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Equipment as a Service: how to finance the way forward

Surmounting the challenges of obtaining sufficient, suitable and attractive financing to grow your EaaS business

Deloitte Debt & Capital Advisory

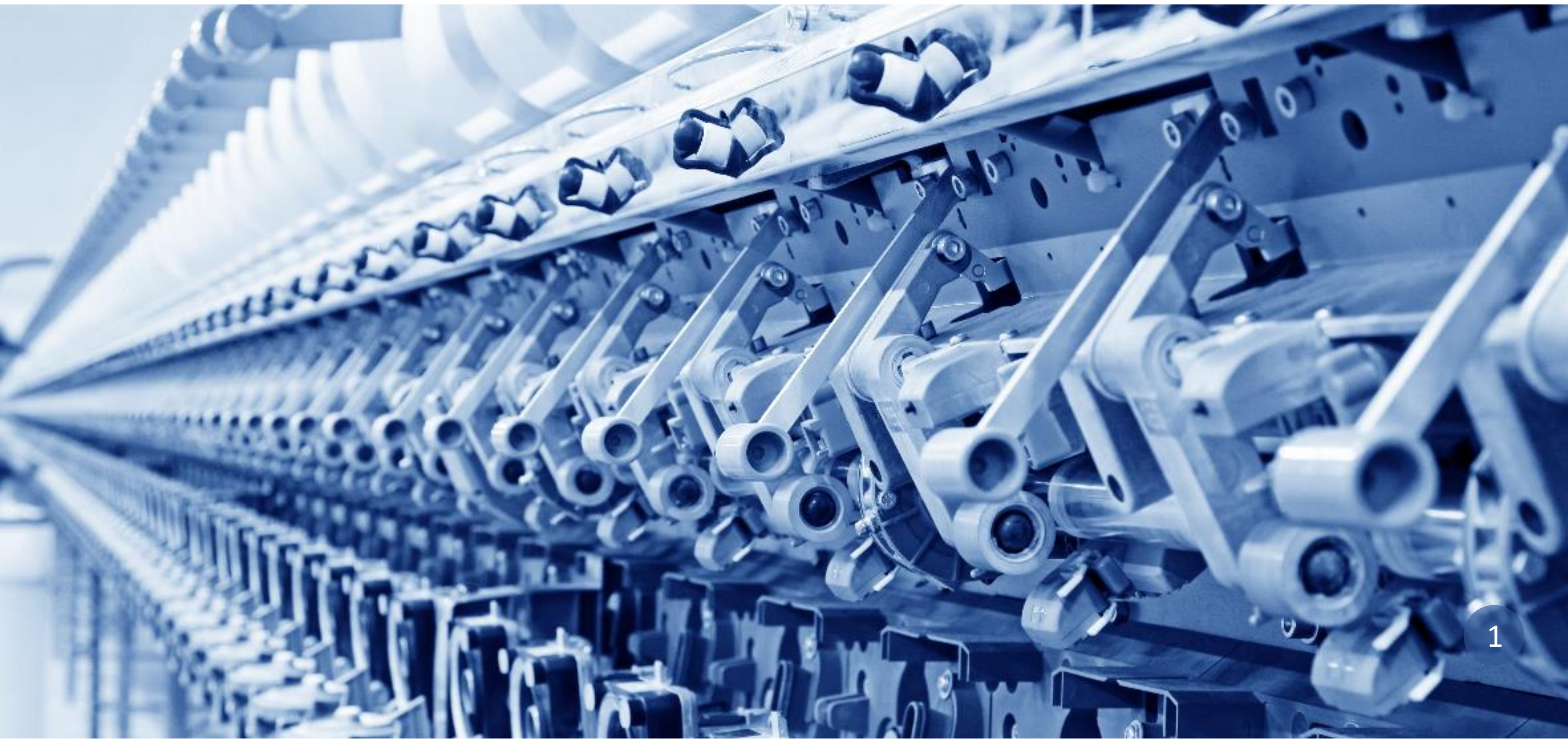
Introduction

Equipment as a Service (EaaS) business models are on the rise. At Deloitte, we advise our clients broadly in this area: from strategy to operations, tax, regulatory and financing. When EaaS businesses at Original Equipment Manufacturers (OEMs) as well as independent providers expand significantly, along grows their financing need. Obtaining sufficient, suitable and attractive financing for EaaS can be a tremendous challenge. But if surmounted, great benefits can be achieved. In this article, Deloitte Debt & Capital Advisory shares their views on the diversity of EaaS and the challenges of how to attract fitting financing to fuel the growth of EaaS businesses.

EaaS: how to finance the way forward

Executive Summary

- Equipment as a Service (EaaS) is an offering of equipment combined with related services. Specific offerings can greatly vary in the details. EaaS provides value to both EaaS providers and their clients. For clients, EaaS aligns with the trend of moving from ownership to usage and helps with cash constraints. For EaaS providers, it offers various benefits such as sales, margins, client intimacy, opportunities for cross/up-selling, client retention, and extended economic life & ESG.
- There are two main types of EaaS offerings: the Serviced Financial Product Offering, which is closest to traditional offerings, and the Fully Flexible Product offering. Examples of the former include serviced operational car lease and solar lease. Examples of the latter are car and retail consumer subscription products.
- EaaS growth typically increases the size of the provider's balance sheet which can lead to financing challenges due to the large amounts involved, the diversity of equipment and offerings, and the increased complexity of the business model.
- Asset-based and structured financing can be a suitable tool for supporting EaaS businesses. This can involve sale-and-lease-back programs, asset-based lending with a borrowing base, securitisation, and white label or forward flow partnerships. Structured financing offers benefits such as better financial terms and leverage, high scalability, and alignment with EaaS objectives.
- Deloitte Debt & Capital Advisory is experienced in preparing, marketing and executing projects to obtain the best possible financing structure, helping clients grow their EaaS businesses.



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What is EaaS?

In short, Equipment as a Service ('EaaS') encompasses **any commercial offerings** whereby a client is:

I. provided possession of, and thereby the ability to use, **physical equipment** (or 'assets'); alongside with

II. able to rely on the EaaS provider to provide certain **related services**.

Generally, there are two types of parties ('**EaaS Providers**') that offer EaaS solutions. One is Original Equipment Manufacturers, or OEMs for short. The other includes independent parties like resellers and platform providers.

As part of the EaaS provider's offering, the client agrees to certain payments to be made. Typically, these **payments fall into three categories**:

