LEASE PORTFOLIO
RECOVERY SERVICES

Top 10
Equipment Lease Myths;
Why Almost Everything You Know About Equipment Leasing Is Wrong

The objective of this eBook is to provide the reader with a detailed understanding of why the generally accepted ideas about equipment leasing should be abandoned. The book lays out best practices for managing equipment leases more efficiently and is designed to help senior finance professionals reduce equipment lease risk and cost.

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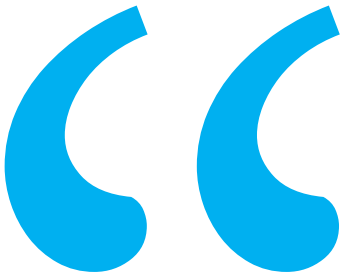
When stories meant to explain how the world works become disconnected from how the world actually works they become myths. Greek myths provided the basis for the ancient Greeks understanding of how the world operates physically (bolts of lightening thrown by Zeus) to interpersonally and politically (wars caused by meddling and squabbling deities manipulating mankind). As our understanding of how the world actually works has evolved these stories have become myths and have taken on new and different meanings. However vestiges of these ancient stories remain a part of everyday modern life. From lucky charms like the horseshoe (ancient Greek symbol of fertility shaped like the crescent moon), to expressions such as being caught "between a rock and a hard place" (from the Greek's stories of Scylla and Charybdis) these tokens of an ancient way of thinking bring sometimes outdated versions of how the word works into everyday modern life.

Equipment leasing does not work the way most CFO's and Treasurers of modern corporations think it does. Equipment leasing is not a low-risk straightforward form of financing in which lessors make money on the sale of returned and refurbished equipment. Equipment leasing began in a setting in which leased equipment generally had substantial residual value which the lessor could leverage at end of lease term to earn a profit. Lessees leased equipment to spread payments and returned equipment at the end of term. Accounting rules evolved that over time in the US accepted and built in this concept of residual value. So a set of understandings about how leasing works and how lessors make money was established. Then with the advent of rapidly evolving and depreciating IT assets everything in the leasing world began to change.



Most IT equipment has little or no residual value.”

Leasing IT equipment with little or no residual value drove a series of changes in the leasing business which shifted the way the leasing world works. However, the way lessees view leasing generally remained unchanged.

Because IT equipment becomes obsolete so rapidly leased IT equipment retained little or no residual value at the end of the typical lease term. As a result lessors incentives changed and so did their behavior. Instead of wanting the equipment back at end of lease term, lessors did not want the worthless IT equipment back. Lessors began to structure contracts that reflected this new reality. These contracts were designed to both offset the lessors’ residual exposure to largely worthless equipment as rapidly as possible and drive lessor profits. These contract changes can be broken down into two categories:

- Terms and conditions designed to offset residual exposure through Interim Rents, Advance Rents & Retention of Security Deposits and Fees - Commitment Fees, Restocking Fees, Usage Fees, Service Fees, Bundled Charges
- Terms and conditions designed to drive lessor profits through end of lease revenue: Transition Terms, Extensions, Renewals, Sale Values, Casualty / Damage Charges, Resale

The contracts supporting equipment lease arrangements changed to reflect the new reality of IT leasing and these changes spread to other categories of leased assets as well. Over time these new terms and conditions found their way into Capital leases as well.

"Leasing myths prevent lessees from reducing the risk and cost of equipment finance."

What evolved was a new reality for equipment lessees, one in which the old assumptions no longer applied. However the ancient beliefs about equipment finance remain with us to this day. This eBook examines the various misconceptions, misunderstandings and false beliefs – the myths – which prevent lessees from identifying, measuring and reducing the risk and cost of equipment leases. The objective of this eBook is to provide the reader with a detailed understanding of why these myths should be abandoned. It will also lay out best practices in order to help the reader to learn to manage equipment leases more efficiently.

CHAPTER 2:

Top 10 Equipment Lease Myths

Myth #1

“Lease Rates are the principal cost driver on leases and should be the focus of evaluating lease options”

Most US companies lease vs. buy analyses ignore the very real and easily quantifiable additional costs which companies encounter over the lifecycle of any individual lease. Most lease versus buy analyses focus on rate and issues such as the tax impact of leasing but ignore other potentially more significant costs. Many of these costs can be quantified with both a close reading of the lease documents and an analysis of recently concluded leases. Lease Rate Factors (LRFs) are not the major driver of risk and cost for lessees. One related issue is that LRFs ARE NOT INTEREST RATES and should not be the element of a lease compared to the Internal Borrowing Rate (IBR) – an issue which is addressed in detail in a "How To" Guide available for download at www.lprecoveryservices.com.

