amount**.

These repurchase programs **limit residual risk** with respect to cars purchased under the programs. For this reason, cars purchased by car rental companies, under repurchase programs, are sometimes referred to by industry participants as **"non-risk"** cars. Conversely, those cars not purchased under repurchase programs for which the car rental company is exposed to residual risk are sometimes referred to as **"at-risk"** cars.

Purchases of cars are financed through funds provided from operations and by active and ongoing global borrowing programs (for the global players).

The **financing of the car fleet is a key determinant of the profitability** of a car rental company. A healthy balance sheet generally enables companies to secure funding on attractive terms.

Assuming that a company is profitable; the higher the gearing of a car rental company, the higher the return on equity. This is because the bank's capital is being used to finance a portion of the capital employed. This must be balanced against the higher risk taken with a higher gearing ratio and cognisance must be taken of the interest rate and inflation rate scenario in the particular country. The example below shows some cases of higher gearing and the return on equity.

Assume price of vehicle = US$ 50000				
Assume fleet size = 1000 cars				
Therefore capital required = US$ 50m				
Interest rate = 5%				
Assume tax rate = nil				
Assume annual operating profit on vehicle = US$5 000				
	0.5:1 gearing	**1:1 gearing**	**4:1 gearing**	**8:1 gearing**
Equity	33.3m	25.0m	10.0m	5.6m
Debt	16.7m	25.0m	40.0m	44.4m
Total capital (US$'m)	**50.0m**	**50.0m**	**50.0m**	**50.0m**
Profit pre-interest	US$5.0m	US$5.0m	US$5.0m	US$5.0m
Interest	US$0.8m	US$1.3m	US$2.0m	US$2.2m
Profit pre-taxation	US$4.2m	US$3.7m	US$3.0m	US$2.8m
Return on capital	***10.0%***	***10.0%***	***10.0%***	***10.0%***
Return on equity	***12.6%***	***14.8%***	***30.0%***	***50.0%***

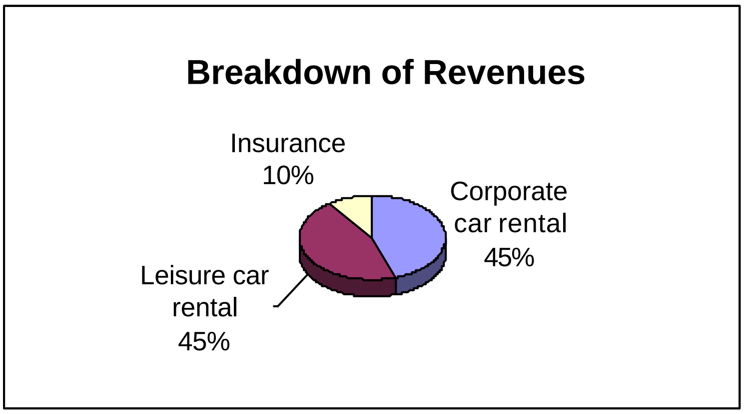
At 0.5:1 gearing, the return on equity in the example above is 12.6%, while at 8:1 gearing the return on equity increases to 50%. The extent of gearing that a company can justify is tied to the certainty of reselling the vehicle at a set price. Hence the higher the level of "no-risk" cars, in agreements with automobile companies with strong balance sheets, the higher the level of gearing that a company can justify and that commercial banks will be prepared to finance.

Although a gearing of 8:1 is seen in some industrialised nations, **a maximum gearing of 4:1** is thought to be **more acceptable**. However, it must be noted that this would not be acceptable in the wrong interest rate environment. It is also important to note that from the point of view of the licensee it is very important to have a strong parent company to back the debt undertaken.

Once we understand the current asset management fundamentals of car rental, the income statement is easier to understand.

2. Revenues

The revenues of a typical car rental company are as follows. (This assumes the company is not a franchisor):



Revenues primarily consist of:

- **Vehicle rental** – revenue generated from renting vehicles to customers including revenue from loss or collision damage waivers, insurance sales and other products provided at rental locations.

  Insurance revenues can comprise 8-25% of the revenues of a car rental company. Because of volumes, car rental companies usually self-insure and can generally make 5-10% profit on insurance revenues.

- **Royalty fees** – fees generated by the company's franchisees.