I. fixed recurring amounts per time period (e.g. monthly);

II. variable recurring amounts; and

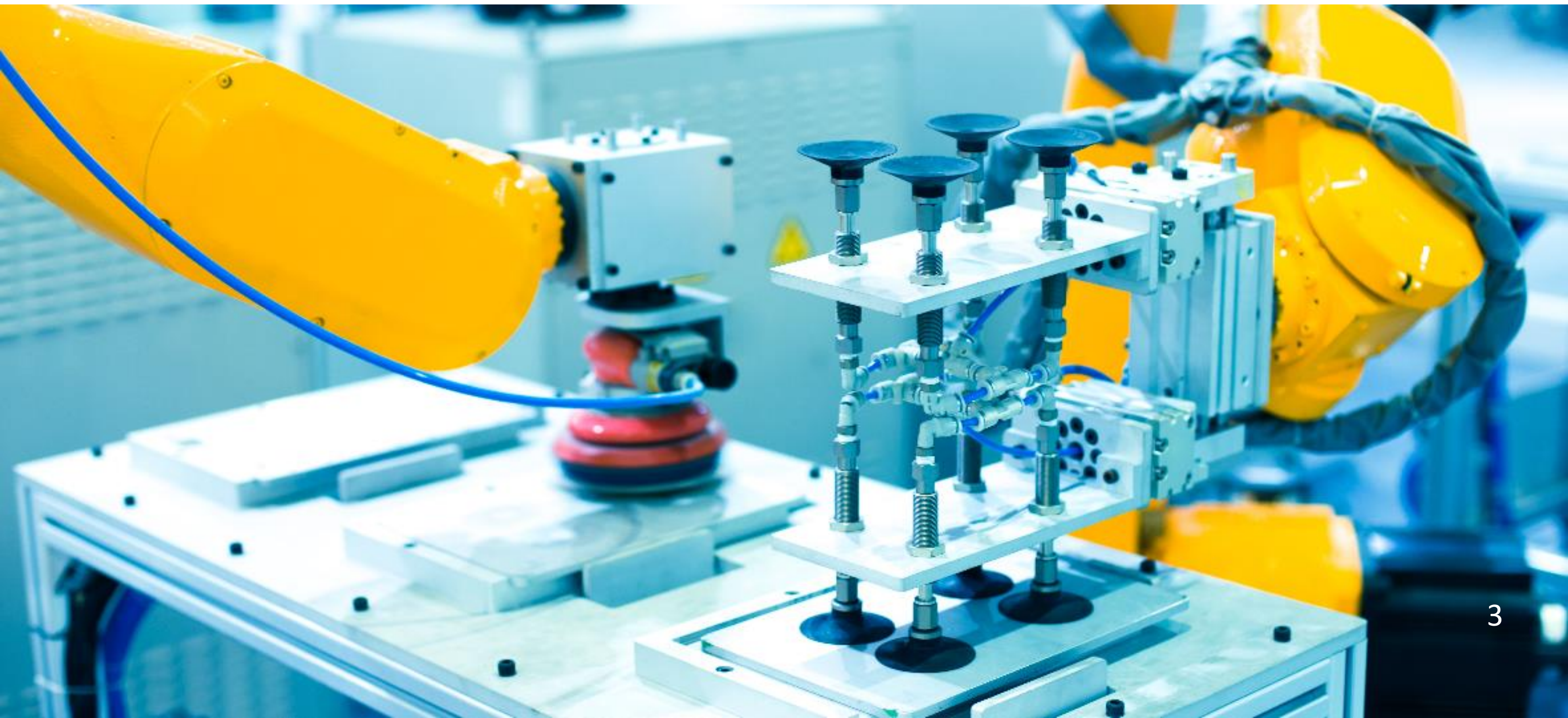
III. usage-based fees.

Payments are **compensation for** (i) the capex of the equipment/assets (and its financing), and (ii) any contracted (or non-contracted) services.

These **EaaS agreements differ** in their contracted tenors, often include automatic extensions, and have varying degrees of flexibility for (early) termination - sometimes none and sometimes considerably. In addition, contracts may provide certain other (operational) flexibilities to customers or the EaaS providers, such as the ability to switch specific assets. For example, with mobile or portable assets, end-clients may be allowed to swap assets to a degree and/or in certain circumstances. Or the EaaS provider may be allowed to swap assets.

In other words: actual **EaaS offerings can differ significantly** in the details. But the **common element is the combination of providing usage of products and related services** being offered in a bundled manner, with -- crucially -- the end-client i.e. user not owning the assets. Instead, the EaaS provider remains legal owner. In some cases, the client has the option to obtain ownership of the asset during or at end of the contracts.

“EaaS is any combined offering of equipment and related services – but offerings can differ strongly in their details”



Why EaaS?

Before zooming in on the financing topic, let us not forget to summarise the rationale for EaaS. What's in it for companies and their clients? In short: EaaS plays into the macro trends 'from ownership to usage' and cash constraints at the client side, and a diversity of reasons at the EaaS provider's side. EaaS models thus unlock value to EaaS providers as well as their clients/users. Below we develop this in more detail.

1

Client Benefits

Value of product use & services – Clients are interested to obtain usage of equipment and want to be able to rely on related services when needed, such as maintenance/repair. The client is not interested or equipped to obtain the assets and/or perform or procure the services themselves. Instead, the client values quality and reliability of the assets and services. This attracts them to a 'one stop shop' provider.