Even when accurately incorporated into a lease versus buy analysis, lease rates are only one – and the most highly commoditized – element of a lease offering. Instead of focusing on the lease rate, a good lease versus buy should include the other lease costs – such as extensions and interim rent payments – which are the more significant drivers of financial risk and the all-in lease cost of leasing.

Every lease vs. buy analysis should include – at minimum – interim rent, likely extensions, and anticipated return (or buyout) costs. Without evaluating these elements, selecting a lessor will be based on selecting the lowest rate – which almost always goes hand-in-hand with the highest risk contracts.

Example: A client with a preference for Operating Lease Structures evaluated a lease quote using a commonly structured lease vs. buy analysis. The analysis included a fairly robust analysis of tax consequences but did not take interim rent or likely extension into account.

Example (continued):

Initial Lease Versus Buy Analysis: The lease vs. buy analysis for $2 million of servers focused only on basic rental payments and showed an NPV of 85%, which led to the decision to put the equipment on an operating lease.

Things Changed: The final lease documents listed a higher lease rate factor than the proposal and the schedule included an automatic 3 month “Transition Term” as well as likely Interim Rent of 45 days per schedule and other contingent charges not mentioned prior.

Adjusted Lease versus Buy Analysis: The final accurate lease vs. buy analysis – when adjusted to include Interim, Adjusted LRF, Transition Term, and some EOL costs – produced an NPV of 103.5%

Dropped Ball: The Adjusted lease vs. buy to reflect the final changed offer was never performed and the post mortem total cost of leasing showed that the total cost of the program was far higher than the anticipated 85%.

Actual Performance Analysis: The client paid 45 days interim rent and rolled and extended various leases, resulting in an NPV of 122%... and the kicker was 75% of the original equipment on the schedule was still owned by lessor and end of lease decisions regarding return, buy-out or extend still needed to be faced.

Conclusion: Lease Rate Factors are NOT interest rates, and are only one of several elements of cost in leasing which should be included in a lease versus buy. The best approach to determining the cost of interim rent, extensions and other costs is to perform an analysis of the all-in cost of leasing for all expired and active leases with each current lessor.

Top 10 Equipment Lease Myths

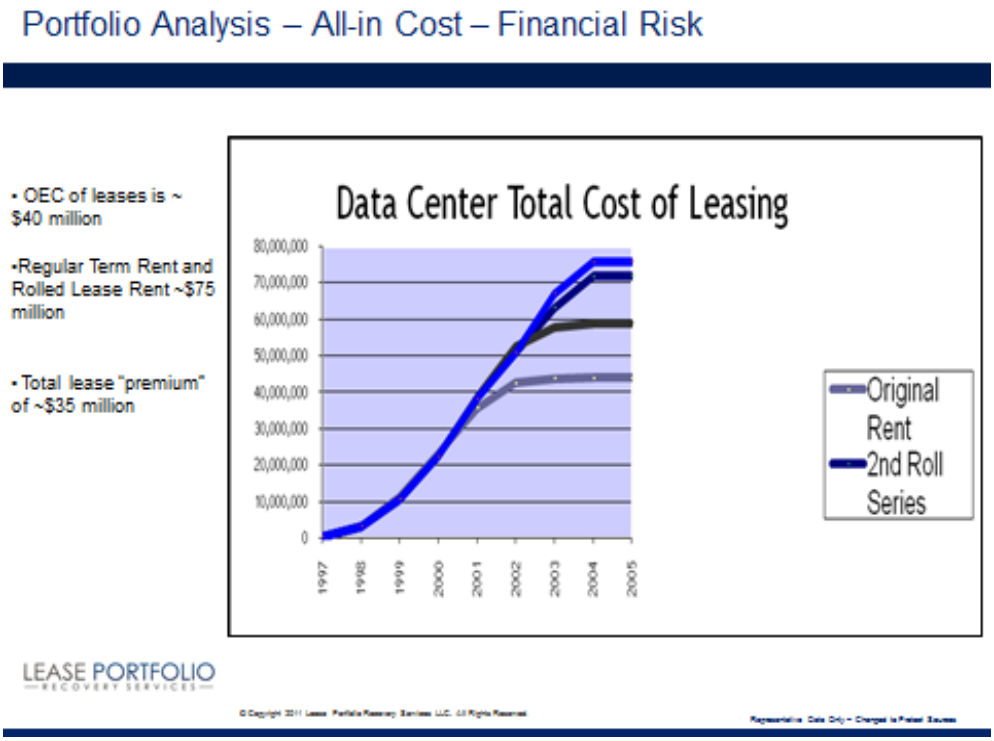
Myth #2

“IT leasing companies make the majority of their money from reselling equipment at end of lease”