- **Sale of vehicles** – vehicles are sold within the year though either the repurchase agreements or through the company itself. The profit on sale is a function of the selling price that can be achieved relative to the depreciation policy that is used in the company.

3. Costs

The typical operating costs are broken down in the following table (note that these are industry averages and can vary materially from region to region):

Operating costs	**% of revenue**
Salaries	20-25%
Depreciation	25-35%
Interest expense	12-15%
Facilities and franchise fees	8-12%
Administration	5-8%
Operating costs	4-6%
Training	4-5%
Operating profit margin	**10-15%**

Depreciation is the largest and most important component of operating costs and indicates the importance of asset management in the business. Depreciation must be viewed in tandem with profits on the sale of vehicles, as overly conservative depreciation will result in an inflated profit on the sale of vehicles. Facilities include airport concessions and franchise fees. Franchise fees typically range between 5-10% of revenue.

4. Cash flows and working capital

Car rental companies have a fairly traditional working capital cycle and accounting earnings and cash earnings should not differ materially. Analysts must take cognisance of the time of the year that the absolute cash balance is assessed. The fleet of a car rental company can vary considerably during the year, so take account of the seasonal nature of the business. Hence, at the seasonal low, the cash balance should be the highest.

Most of the operational **cash outflows** are paid monthly/at the end of the month. The material difference can be the equation that the company adopts for financing and paying for motor vehicles

As far as **cash inflows** are concerned:

- Car rental income is fairly predictable as this is paid at the conclusion of the rental contract, whilst loss waivers are paid at the end of the contract.

- The sale of vehicles can be assumed to be fairly constant as cars are held for less than a year and, due to repurchase agreements, is also known in advance. Thus the higher the percentage of cars bought through repurchase agreements the more predictable the cash flows are.

The management of working capital and current asset management, as discussed earlier is one of the key determinants of the success of a car rental company.

5. Returns

A car rental company's business is based on the utilisation of assets and it is an industry that has competitive pricing pressures. Hence normal industry forces should prevent any one car rental company from getting a significantly higher **return on capital employed (ROCE)** than any other in a particular region. Generally, car rental companies will earn a ROCE around the industrial average in a country.

However, the industry has an above-average ability to gear without adding significantly to risk. This enables car rental companies to achieve **above-average returns on equity (ROE)** as shown in the above examples.

The ability of company to optimise the use of its assets is one of the keys to the profitability of a car rental company. This, together with the ability to contain costs, will determine the **profit margins** of the business. The **operating margin** of a well-run car rental company should be in the region of **15%** and the **return on sales (ROS) in the region of 8-10%.**

	1999	**2000**	**2001**	**2002**
Avis Group Holdings	8%	9.4%		
Avis South Africa	16.8%	17%	16.3%	18.3%

7. Accounting issues

The key accounting issues that are relevant to this industry are as follows:

- **Revenue Recognition**

  Revenue is recognised over the period the vehicle is rented i.e. at the conclusion of the rental contract. Loss waivers are recognised at the conclusion of the rental contract. As long as the typical rental periods of a car rental company are less than 12 months, **revenue recognition is not a contentious issue** in the industry.

- **Depreciation**

  As depreciation is the largest component of operating costs it is important that it is treated appropriately. The depreciation method that is typically used is a useful life of five years and this is written off on a straight-line basis. **A consistent approach** that is conservative is thought of more favourably.

- **Recognition of profit on sale of vehicle**

  This is linked to the depreciation rate applied to vehicles. **Analysts should ask the key question: is the value realised on the sale of the vehicle more than the depreciated book value of the vehicle.** Recognition is fairly simple; if the car is sold for more than cost minus the depreciation it is considered an accounting gain and profit is recognised. Analysts must bear in mind that cars are effectively the "trading stock" of the business. Hence, while in a traditional industrial company an analyst should exclude the profit on the sale of an asset from sustainable profit, this is not the case with car rental companies.

- **Repurchase agreements**

  The greater the percentage of repurchase agreements the more important it is to make sure that **provisions have been made for buy-back damages**.

- **Fraud**

  Credit card fraud is a growing concern for car rental companies. In the U.S. 60% of rental transactions are done through credit cards while the average for the rest of the world averages 40%. Once again provision should be made for this.

