

## **EQUIPMENT RENTAL**

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Rental is an interesting area to examine from a strategic point of view. Let's look at rental growth in the last 20 years.

In 1987, did you consciously make the decision to enter the rental market? Consciously make the decision to commit a certain amount of funds to rental? Did you establish specific financial benchmarks for rental operations and continuously monitor progress against those goals to adapt, change, and improve? Or, did you get into the rental business as a reaction to certain factors?

What we've seen as a consulting firm is that most heavy equipment dealers are in rental not as a strategic focus established but, they're in rental as a reaction to certain situational drivers.

The drivers were:

- The growth in companies such as Hertz and other national rental companies, other dealers doing rental business and customers asking more about rental. This lead dealers to say to themselves "Boy, we better be in this rental business."
- Our salespeople quickly discovered and our practices reinforced the fact that you could avoid dealing with the price objection regarding new unit retail price if you sold the customer a rental unit at a significant discount. And the more reinforcement we gave to the issue of equipment prices being too high the more we legitimized salespeople looking for low hour, low price units to avoid the price question.
- Customers are coming to the conclusion that they don't need to own every single piece of equipment. They really want to use equipment until they fulfill the contract or job they are working on. We see this outsourcing also in the area of extended warranty and guaranteed maintenance. Customers today really want to focus on doing their business, home building, road building, mining, forestry, whatever and not have to worry about equipment utilization, costs and the like. These customers are looking to rental.
- The latest trend we see is customers wanting to single source. If they are comfortable with the dealer, the relationship, the service, the product offering, then more and more they want that dealer to be flexible enough to meet all their needs. A major one is rental.

We like to think as management consultants that after we do training in strategic planning, all our clients use this approach in a very disciplined way. The reality is that most business ventures evolve as this rental question evolved. One day we wake up and realized that we have 1 million invested, that we're operating a strategic business unit - rental; and our customers are asking for more and more of it. Our problem is we really haven't said, "given a clean sheet of paper, how do we execute the rental business in an efficient profit focused way?"

The first strategic question to be answered about rental is "Are you in the rent to sell or the rent to rent business?" The answer we frequently get is "Yes". Depending upon which day and who asks the question, we can get different answers. Again, this is because rental grew not as a result of a strategic plan but as an alternative to some other difficult issues.

Suppose we ask two CEOs about their rental business. One CEO is in the lift truck business and his expectations of rental are X the other CEO is solely in the rental business and his expectations are Y. Their expectations differ because of the way they define their businesses. The CEO whose rental business is viewed as a support to sales and has an "everything is for sale" mentality, may be willing (in our experience they are willing) to accept a lower level of performance because they believe they'll make it up in the other aspects of the business.

The other CEO in the rental business doesn't have a choice. He must make his profit through rental and thus his expectations and probably performance will be higher due to this focus. He is in a true rent to rent business.

For example, the "everything is for sale" or rent to sell dealer has a light equipment unit that they purchased for 25,000 in their rental fleet. The unit has had good rental experience and now has a book value of 17,500. A sales person looks at that unit and says if we can get 20,000 then we make a nice 2,500 gross profit on that unit. Everyone is happy.

A company in the rent-to-rent business might look at this transaction differently. If that unit was bought for 25,000 and returned 6,750 of gross profit in the first year, 6,750 in the second year and it is expected to continue at that level, the sale of that unit for 2,500 profit would not be adequate. Their expectations are different.

The rent to sell dealer would probably say "yes, but this helps with our marketshare, it gives us another unit in the field on which to do parts and service business, also I can replace it with a new unit (probably at a higher price). And, we're comfortable with all that if your intent is rent to sell. We're not comfortable with all that if your intent is rent to rent because you may be giving up margin by turning the unit over too quickly.

This is exclusive of maintenance, which I know some of you are thinking about. What we find though in our work with lots of dealers is that the maintenance issue is not the critical factor around which you make decisions about retiring rental units. It is a factor but it is not the critical one. In fact here is a suggestion for those of you who are maintenance focused, do an analysis of all units you've retired from rental. Calculate for each unit, total revenue, total maintenance expense, and number of months in rental. See if those units with the highest months in rental had significantly higher maintenance expense as a percent of sales. You might be surprised at what you find.

Our conclusion is that we probably need a different set of financial expectations for a rent to sell business as compared to a rent-to-rent business. So let's look at those two businesses and how each of them performs financially.

In a dealership, rental is part of a larger operation. So, we need a view of the whole company in order to evaluate properly the rental position. Here is a financial view of the whole context with a rent to sell orientation.

### RENT TO SELL MODEL %

	New & Used	Rent to Sell	Service	Parts	G & A
<b>Sales</b>	15% Profit Margin	100%	100%	100%	
<b>Gross Profit</b>	100%	30%	65%	35%	
<b>Personnel</b>	50%	10%	20%	10%	5%
<b>Operating</b>	25%	3%	10%	3%	3%
<b>Occupancy</b>	10%	2%	5%	2%	2%
<b>Total Expenses</b>	85%	15%	35%	15%	10%
<b>Operating Profit</b>	15%	15%	30%	20%	-10%

So, what does this model look like in real money with a typical sales mix? The following chart is an example of how these percentages work out.