IT leasing companies are not staffed with magicians. They cannot – in the case of IT leases for example – take 5 year old servers – refurbish them and sell them for 20-30% of original equipment cost to cover their residual exposure at end of lease along with their various costs and earn a nice profit. Sure leasing companies can make some money selling used and refurbished gear but almost always not enough to cover their residual exposure on the lease and earn a satisfactory net profit. Often a lessor's refurbishment operations are separate profit and loss centers from the lease origination group or outsourced to a third party.

Most IT lessors' core finance operation makes a profit on its own – most commonly based on enforced contract language such as extensions, interim rent and other charges.

Example: The analysis on the following page shows the lifecycle costs of a lease program for a firm which had never returned any equipment at all at end of lease but simply rolled the equipment from one lease into a subsequent lease. The benefit for the lessee was a reduced lease payment amounts or extensions on equipment they could not return. The lessor earned a handsome profit without ever receiving any equipment back from the lessee. All told the lessee paid ~$75 million for equipment with an original cost of ~$40 million (Original Equipment Cost - OEC). This return on investment dwarfs any possible economic benefit which could have been realized by the lessor if the equipment had been returned. With those kinds of incentives in place for the lessor it is not surprising that many lessees find returning equipment contractually and operationally difficult at end of term.



Conclusion: IT leasing companies do resell off-lease equipment but given the rapid decline in value for such equipment and the cost of processing, this activity is not the major source of most IT lessor's profitability. The key to lessor profitability is a combination of extension rents, interim rents and other charges – and carefully developing contracts that make all of these costs not just possible, but probable. All lessees (companies which lease equipment) should measure the all-in cost of their lease programs to determine how much the program costs and why.

Top 10 Equipment Lease Myths

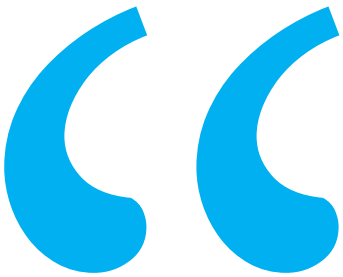
Myth #3

“Leasing is a cost effective hedge against technology obsolescence”

The reality of rapid technology obsolescence raises important questions regarding the role of leasing, specifically: which of the parties (Lessor or Lessee) in a lease transaction processes the most financial and technology risk as a result of technology obsolescence and how does this compare to the risks a Lessee may process if the equipment was purchased instead of leased? Below is an examination of how leasing affects technology risk and financial risk for Lessees relative to Lessors.

Technology Risk: Leasing an IT asset over a set lease term reduces risk of obsolescence if the lease term ends at the optimal time to replace old technology with new equipment and the lessee can easily return the equipment to the lessor. If this occurs then the lessor is processing technology risk and leasing can be an effective hedge against technology obsolescence for the lessee. However, in reality the lessee's technology-based risk is usually increased by leasing because the lease term – an arbitrary period of time – locks in the date in the future when any upgrade or technology refresh will need to take place whether that moment in time is optimal or not.

By contrast owning equipment allows a company to upgrade equipment at any point. The company may choose to refresh or upgrade – after 1 year, 2, 3, 5 years.... This flexibility puts the user and owner of the equipment in the power position in upgrade negotiations. The user and owner can evaluate upgrade offers at any time and if the deal is not a good one, the user and owner can refuse to buy from any vendor. Few considerations beyond the user and owner's needs, the condition of the equipment and related maintenance cost as well as the attractiveness of the refresh proposal demands that the client take the offered refresh deal.



> If Lessees return IT gear on time per the lease, most lessors can't make money"

However, if the equipment is leased, the lease term and the contractual conditions shift the balance of power. When equipment is leased the Lessor controls the clock – not on the first transaction – but on every subsequent transaction. Does leasing deliver enough value to the Lessee to justify giving up significant control over the timing subsequent transactions to the Lessor?