8. The role of regulations

Throughout the world, car rental businesses are subject to numerous types of governmental controls, including those relating to price regulation and advertising, currency controls, labour matters, environmental protection, used car sales and franchising.

9. The role of technology and change in the industry

Technology in the car rental industry is focused mainly on the interaction with customers. There has been a demand for broader and faster access to information and thus the ability to deliver information more quickly adds to a better overall customer service.

A car rental business needs to have a reliable global IT rental, reservation and billing system that adds significant value to the customer interface.

10. The industry in five years time

The industry in five years time should be larger. Ever increasing air flights should provide a strong underpin for growth in the industry. Returns in the industry are likely to be similar, as a level has been reached which looks to be sustainable. The material difference in the industry should be the utilisation of technology to improve yields on assets.

11. Warning signals

There are some typical warning signals for failure in the car rental industry. Each factor alone may not necessarily mean that failure is probable, but a combination of the factors can often give a strong indication of a company in trouble. Some typical warning signals are:

- Continued **declines in revenue**.
- **Significant consecutive decreases in rental days**, **revenue per rental days or utilisation rate**. An utilisation rate of 65% and below is a sign of badly run business.
- The use of an inappropriate **depreciation rate or method** or using depreciation to manipulate earnings.
- Bad cash flow management in terms of receivables.
- Excessive gearing in the wrong interest rate environment.
- The wrong mix of fleet or reliance on only one manufacturer to supply vehicles.
- No outlet to resell to.
- Significant drop in air travel.
- A troubled used car market environment.
- Excessive general overhead cost structure.
- Not having the right global IT reservation system.
- A cancellation or non-renewal of concessions from airport locations.

12. How to identify a winner in the car rental industry

The car rental industry is extremely competitive but a winner will most probably come from the major dominant players already with large market shares.

A company with the **optimal amount of gearing** will benefit in the right interest rate environment, especially if it has **established favourable lending arrangements**. The right mix between corporate and leisure travel is also essential.

The **management and track record** of a company is extremely important and the experience of operating in a competitive and cyclical environment is crucial. In order to succeed a company needs a unique combination of **management**, **vision**, **brand presence** and complete **commitment to superior service**. A winner should most certainly have a reliable global IT system that can help it interact efficiently on both the supply and demand sides.

A **reliable outlet to resell cars** that are not under repurchase agreements is also important to look at. The more flexibility a car rental company has in being able to manage its fleet size, the less it will be affected by adverse conditions that might prevail.

Because a car rental company buys and sells a vehicle within a 12-month period, the value of the used car at the time of selling is key. Hence an environment of **modest inflation and steadily increasing car prices** is ideal for car rental companies.

13.

Valuation methods in the car rental industry

a. Key ratios

The key ratios that should be assessed when valuing a car rental company are as follows:

- **Return on equity (ROE)** is probably the most relevant ratio and combines the operational performance with the gearing level of the company.
- **Return on capital employed (ROCE)** is an indication of the operational competence of the business.
- **Interest cover** (operating income/interest cover) is also important and can be compared to competitors in the industry.
- **Operating margin and Return on Sales (ROS)** are an indication of the businesses's ability to convert their positioning and appropriate leverage to generate profits.
- **Operating cash flow:** This should be compared with accounting operating profit.
- **Depreciation rate:** If a company's depreciation rate is less conservative than that of its competitors, its valuation should be penalised.
- **Fleet utilisation** is based on the average number of days vehicles are rented compared to the total number of days vehicles are available for rent.
- **Growth in rental days** is a key indicator to evaluate growth.

Comparative information is a useful tool that analysts can use when comparing car rental companies. An example of comparative information and typical figures in the industry is shown in the following table and is based on numbers from Avis plc:

Utilisation	68.5%
People productivity	818
Rental Length	5.7
Revenue per billed day ($: 31/03/02 spot)	35.30
Revenue per rental ($: 31/03/02 spot)	201.00

b. Valuation ratios

The most appropriate valuation ratios to use for a car rental company are:

- **P/E multiple**. A good car rental company should attract a P/E multiple higher than the average of industrial companies in its region.

