WHITE PAPER

Central Cost Center

wheels

Introduction

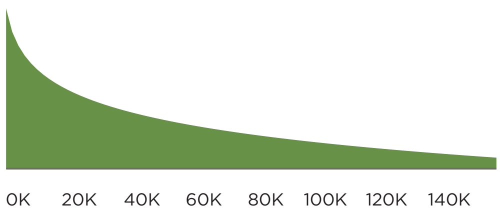
When a fleet acquires vehicles, it knows the exact amount and duration of the monthly payments. By contrast, when those vehicles develop mechanical problems as they age, the exact type and timing of the costs are unpredictable even though the general upward trend in cost can be foreseen.

Consequently, when a branch or decentralized fleet office is financially responsible for the monthly lease payment on its vehicles, it has a short-term incentive to reduce costs by holding onto the vehicles until no lease payments are required. However, this can result in the vehicles aging beyond the point where it is financially prudent to keep them. The practice of creating a "Central Cost Center" can eliminate this incentive, resulting in vehicle replacement decisions more beneficial to the company over the long term.

The Financial Goal: Optimal Replacement Timing

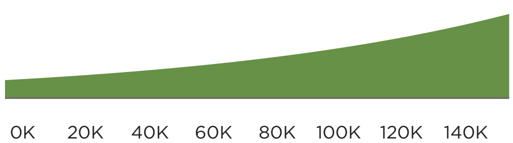
The largest single cost of a vehicle is depreciation. This cost hits hardest at the very start of a vehicle's life and decreases over time.

DEPRECIATION COST



In contrast, maintenance costs start out low, remain near that level the first few years and then gradually ramp upward as vehicles age.

MAINTENANCE COST

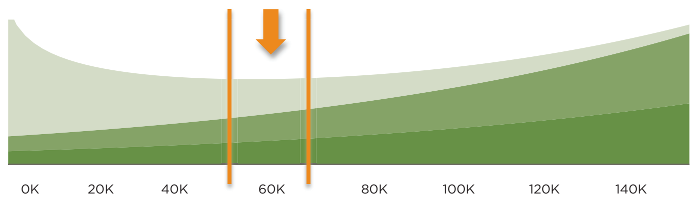


Aging vehicles incur a variety of other costs as well. They subject the lessee to higher levels of unscheduled maintenance that results in rental expense and lost driver productivity. They expose companies to safety risks, a greater need to keep additional surplus vehicles sitting dormant, or a detrimental perception of the company due to the downmarket image of aged vehicles.

Beyond the increase in Total Cost of Ownership, an aged fleet limits a company's ability to take advantage of more efficient technology. The latest model year vehicles typically provide the lessee with improved fuel efficiency and the latest safety technologies to help avoid or mitigate severity of collisions.

Optimal replacement timing is the point in the vehicle's life when retiring it yields the lowest lifetime cost per mile. That point is calculated by analyzing costs related to depreciation, maintenance and loss of productivity at different times of the vehicle's life cycle. It varies based on multiple factors including the type of vehicles and how they are used, but can be estimated with considerable reliability.

OPTIMAL REPLACEMENT



How a Central Cost Center Works

A logical way to keep branch fleet offices from keeping vehicles too long is to remove their incentive to do so, by restructuring how they pay for vehicles. This is the goal of Central Cost Center.

Instead of the branch office being obligated to make the lease payments directly to Wheels, the Central Cost Center sets up an intermediary at the corporate level: a "Cost Center" for vehicle depreciation. The corporate Cost Center charges a fixed payment to the branch to cover the depreciation, interest and registration. In turn, the corporate Cost Center assumes the obligation of the lease payments to Wheels (the lessor), but also realizes any gains or losses on sale as the vehicles are retired. The local branch still pays for running costs such as fuel, maintenance, collisions, tolls and violations.

Since the branch office makes a fixed payment whether it keeps or replaces its older vehicles, it has no incentive to keep them beyond their time of optimal replacement. Vehicles are replaced when they should be, leading to productivity gains and long-term savings for the company as a whole.

Setting the Payment Amount

The key decision in setting up a Central Cost center arrangement is the size of the monthly payments the branches must make to the corporate Cost Center. A starting point is to establish the parameters that define optimal replacement time for every model or class of vehicle in the fleet, and setting a target resale value for each. The payment amount is then based on the forecasted effective depreciation, an assumption for interest, plus the cost of registration.

The resale target can be adjusted to reflect the Cost Center's tolerance for risk. Lower resale targets lead to higher payments but reduce the risk of future deficits. Conversely, higher resale targets lower the payments but increase the Cost Center's exposure to future deficits if the targets are not met at resale time.

Designing the appropriate program depends on two main factors:

1. What is the forecasted resale value at the optimal replacement point?
2. In the ongoing dynamic between the actual effective depreciation of the vehicles and the payment amounts collected from the branches, do you prefer that the corporate Cost Center runs at a surplus or a deficit?

In setting the payment, you need to decide whether it's acceptable for the Cost Center to run at a cash flow deficit until units are sold, thus returning the portfolio to a breakeven or surplus later, or whether you prefer to charge branches a higher payment to keep the Cost Center at a surplus throughout. How long are you willing to let the Cost Center absorb a higher lease payment than what you collect from the field in order to keep potential gains (or losses) when vehicles are replaced? This decision obviously is also impacted by the payment tolerance of the branches — how high a payment they are willing and able to make now in order to fund eventual gains for all.

Determining Whether a Central Cost Center Makes Sense for You

A Central Cost Center can be a logical option for decentralized fleets. From a budget standpoint, it allows branch offices to make centralized decisions based on optimal replacement parameters, without feeling financially pressured to retain its vehicles longer than they should.

By smoothing out depreciation cash flows, the Central Cost Center also lessens the volatility of your branches' fleet expense and gives them a clearer picture of what they're really paying for maintenance and other vehicle costs, which makes them more open to replacement of aging vehicles as their maintenance costs rise.

To learn more about Central Cost Centers, please contact a member of your Wheels Account Team or e-mail us at info@wheels.com.