In practice lease terms typically drive the timing of upgrades. The Lessee is compelled by the lease commitment to either make upgrade decisions on a timetable which may not be optimal or pay extension rents. This reduces the Lessee's leverage in negotiations regarding those upgrade transactions and increases the likelihood that sub-optimal decisions regarding technology will be made.

Financial Risk: If the Lessee can return all of the equipment at end of the lease term with no additional costs beyond the committed payments, then in most technology lease transactions, the Lessor is processing the financial risk and leasing can be an effective hedge against technology obsolescence for the Lessee.

However, an analysis of the all-in cost of leasing programs can often rapidly establish that due to end of lease and other costs, leasing is not a cost effective hedge against technology obsolescence for the Lessee. All-in cost analyses of past leases have almost always shown that despite the fact the Lessor owns the equipment; the Lessee is processing the most financial risk.

"refresh programs are a bet that the end of lease term will be the exact moment to refresh technology."

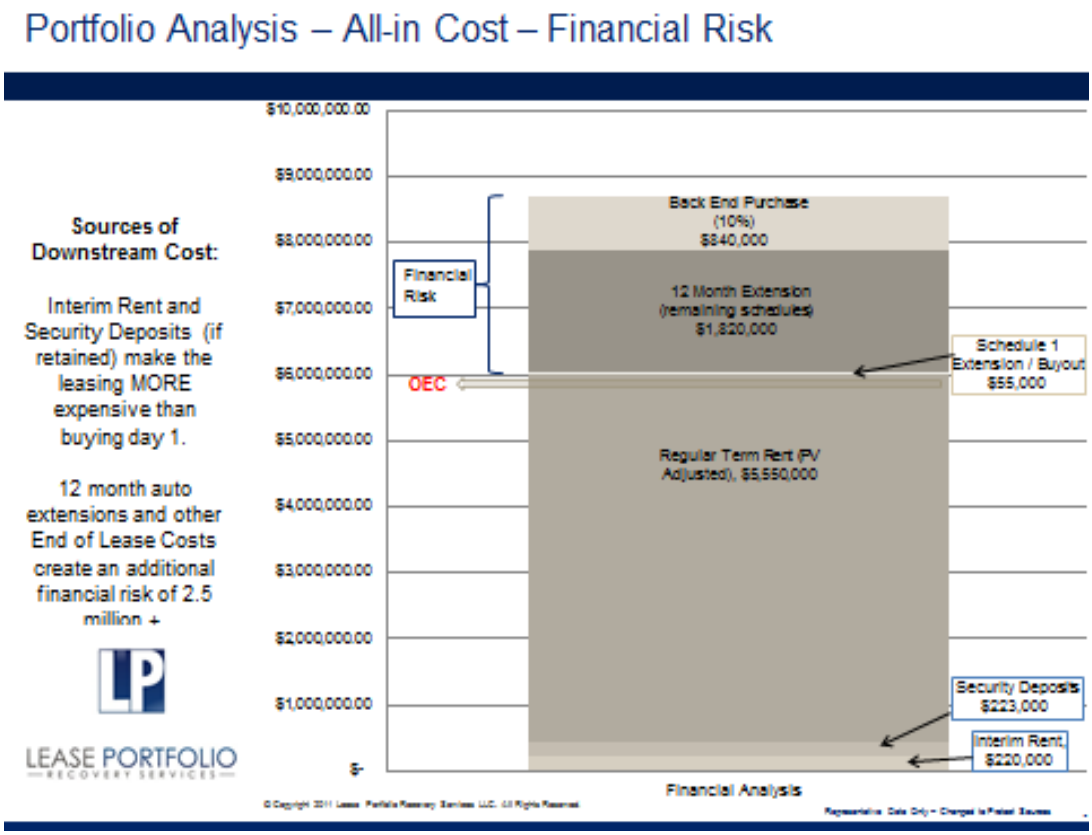
The idea that leasing is a cost effective hedge against technology obsolescence is fascinating because it acknowledges that from a financial point of view, leasing is potentially a zero sum game in which the Lessor will lose if the Lessee returns the equipment on time per the terms of the lease contract. To achieve targeted financial return net of refurbishment and other lessor costs, the lessor that receives equipment back on time at end of lease must typically sell old used equipment for at least 35%+ of the original equipment cost to earn a profit – often an impossibility. In contrast, a lessor can achieve financial return by collecting extension and other payments AND still maintain interest in the end of lease charges as additional financial upside. This upside – additional profits - are commonly based on the Lessees paying extension rents and other charges.