- **Net asset value**. A car rental company is effectively an asset-based business and the asset value should give a reflection of the value of the business, as the majority of assets are renewed every year. However, car rental companies can trade at a significant premium to net asset value. This is because effective use of leverage against the assets can result in shareholders getting a return on their funds well above the industrial average.
- **Cash flow** valuation ratios.

Analysts should **avoid the EV/EBITDA ratio**, as it fails to take account of the effective use of leverage, which is a distinct feature of this industry.

14.

The risks

The risks that affect the car rental business are as follows:

- Adverse effect from interest rates
- Changes in repurchase agreements
- Foreign currency risk
- Seasonality
- Economic downturn or decrease in air travel
- Dependence on subsidiaries' cash flows
- Risks in international operations
- Changes in car prices and industry policies
- Dependence on manufacturers
- Fluctuations in fuel costs or supplies
- Competitive nature of business
- Reliance on asset-backed financing
- Technological advances
- Government action/regulation
- Bearing the residual risk

An increase in interest rates could reduce profitability

An increase in interest rates, whether because of an increase in market interest rates or an increase in the cost of borrowing, may materially reduce profitability. In addition, in the event of an increase in prevailing interest rates, lessees with floating rate leases may have greater difficulty in meeting their increased payment obligations, which could result in an increase in default rates. Moreover, lessees generally have the option to convert floating rate leases to fixed rate leases which could, if not properly hedged, expose them to additional risks resulting from interest rate fluctuations.

Changes in repurchase programs may affect the business

Under a Repurchase Program, a company agrees to purchase a specified minimum number of vehicles directly from franchised dealers of the manufacturer at a specified price, and the manufacturer agrees to buy those vehicles back at a future date at a price that is based upon the capitalized cost of the vehicles less an agreed-upon depreciation factor and, in certain cases, an adjustment for damage and/or excess mileage. The Repurchase Programs limit the risk of a decline in the residual value of the fleet and enables the fixing of depreciation expense in advance. Vehicle depreciation is likely to be the largest cost factor in a car rental operation. If automobile manufacturers reduced the availability of Repurchase Programs or related incentives, it could have a material adverse effect on the financial condition and results of operations.

In addition, a car rental company could be placed at a competitive disadvantage if automobile manufacturers selectively restricted eligibility to participate in their Repurchase Programs.

For example, any effort by a major car manufacturer to reduce the scope of an existing car rental company's Repurchase Program could adversely affect its ability to compete with those competitors whose access to similar programs is not reduced or that have well established alternative vehicle disposition facilities.

Furthermore, if a substantial portion of financing were reliant on Repurchase Programs, a significant change in the financial condition of the vehicle manufacturers, would significantly affect the ability to continue to obtain this financing on favourable terms. In addition, under the terms of certain credit facilities, various events over which there will be no control include:

- The bankruptcy of a repurchase party, and,
- Material default of a repurchase party under a Repurchase Program may result in: termination of the credit lines for the purchase of vehicles under Repurchase Program from such repurchase party, and a requirement to liquidate vehicles purchased from that repurchase party.

Exposure to foreign currency risks

This is important when a significant portion of revenue and operating costs are denominated in foreign currencies. A company is therefore exposed to fluctuations in the exchange rates between the home currency and the currencies in which the foreign operations receive revenues and pay expenses. Consolidated financial results will therefore require translation adjustments for purposes of reporting results from foreign operations. Such adjustments, which may arise, for example, due to an appreciation of the U.S. dollar relative to the pound sterling, may be significant. Although companies can hedge their exposure under such borrowings to exchange rate fluctuations, they cannot be sure that such hedges will be successful or that the costs of such hedges will not be significant.

Highly seasonal nature of the vehicle rental business

Any occurrence that disrupts travel patterns during the summer period could have a material adverse effect on the annual operating results. Many operating expenses, such as rent, insurance and personnel, are fixed and cannot be reduced during periods of decreased rental demand.

A decrease in air travel

The majority of car rental companies' revenue is generated at airport rental locations. A sustained decrease in airline passenger traffic or the loss of a significant airport concession could have a material adverse effect on the financial condition and results of operations. Events that could reduce airline passenger traffic include, in addition to a general economic downturn (as discussed below), labour unrest, airline bankruptcies and consolidations, substantially higher airfares, the outbreak of war, high-profile crimes against tourists and incidents of terrorism. In addition, leases at major airports may be renewed on a month-to-month basis.