### RENT TO SELL SALES MIX

	New & Used	Rent to Sell	Service	Parts	G & A	Totals	Percent ages
<b>Sales</b>	600	150	100	150		1,000	100%
<b>Gross Profit</b>	90	45	65	53		253	25.3%
<b>Personnel</b>	45	15	20	15	20	115	11.5%
<b>Operating</b>	23	5	10	5	12	54	5.4%
<b>Occupancy</b>	9	3	5	3	8	28	2.8%
<b>Total Expenses</b>	77	23	35	23	40	197	19.7%
<b>Operating Profit</b>	14	23	30	30	(40)	56	5.6%

We expect in a rent-to-sell dealership to achieve a 30% Gross Margin on rental. This is for a capitalized rental fleet. So, the issues of rate and utilization have a significant impact on whether you make or don't make the 30% number. For those of you who use a percentage method for rental gross profit, you know that rate and

utilization do not directly impact rental gross profit. However they certainly impact the total amount of profit you make when your rental unit is sold and you examine total wash out gross profit. .

In a rent-to-rent dealership the expectations in terms of expense levels remains the same but the gross profit expectation is raised to 45%.

### RENT TO RENT MODEL %

	New & Used	Rent to Rent	Service	Parts	G & A
<b>Sales</b>	15% Profit Margin	100%	100%	100%	
<b>Gross Profit</b>	100%	45%	65%	35%	
<b>Personnel</b>	50%	10%	20%	10%	5%
<b>Operating</b>	25%	7%	10%	3%	3%
<b>Occupancy</b>	10%	3%	5%	2%	2%
<b>Total Expenses</b>	85%	20%	35%	15%	10%
<b>Operating Profit</b>	15%	25%	30%	20%	-10%

Using the same sales mix, let's see what this model achieves in terms of real money.

### RENT TO RENT SALES MIX

	New & Used	Rent to Rent	Service	Parts	G & A	Totals	Percent ages
<b>Sales</b>	600	150	100	150		1,000	100%
<b>Gross Profit</b>	90	98	65	53		275	27.5%
<b>Personnel</b>	45	15	20	15	20	115	11.5%
<b>Operating</b>	23	1	10	5	12	60	6.0%
<b>Occupancy</b>	9	5	5	3	8	30	3.0%
<b>Total Expenses</b>	77	30	35	23	40	204	20.4%
<b>Operating Profit</b>	14	38	30	30	(40)	71	7.1%

The difference in net profit contribution between rent-to-sell and rent-to-rent is significant. In the rent-to-sell business we expect 5.6% Operating Profit while in the rent-to-rent business we expect 7.1%

You might be asking why we have a different profit contribution between rent-to-rent and rent-to-sell. Let's compare the rent-to-sell expectations and the rent-to-rent expectations.

	Rent to Rent	Rent to Sell
<b>Retail Pricing Multiple</b>	6% (Four week rate)	4% (Monthly rate)
<b>Monthly Actual Revenue Multiple</b>	5%	3.6%
<b>Unit Utilization</b>	75%	90%
<b>Maintenance Costs</b>	Unit Specific	Unit Specific
<b>Expenses as a Percent of Revenues</b>	15%	15%

Utilizing the chart above, you can calculate what the appropriate rental rate should be for a unit. For example, if you acquired a unit for 25,000 you would multiply this by 6% to get a 4-week rate of 1,500 in a rent-to-rent application. In a rent-to-sell application you would price the same unit at 1,000.

- The revenue stream associated with the above rent-to-rent application is calculated by multiplying the 4-week rate of 1,500 by 13 periods and then multiplying that by the 75% utilization rate to get a yearly revenue stream of 14,625 (5% monthly revenue multiple).
- The revenue stream associated with a rent-to-sell application is calculated by multiplying the monthly rate of 1,000 by 12 periods and then by the 90% utilization rate for a yearly revenue stream of 10,800 (3.6% monthly revenue multiple).

The difference is significant. You must decide the best use of your rental assets and set out the financial expectations to be achieved.

So far we've talked about gross profit on a monthly basis or annual basis. And, previously we talked about gross profit as calculated by some people on a straight percentage basis. All this gross profit analysis is critical. However, at some point in the future you'll want to dispose of this unit probably more quickly if you're in rent-to-sell applications or you will want to hold it longer if you're in rent-to-rent applications. After you get rid of the unit a very important analysis must take place in order for you to understand whether that unit gave you an appropriate total return on investment. That process is called wash out analysis.