> “Most lessees do not track all lease costs and believe leasing reduces risk when the opposite is true”

Further, Lessors’ future profitability is commonly based on the expectation that Lessees will continue to pay extensions in the future. In contrast, Lessees typically expect to return equipment on time at end of lease and their Lease vs. Buy analysis is generally built on this expectation – adding up the regular-term lease payments and comparing that to the cost to buy the equipment and achieving a financial benefit at the expense of the Lessor who would be stuck with old worthless gear. But leasing companies are almost universally very profitable which suggests their clients must process the most risk in leasing arrangements ...

The fact is Lessees DO process the most financial risk in lease arrangements. Leases are commonly more expensive than clients anticipate, since most lease portfolios experience some material amount of extensions and other charges beyond the base term payments. Worse still, most Lessees do not track these costs and often continue to believe leasing reduces their financial risk when it actually increases it.

On the following page is an example of a refresh program in which the key driver for the Lessee was reducing technology obsolescence risk. The company wound up paying over $8.5 million for $6 million in Original Equipment Cost (OEC) of IT equipment over 6 years.



The company paid Interim Rent , Security Deposits, Extension, and buyouts which drove a total cost of over $8.5 Million for $6 million worth of equipment.

Conclusion: Leasing is NOT necessarily an effective hedge against technology obsolescence and may actually increase both technology and financial risk. Companies must be very careful when entering into leases with the intention of refreshing their IT gear at the end of lease. A key step in evaluating how leasing might reduce cost and technology obsolescence risk is to evaluate the all-in cost of existing and past lease programs.

Top 10 Equipment Lease Myths

Myth #4

“Fair Market Value (FMV) is a well understood concept which reflects the generally agreed upon approach to establish the value of equipment available at any point in time in the secondary market”

"Fair Market Value," or FMV, is often referenced, and frequently capitalized in lease documents and therefore looks like a defined term in a contract. Most lessees reading a lease contract which contains FMV assume it's defined in the lease document in some reasonable and straightforward manner. However, in many leases, FMV is not defined and when it is defined it is often defined in a manner which is extremely lessor-favorable. Many apparently benign elements of the definition such as "as mutually agreed" actually create material risk for the lessee and can result in extensions since the lessor's incentives are affected by the fact that monthly rents continue to be paid while negotiations go on.

Other contractual approaches to more tightly defining FMV like hiring an appraiser or a few appraisers have similar risks – the whole process leads to extensions since these definitions rarely include a time frame. The bottom line is that while FMV can be well structured to reflect the lessees understanding of Fair Market Value – this is almost never properly addressed in lease documentation from the lessee's point of view. If you want to put your FMV definition to the true test– just ask your lessor for an FMV quote on all of your remaining leases and see what you get back. If the number is surprising you may need help from an expert.

Poorly defined FMV has a particularly pernicious effect in IT leasing where the value of IT equipment at the end of lease term is commonly understood to be a fraction of the original cost. Because "Moore's Law" is well known, lessees assume all parties understand and agree that computer equipment rapidly declines in value and that "fair" means a very low value.

However, it is very common that the FMV quoted by lessors at the end of lease does not reflect the cost to buy a piece of replacement equipment. When IT lessees actually ask for a lease buy-out amount for a substantial amount of equipment at the end of lease, they are commonly shocked when the lessor's fair market value quote is 20-30+% of the original value of the gear. Every lease which contains ill-defined FMV language contains substantial risk and the negative financial consequences can be material.

Example – One way that FMV language can be constructed to favor the Lessor is for the FMV definition to be "in-place" versus "de-installed and available for delivery." Consider a retail store which leased much of its store fit out and display equipment and signage. If valued on an in-place basis if purchased by the lessee, the equipment clearly has significant value to the company. How would the public know where the store is without the signage? However, how much would an old sign be worth on the secondary market to a third party? Very little. Similarly, computer equipment sitting on desktops and in the overhead compartments of airplanes above traveling sales people across the country have relatively high "in-place" value to the lessee but their real secondary market value is likely minimal.