Economic downturn

Business is affected by a number of economic factors, including the level of economic activity in the markets in which the company operates. A decline in economic activity either in the United States or in international markets could materially affect the financial condition and results of operations. In the vehicle rental business, a decline in economic activity typically results in a decline in both business and leisure travel, and, accordingly, a decline in the volume of vehicle rental transactions. In the case of a decline in vehicle rental activity, the company may reduce rental rates to meet competitive pressures, which could adversely affect the financial condition and results of operations. With regard to vehicle leasing and other vehicle management services, economic downturns may result in a decrease in sales volume and fee revenues, as well as reduced margins.

A decline in economic activity may also adversely affect residual values realized on the disposition of vehicles that are not covered by Repurchase Programs. In addition, an economic decline is likely to result in an increase in default rates. Any of the above factors could contribute to a downgrading of the credit rating given. Any such downgrading could increase our funding costs and decrease the spread between our cost of borrowing and our lending rates.

Holding company depending on its subsidiaries for cash flow

If a holding company conducts substantially all of its operations through its subsidiaries, it will depend on dividends or other inter-company transfers of funds from its subsidiaries to meet its debt service and other obligations.

In addition, the ability of the subsidiaries to pay dividends and make other payments to it may be restricted by, among other things, applicable corporate and other laws and regulations and agreements of the subsidiaries. Although the Indenture will limit the ability of such subsidiaries to enter into consensual restrictions on their ability to pay dividends and make other payments, such limitations are subject to a number of significant qualifications and exceptions.

Risks in international operations

The international nature of existing and planned operations involves a number of risks, including changes in home and foreign government regulations, tariffs, taxes, fuel duties, other trade barriers, the potential for nationalization of enterprises, economic downturns, inflation, environmental regulations, political and social instability, foreign exchange risk, difficulties in receivables collections, and dependence on foreign personnel and foreign unions. Foreign government regulations may also restrict the ability to own or operate subsidiaries in those countries, acquire new businesses or repatriate dividends from foreign subsidiaries back to the holding company

Rising car prices and changes in industry policies

In recent years the average price of new cars has increased. From time to time, automobile manufacturers sponsor sales incentive programs that tend to lower the average cost of vehicles for fleet purchasers, however these cannot be anticipated. Thus the risk of passing on price increases to customers is greater due to the competitive nature of the industry.
In addition, if car prices were to decline, it is expected that leasing revenues would decline as well.

Dependence on a particular manufacturer for the supply of vehicles

Shifting significant portions of fleet purchases to other manufacturers would require significant lead-time. As a result, a manufacturer's inability to supply the planned number and type of vehicles could have a material adverse effect on the financial condition and results of operations. In addition, if it is not able to offer competitive terms and conditions and the car rental company is unable to purchase enough vehicles from other manufacturers on competitive terms and conditions, then it may be forced to purchase vehicles at higher prices or on otherwise less favourable terms. Such a situation could adversely affect the financial condition and results of operations through increased vehicle acquisition and depreciation costs if the company is unable to pass these costs on to our customers through increases in rental rates.

Fluctuations in fuel costs or reduced supplies.

A car rental company could be adversely affected by limitations on fuel supplies, the imposition of mandatory allocations or rationing of fuel or significant increases in fuel prices. A severe and protracted disruption of fuel supplies or significant increases in fuel prices could have a material adverse effect on the financial condition and results of operations. On the other hand, decreases in fuel costs, including decreases in applicable taxes, could reduce fuel card revenues, since fuel card fees are generally based on the gross amount of purchases.

Highly competitive business

The vehicle rental industry is highly competitive, particularly with respect to price and service. In addition, recent changes in ownership of a number of the major vehicle rental companies could further intensify competition. In any given location, franchisees may encounter competition from national, regional and local companies, many of which, particularly those owned by the major automobile manufacturers, have greater financial resources. Similarly, the vehicle leasing and vehicle management services are also highly competitive. In addition to the major providers of fleet management services hundreds of local and regional competitors and numerous niche competitors who focus on only one or two products.