Alleviating cash constraints - Clients may be cash constrained to obtain the assets through outright purchase. Or prefer to employ their cash differently. Alternatively, they may simply lack sufficient free cash flow for large infrequent capex investments and/or the ability to borrow the required funds at attractive terms (e.g. SMEs).

- This is further boosted by electrification (e.g. of vehicles and mobile equipment, electricity and heating provision at homes and business, etc.) and the overall energy transition of the economy. Assets related to these technology trends typically have a good or great cost-benefit analysis over multiple years but require relatively high capex investments upfront compared to legacy technologies.

2

EaaS Providers' benefits

Increased sales & market share

In markets where EaaS is an underserved demand, EaaS providers can expect to increase their share of business in existing clients' wallets and/or successfully gain new clients.

Higher margins

Services related to the equipment typically enjoy higher margins compared to direct sales or traditional (non-serviced) rental- or lease offerings. Although this depends on the case, an increase of EaaS in the total sales mix often results in higher overall profitability margins.

Improved client intimacy

Through contracts that entail regular payments and servicing interactions, EaaS providers stay right on top of their clients' wants, needs and welfare. This provides them with highly valuable data.

Cross-/upsell

As the EaaS provider is close to the client and has more frequent contact points, and understand their clients better, marketing and sales are provided more cross- or upsell opportunities based on better data.

Client retention /lock-in

As clients become accustomed to relying on the equipment in combination with (quality) services, their likelihood of switching to a competitor decreases.

Extended economic life of assets

By remaining owner and servicer of their equipment, EaaS providers can extend the economic life of the assets or extract more value from them within a given timeframe. As a result, more value is extracted over the life cycle, which concludes by re-selling/re-marketing the asset (or scrapping it sustainably). As a bonus, such enhanced efficiency in the usage of assets can contribute to the circular economy, boost ESG targets such as reducing waste and cradle-to-cradle objectives. If EaaS providers are able to expand more and replace traditional sales models, for example through suitable and attractive financing, ESG objectives are further accelerated.

The EaaS spectrum

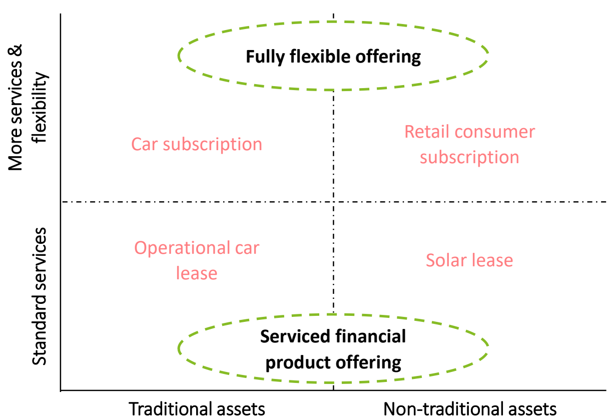
Not all EaaS offerings are equal. Indeed, a spectrum of offerings can be identified which roughly speaking has two opposing ends: the Serviced Financial Product Offering on one end, which is closest to traditional offerings, and the Fully Flexible Product offering on the other end. Moreover, these offerings can be found both for more traditional assets and non-traditional assets. As such, the broader spectrum can be visualised as in Figure 1. Below we develop this in more detail.

Serviced Financial Product Offering

One end of the spectrum are product/service combinations that are very close to traditional offerings. Take serviced car rental & leasing as an example. The traditional and dominant product in most European countries are financial lease or loan offerings towards B2B or B2C clients, enabling them to essentially purchase the asset in linear or annuity-style instalments. This end of the EaaS spectrum is different in two regards.