As an example we will use a light equipment unit that is 24 months old with an original acquisition of 25,000. Certainly this price is "generic" for this discussion, the numbers work easier in round figures. We have also established the pricing multiple at 5%, which is the average of 6% and 4%.

Step 1) Determine the expected rental revenue from the unit using the following formula.

Acquisition Price	X	Pricing Multiple	X	# of Periods	X	Utilization Rate	X	Number of Years	=	Expected Rental Revenue
25,000	X	0.05	X	13	X	0.75	X	2	=	24,375

Step 2) Gather information concerning interest and maintenance costs associated with this unit over its life. For our example we will use an interest cost 3,600 and a maintenance and repair cost of 1,725.

Step 3) We now need be calculate the expected wash out gross profit using the following formula:

Acquisition Price	X	Monthly GP Return on Acquisition Price	X	Number of Months	=	Wash Out Gross Profit
25,000	X	2.50%	X	24	=	15,000

\*This figure, monthly gross profit return on acquisition price, is a target number. We recommend using 2.5% when you are in the rent-to-rent business and want to maximize profits. If you are in the rent to sell business and will sell rental units out within the first two years, we recommend you use 1.5%.

Step 4) Now plug in the above number to the exhibit below:

<b>Expected Rental Revenue</b>	<b>24,375</b>
<b>Final Sale</b>	?
<b>Total Cash In</b>	?
<b>Acquisition Price</b>	25,000
<b>Interest</b>	3,600
<b>Maintenance &amp; Repair</b>	1,725
<b>Total Cash Out</b>	<b>30,325</b>
<b>Wash Out Gross Profit</b>	<b>15,000</b>

Step 5) Add the Wash Out Gross Profit to the Total Cash Out to calculate Total Cash In.

Wash Out Gross Profit	+	Total Cash Out	=	Total Cash In
15,000	+	30,325	=	45,325

Step 6) Now, subtract Expected Rental Revenue from Total Cash In and you will get the minimum price you should accept for the unit at its final sale.

<b>Total Cash In</b>	-	<b>Expected Rental Revenue</b>	-	<b>Final Sale Price</b>
45,325	-	24,375	=	20,950

Step 7) Let's plug in the above numbers to the Wash Out Exhibit.

(The same process is applied to rent to sell at a wash out gross profit of 1.5%)

	Rent to Rent	Rent to Sell
<b>Expected Rental Revenue</b>	24,375	18,000
<b>Final Sale</b>	20,950	21,325
<b>Total Cash In</b>	45,325	39,325
<b>Acquisition Price</b>	25,000	25,000
<b>Interest</b>	3,600	3,600
<b>Maintenance &amp; Repair</b>	1,725	1,725
<b>Total Cash Out</b>	30,325	30,325
<b>Wash Out Gross Profit</b>	15,000	9,000
	2.50%	1.50%

**A word of caution:** the above analysis assumes you will be getting close to the expected rental revenue. Using actual revenue generated (if significantly lower than expected) may cause a final sale price that is unrealistic. This is why it is critical to manage your short-term rental fleet to the 5.0% rental revenue multiple.

So, we have 15,000 in wash out gross profit. The question a financial analyst would ask is "Did you get that 15,000 in a one year period, a five year period or a 10 year period? There is a time value issue relative to money. So, we need to examine this profit in terms of the time it took to get that profit. And, we need to examine it relative to the investment it took to get that profit. Over time we had a monthly gross profit of 625.

Good, now, did we have a 1 at risk, 25,000 at risk, or a 1,000,000 at risk? Obviously in this case we had 25,000 at risk. So, that monthly return compared to the acquisition price gives us a wash out gross margin monthly percent of 2.5%. This calculation is designed to take into account the investment and the time value of money in a very straight forward calculation without getting into a lot of discounted cash flow, complicated, financial analysis. We're in the equipment rental business we are not currency traders in Zurich or Wall Street. So, we want to keep all analyses simple and straightforward.

In the seminars we go through a lot of variations on this wash out analysis. Obviously, if you play with the rental revenue, final sale price, acquisition cost, interest and maintenance you can drive a number of interesting scenarios:

- to make the analysis more profitable or
- to lower final sale price if market share is your goal, or
- raise questions about acquisition cost relative to an expected revenue stream.

So, you can see there is a lot of interesting, valuable, insightful analysis you can do from the wash out calculation.

You need to understand the elements that contribute to a profitable rent to rent department.

1. Monthly rental revenue multiple of 5% which is achieved by renting equipment out for the right price, with the right time period mix, for the right utilization.
2. Period mix is developing the marketing programs and the capabilities to rent by the week and the day and emphasizing short term.
3. Pricing multiple of 6% for a four-week period.
4. Determining the utilization required for the fleet and each unit to achieve the rental revenue multiple of 5%.

There is no "one" way to be successful with rental. You will need to take the principles discussed and determine how to apply them to your specific market and business situation. In the August 2008 AED Rental Workshop Currie Management Consultants will be focusing on the operational principles that lead to profits.