From time to time, either because of overcapacity or reduced demand, the major vehicle rental companies have been subject to industry-wide price pressures. A recurrence of oversupply or a marked reduction in overall demand could adversely affect our ability to maintain or increase our rental rates.

Relying on asset-backed financing to purchase vehicles

If access to asset-backed financing were reduced, replacement financing may be difficult to obtain on favourable terms. As a result, any disruption in the market for asset-backed securities or in the ability to access that market would have a material adverse effect on the financial condition and results of operations.

Technological advances could reduce the competitive advantage in information technology

Customers, especially in the United States, are demanding broader and faster access to information. Technological advances could enable competitors to develop the ability to deliver information in a similar manner more quickly than currently anticipated. If competitors develop this ability, it would reduce the competitive advantage in information technology.

Government action and regulation

Governmental action could affect several sources of revenues. For example, a significant source of profits for the vehicle rental industry has been the sale of loss damage waivers, by which rental companies agree to relieve a customer from financial responsibility arising from vehicle damage sustained during the rental period. The U.S. Congress has from time to time considered legislation that would regulate the conditions under which, loss damage waivers may be sold by vehicle rental companies.

Bearing the residual risk on the value of a portion of leased vehicles

Leased vehicles can be based on both 'closed-end' and 'open-end' bases. Car rental companies generally bear the residual value risk on the value of vehicles leased under closed-end leases. Therefore, if the market for used vehicles declines, they suffer losses in remarketing vehicles upon the expiration of closed-end leases.

Other risks that are relevant are found below:

Clean up costs relating to petroleum storage

Domestic and international facilities may contain tanks for the storage of petroleum products, such as gasoline, diesel fuel and waste oils. One or more of these tanks can be located underground. A car rental company cannot be sure that these tank systems will at all times remain free from leaks or that the use of these tanks will not result in spills. Any such leak or spill, depending on such factors as the material involved, quantity and environmental setting, could result in interruptions to operations and expenditures that could have a material adverse effect on the financial condition and results of operations.

Thus, based on currently available information, future expenditures for remediation of known contamination should be approximated. Such amount does not take into account possible recoveries under any insurance that may be available or reimbursement that may be available from certain reimbursement programs applicable to leaking underground storage tanks.

Potential to be sued as a result of accidents involving rental cars

The type of business exposes car rental companies to claims for personal injury, death and property damage resulting from the use of the vehicles rented or leased.

Difficulty managing future growth

If rapid growth is experienced, such growth would require the hiring, retention and training of new personnel, the development and introduction of new products, the expansion of our management information systems, the control of expenses related to the expansion of our information network and customer base, and the management of additional demands on our customer support, sales and marketing, administrative resources and network infrastructure. If these requirements are unable to be satisfied, or if we are otherwise unable to manage growth effectively, our operations and financial condition could be materially adversely affected.

Ability to attract and retain key personnel

Success will depend in large part upon the ability and experience of certain key management employees. In addition, performance will be highly dependent on the ability to identify, hire, train, motivate and retain highly qualified management, technical, sales and marketing personnel. The need for new personnel will be heightened attempts to expand operations. The inability to attract and retain the necessary management, technical and sales and marketing personnel, including without limitation, senior management personnel, could have a material adverse effect on the business, results of operations and financial condition.

15.

Template of key questions to ask management

1. What are the key profit drivers of the business and were do they stand currently. How are they doing when compared to competitors?
2. What is the market share of the company compared to its nearest competitors?
3. What are the major risks currently affecting the business?
4. What is the operating profit margin of the business?
5. What is the operating cash flow?
6. Is there rental day growth and what is the utilisation rate?
7. What is the gearing and interest cover of the business? Is it reasonable in terms of the expected interest rate environment?
8. What depreciation method does the company use?
9. What percentage of the fleet is under repurchase agreements? What is the structure of these arrangements?
10. What is the breakdown of revenue and expenses?
11. How much does insurance contribute?
12. What new services are being brought to the market?
13. Are the lending arrangements favourable?
14. Are appropriate provisions made for buy-back damages or credit card fraud?
15. Does the car rental company have a good relationship with its suppliers?
16. What is the customer service like and does the company have a reliable global IT system for both the demand and supply sides.
17. What is the track record of management like?
18. What are the expansion strategies of the company?