- Firstly, the lease- or rental product does not lead to transfer of the legal title of ownership. Instead, ownership remain with the EaaS provider during the lifetime of the contract. At most the client has an option -- but no obligation -- to purchase the asset, typically at the end of a contracted term. As a result, most benefits/rights and liabilities regarding the assets remain with the EaaS provider.
- The second differences lies in the fact that the client is entitled to a specific range of services related to the asset, which the EaaS provider is required to deliver. In exchange, the client agrees to make certain payments.

Figure 1. EaaS Landscape



Examples in red

Examples

- The typical example would be longer term serviced/operational lease- and rental-contracts. For example, with **cars and other vehicles** this is already a common product in some European markets.
- Other examples can be found in sectors where the assets have a long useful economic life for the manufacturing or resellers as well as for the user, where the user derives value from not needing to put up the full (high) upfront costs and a certainty that any services (maintenance) will be taken care of. In particular this product type is already offered in somewhat more traditional industrial equipment sectors (e.g., forklifts and specialised trucks), as well as in newer sector such as rooftop-solar and other energy-efficiency improvements such as heat pumps and batteries.

Fully Flexible Product Offering

- On the other end of the spectrum are offerings that are highly flexible.
- The contracted terms with the clients are relatively (very) short. Automatic extensions however, may result in longer effective contracts.
- Clients' have the ability to prematurely terminate the contract without (severe) financial consequences (such as the requirement to pay certain instalments or fees).
- The contracted payments which clients need to make under the EaaS contracts are, next to some base of fixed amounts, to an important degree also based on (a) services and/or (b) usage of the physical assets.

The client and/or the EaaS provider has considerable ability to request/demand/effectuate replacements of (parts of their fleet of contracted) assets.

Examples:

- Car Subscription offerings, which are similar to rental products with a full package of included services (insurance, maintenance & repair etc.), but with short tenors
- Other mobility solutions - e.g. shared cars, bikes, micro-mobility
- Device-as-a-service & IT-equipment managed services contracts - e.g. handheld devices, laptops and other IT-equipment is often offered in an offering combining financing and servicing, often with (bound to certain limitations) significant degrees of flexibility with the EaaS provider and/or the client
- Industrial equipment e.g. in material handling - users typically require a fleet which they can up/downscale easily, and wanted services included. Tenors differ from short to long

At Deloitte, we work with clients providing EaaS offerings all across the spectrum, covering all asset types and markets.

Challenges of Financing EaaS

A developed proposition from a company and market perspective goes a long way. But if the EaaS provider is going to remain owning their physical assets, how should this be financed? Indeed, scaling up an EaaS business typically leads to a significantly increased balance sheet, as the EaaS provider moves away from direct sales and/or traditional off-balance sheet leasing only. Can this be done successfully in a manner that enables the offering / business model and is financially attractive?

As a result, financing of this self-owned and self-managed fleet of equipment becomes an indispensable part of the EaaS providers' business. Indeed, Deloitte's view is that it is advisable **to consider financing already when designing the product proposition and embed financing aspects within your organisation broadly**. However, in Deloitte's experience, working with numerous and diverse EaaS providers of all asset types and broadly across the EaaS spectrum: financing EaaS can present herculean challenges. Why is that the case?

→ The sheer amounts concerned

As long as the fleet on balance sheet is relatively modest, or off-balance, EaaS providers can finance this activity through other traditional financing instruments (for instance with term loans or straightforward revolving credit facilities), from general corporate funds, or with equity. However, as soon as the composition of revenues and profits shifts significantly to EaaS, the financial profile of the EaaS provider changes considerably. Modalities and covenants of existing debt financing may no longer fit. (Cash) Returns on shareholder equity (at least in the short term) may decrease (even if the shift is fundamentally value-enhancing). Existing financiers may or may not be able to facilitate. The sheer amounts may (far) exceed typical exposure levels existing financing with traditional instruments can accommodate. For all these reasons, the EaaS provider is forced into re-evaluating its debt financing strategy holistically, and search for suitable and equity-efficient financing of the increasing balance sheet. It may lead to a fundamental departure from historic financing strategies, which is far from easy without bringing in expertise.

