LEASE PORTFOLIO
— RECOVERY SERVICES —

How Equipment Lessors Make Money

Equipment leasing is a highly competitive business. Since most companies choose their leasing company largely or entirely based on the lease rate offered, the competitive pressures of the market push rates down which reduces the money which a lessor can earn on the spread between implicit interest rate in the regular lease term and a lessor's cost of funds. Some lessors may actually run a negative spread and in effect "buy" the leasing business. This leads to lessors looking for other ways to make money.

Lessors make money in the following ways:
1. Interim Rents, Advance Rents & Retention of Security Deposits
2. Fees (Commitment Fees, Restocking Fees, Usage Fees, Service Fees, Bundled Charges)
3. Timing of Cash Flows
4. End of Lease Revenue (Transition Terms, Extensions, Renewals, Sale Values, Casualty / Damage Charges, Resale)
5. Tax Benefits (Depreciation Expense)

To both increase the reach of each dollar available for investment and enhance return on investment, lessors usually discount leases (on a non-recourse basis) with lenders. The present value of the rent stream is the basis for the loan amount and the assigned rents amortize the loan. End of lease proceeds usually remain owned by the lessor (unless they are fixed and discounted as well).

Key drivers of lessor profitability are upfront fees, interim rent, retainable deposits collected early in the lease lifecycle which largely or completely offset the lessors residual exposure, and end of lease charges.

Covering Residual Exposure:
In 'plain vanilla' operating lease structures the lessor prices the rental stream to meet FASB 13 requirements – specifically the requirement that the PV of the rental stream amount to no more than 89.9% of the value of the equipment. The balance of ~10.1% is the lessors' residual exposure or the leasing company's "equity" in the deal. Excluding all other sources of revenue this residual exposure means the lessor is underwater on the transaction from the beginning and must make up that residual before earning money on the transaction.

It is common for lessors to collect significant fees prior to the beginning of the regular lease term such as retainable deposits, interim rents, and various other documentation or service fees to decrease this residual exposure and sometimes eliminate the exposure altogether. But to earn significant returns lessors are typically dependent on end of lease revenue. Since most lessees do not adequately track end of lease costs or include estimates of these costs in their lease vs. buy analysis, lessors can earn significant returns at end of lease without reducing future lease volume from any given client or market.

End of Lease Revenue:
Sales of leased assets which are returned to the Lessor can be a source of lessor profitability for certain asset types but for technology equipment, medical equipment, telco gear and many other asset types which either decline rapidly in value and/ or tend to remain in service past the end of lease, asset sales are typically not a major source of lessor revenue and profit. The key drivers of lessor profitability include Transition Terms, Extensions, Renewals, Casualty / Damage Charges, Asset Sales to Lessees.

Transition Terms:
A transition term is typically a period at the end of the regular lease term (typically 3 months) during which equipment is returned to the lessor and replaced with new equipment leased under a subsequent new lease schedule. During the transition term the lessee is usually not required to pay interim rent on this new replacement lease schedule. Many accounting departments have therefore not counted the transition term payments as a part of the basic term rents on the initial lease. In practice transition terms require perfect timing for order and delivery of new replacement equipment. Since the timing can be difficult to control the lessee typically pays the transition term as well as some extension rents and interim rent on the new equipment as equipment is replaced.

Extensions and Renewals:
As a part of the pricing and structuring of the deal, most lessors estimate – based on prior experience in a given market and with a specific client – the approximate number of extension rents a client is likely to pay. Extensions, renewals, lease rolls, partial extensions and other forms of continued payments are the most common source of lessor profitability and since they are open ended and can continue for months or years, extensions can lead to lessor returns of 40% to 200% or more.

Asset Sale to Lessees:
Most asset sales to lessees occur only after some number of extensions have taken place and are commonly tied to or rolled into additional leases of new equipment leading to further lease extensions. As a result the sales or “buy-out” deals are often priced on the low end of the spectrum to keep the related extension payments going and the overall profitability of the lessor on the relationship with the lessee increasing. In fact, asset prices at end of lease vary depending on the size and duration/age of the lessee’s portfolio and the lessors projected or booked return, rather than being based on the “Fair Market Value” of the assets. The asset price can also vary depending on whether there is a right to buy-out specified in the Master Lease or Schedule and the

details of that definition. But asset sales to lessees can be a strong driver of lessor overall return.

Asking for the price of a buying the equipment as a part of the end of lease process is a good way for a lessee to learn the anticipated end of lease cash flow expected by a lessor on an individual transaction. Asking for the price of buying out all active leases is a good way for the lessee to learn the lessor's anticipated cash flows for the overall relationship at that point in time.

Asset values of 40%-50% or more of original equipment cost of IT assets with little street value are common for buy-outs executed at end of lease term. These prices are usually negotiable and are typically far below the 40%-200% return some lessors may look for on extended and rolled leases.

Casualty / Damage Charges:
Depending on the lessor, damage charges can have a material impact on the lessor overall profitability. Many large vendors and their captive leasing arms charge higher and more frequent damage charges than banks or independent leasing companies. Banks and independent lessors typically outsource return processing and frequently get flat rates for returned equipment and as a result casualty charges are lower and less frequent and contribute less to overall profitability for banks and independents.

Summary:
The common thread linking the lease charges outside the committed rent stream – whether occurring at beginning or end of lease is that these charges are:

- Rarely considered by lessees when performing a lease versus buy
- Driven by fairly arcane contract terms and conditions
- Rarely measured by lessees as a part of evaluating the financial performance of equipment leasing
- Drive lessor financial performance

Understanding how a lessor makes money can make sourcing and measuring the performance of equipment lease programs more effective, reducing the all-in cost of an equipment lease program.