→ The diversity in equipment, some of which are relatively new assets

EaaS is a macro-trend that extends through many sectors and markets. Compared to traditional business models, however, the risk related to the asset remain primarily with the EaaS provider. First and foremost, the risk of the assets' value.

Financiers who were used to financing a direct sales model, will suddenly need to be comfortable with the (market) values, residual and recovery values of the physical assets. As they will be in your boat in terms of the assets' risks, they will need to understand the markets for these assets in far greater detail than before. Some lenders might already have expertise in, and therefore considerable comfort with, the assets. Typically, these are parties offering traditional sale-and-leaseback financing. Even if that is the case, the parties still need to feel comfortable with the EaaS offering and need to be able to offer modalities that suit EaaS -- which is not always obvious. Moreover, the aforementioned mostly applies to more traditional assets, whilst EaaS also thrives in certain relatively new assets classes (e.g., shared mobility or rooftop solar).

→ The diversity of offerings...

As mentioned, there is no standard template EaaS offering. The spectrum is very broad. Offerings that look similar can actually in the details differ quite importantly. This means that a financier will have to acquire in-depth understanding of each offering in detail, doing the homework every time and evaluate each aspect uniquely. Not only the economic and practical aspects of the (contracted) offering, but also its legal, tax, regulatory and accounting aspects. Moreover, -- especially relevant in Europe -- the specifics of treatment may differ per jurisdictions. Indeed, these specifics may influence what are in each jurisdiction the most suitable and attractive ways for the EaaS provider to finance its portfolio of client contracts. You either need to tailor the offering per jurisdiction, or the financing structure, or both.

→ The enhanced complexity of the business model

Embarking on EaaS entails that the providers add operational capacities that increase the complexity of the business model. Whilst this is done to enhance value delivered, this does create more areas in which the company may excel or fail. For example, EaaS providers:

- become owners of vast amounts of data which they need to manage properly;
- start having daily client-servicing and other interactions (such as financial ones);
- need to be able to monitor their fleet and client/contract portfolio in great detail; etc.

Luckily for investors, it is fully in line with EaaS providers' own best interest to be good or excellent at all such tasks. But it does require enhanced levels of scrutiny/diligence compared to e.g. a direct-sales-only model.

Financing solutions - Structured Finance

Of course, EaaS businesses can be financed through equity and many different debt instruments, or from general corporate funds. However, the upfront manufacturing or acquisition of the asset is a capex investment resulting in a cash flow dip that is only recovered over time. As a result, especially if an EaaS business grows significantly, the benefits of dedicated (structured) financing for the assets/contracts increase.

What are these asset based and structured financing solutions?

Sale-and-lease back programs

- Closest to traditional offerings provided by certain banks, bank subsidiaries, or specialised financiers
- Traditionally the offerings were only suitable for classic lease offerings to the end-client and requiring substantial individual per-contract approvals with significant processing times. However, some financiers have been able to accommodate the type of flexibility for the EaaS providers that is required more closely.
- Ownership of the asset lies with the financier (or its financing vehicle). This does mean that one fundamental aspect of the EaaS business model -- ownership remaining with the EaaS provider -- is not met. Often buyback options do exist.

Asset-based lending with a borrowing base

- This facility type resembles a revolving credit facility with the specific purpose of financing the assets on a portfolio basis. Ownership of the assets remains with the EaaS provider, although they will be pledged to the lender(s).
- The borrowing base value is determined either on book values, or on discounted cash flow basis. The allowed drawdown amount is the borrowing base value multiplied by an advance rate. The facility includes mandatory repayments in line with depreciation. However, it does have a revolving character where repaid funds can be redrawn as new eligible assets are brought into the facility.

Securitisation

- Securitisation facilities utilise similar borrowing base mechanics to asset-based lending. However, the set of eligible assets is defined more specifically, and monitoring and reporting is enhanced in frequency and detail.
- The borrowing base value is determined either by book values, discounted cash flows, or both.
- The risk/recovery position of the lenders is significantly enhanced compared to asset-based lending, through many structural features, bankruptcy remoteness of the borrowing entity and covenants at both the entity and portfolio level.
- Securitisation can be more complex and works best for large financing amounts, but if done properly, typically results in significantly enhanced financial terms & conditions.

White label or forward flow partnerships

- In these arrangements, the financier (or its vehicle) purchase the full portfolio of assets and/or the receivables related to the contracts under which the assets are provided to clients. This may lead to full or close to full financing and the majority of credit risk being transferred. However, in return the EaaS provider should expect that (close to) all returns accrue to the financier, minus fees which the EaaS provider can charge. Indeed, the EaaS provider functions more as an intermediary, albeit partnering under a dedicated framework.

Other tailor-made financings

- Some situations are simply unique, not fitting any off-the-shelf financing product. In those situations, as an EaaS provider you need to find one of those few needles in the proverbial haystack: a financing partner that can tailor a financing package to a large degree uniquely to you.

Benefits from Structured Financing for EaaS

EaaS providers which attract suitable structured financing, may enjoy several important benefits as fruits of their hard work.

Better financial terms & leverage

- Whilst depending on the company profile and specific circumstances, asset based and structured financing often enjoy lower funding rates than other traditional financing instruments, and/or (effectively) higher leverage. For equity investors, the ability to obtain structured financing may make or break the investment case.

High scalability

- As the risk profile for financiers is reduced, potential upper exposure limits in asset based and structured financing are relatively high. As a result, potential total facility sizes are enormous, especially with securitisation or forward flow arrangements.
- Moreover, as assets values are the primary metric determining amounts that can be borrowed (as long as covenants are met), rather than traditional corporate metrics such as e.g. EBITDA (there is typically no covenant on the EBITDA-multiple), funding capacity is more directly tied portfolio growth and performance.

Match with EaaS objectives

- With asset-based or structured financing, a financing package is implemented that is directly linked to your own EaaS objectives. This usually has committed funding and significant headroom to grow. And top-ups are possible if your asset base increases.
- Compared to other/traditional debt funding instruments, asset based & structured funding creates a closer funding match of balance sheet assets and liabilities, and the related cash flows. This enhances the predictability of your financial projections (and with this your enterprise valuation).
- Moreover, a switch to or addition of an EaaS offering entails operational changes as well as new objectives regarding the availability of management information and the setting up of organisational (governance) structures that are closely aligned with dedicated EaaS financing. For example, in the areas of excellence in client onboarding and monitoring, contract pricing, asset maintenance/servicing and remarketing, and fleet management. In other words: things which bring business success enhance opportunities for attractive structured financing.

What's next?

Which financing type fits your unique EaaS offering as well as your financial and strategic goals is usually not immediately obvious. There is seldom a clear-cut, silver-bullet solution. As a result, a thorough investigation into your financing options as EaaS provider is highly valuable, as well as ensuring strong project management and relevant high-quality expertise.

Deloitte Debt & Capital Advisory can assist you every step of the road to financing, or on specific parts, including:

Preparation

- Option analysis and deciding which financing route to take.

Marketing

- Bringing your financing proposition to market strongly towards potential financiers, and to the right parties.

Execution

- Negotiating, choosing, and executing the most suitable and attractive financing package

In addition, depending on your potential needs, we can involve relevant experts on a vast number of related topics, to provide you an integrated service offering. For example, in the areas of M&A corporate finance, transaction services, accounting advisory and pool audits, legal, tax and regulatory topics.

As Deloitte we have advised companies across Europe with EaaS offerings in all sectors described in this article: from traditional to more flexible offerings, from autos and industrial equipment to mobile devices and IT equipment as well as newer assets such as rooftop solar, and everything in between. We are keen to share our expertise in order to make an impact that matters with our clients and enable them to grow their EaaS businesses.

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