Here is an example of some Lessor favorable language for an IT lease: *"Fair Market Value means the price obtainable for the Equipment in an arm's length sale or lease transaction (as applicable) between informed and willing parties, neither under compulsion to contract, for the sale of Equipment* ***utilizing the assumption that the Equipment is installed and under continuous and uninterrupted use by the buyer / user.***"

In a situation in which the Lessee wants to purchase the equipment at end of lease, the equipment has significant value when in use / in place, but virtually no value on the secondary market.

Conclusion: FMV is an element of lease contracts which can create significant risk for lessees. The most certain way to quantify FMV risk on existing leases is simply to ask your lessor(s) for an FMV quote on all of your remaining leases if they were bought out today. This effort will have the additional benefit of giving you a reasonable picture of the downstream financial exposure which exists in the portfolio.

Top 10 Equipment Lease Myths

Myth #5

“Most companies return 100% of leased gear on time per the contractual requirements”

Not only is this myth both ubiquitous and wrong, it exposes a key difference in the way lessors and lessees understand the economics of leasing. Lessors count and plan on receiving some version of extension payments from most IT equipment lease transactions – it is core to their business model. IF LESSEES RETURN ALL RAPIDLY-DEPRECIATING (Technology) EQUIPMENT ON TIME TO THEIR LESSORS THEN THE LESSORS WOULD STRUGGLE TO EARN ANY PROFIT AT ALL. Please read that sentence again.

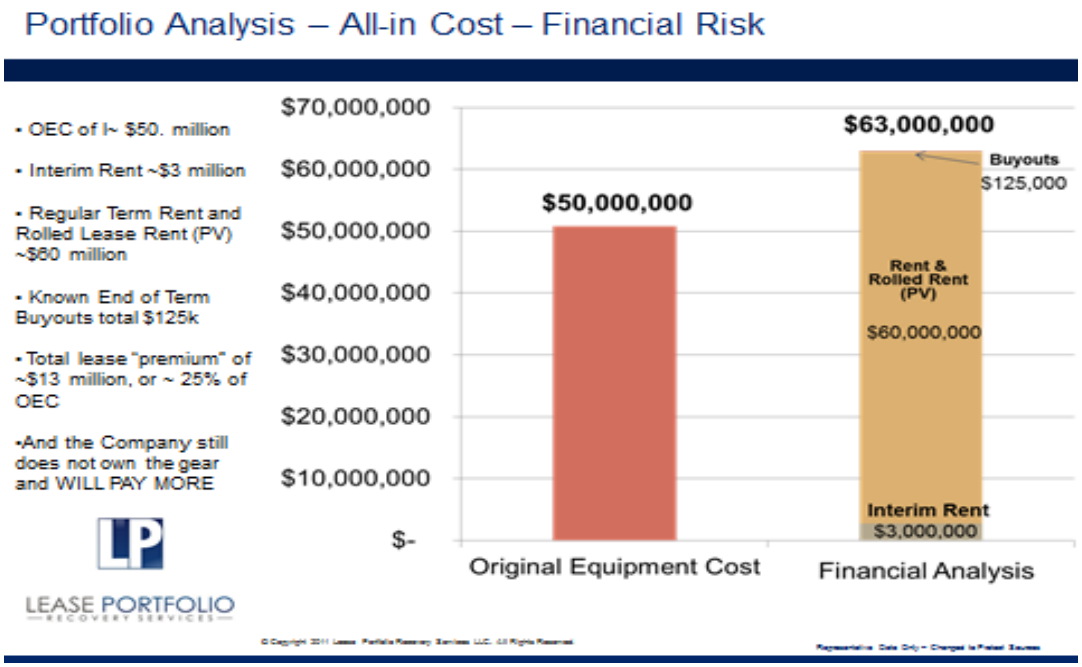
However if you talk to the lease manager at most companies a version of the following will almost certainly be the description of the program**:** *"We used to have some issues with leasing – especially at end of lease - but we changed vendors or contracts with the existing vendor, and now we have no problems at all – the program is running smoothly. We return almost 100% on time with no additional charges and the lessor is very flexible and works with us to maintain that level of performance."*

Here are a couple of interpretations of what that statement almost always actually means:

"We return 100% of the equipment we can return. We then re-lease the equipment we cannot return under new leases at reduced rental amounts usually combined with new equipment. When these new leases come to conclusion the process repeats. Nobody ever notices because we get the new equipment and the relative budget impact is small."

"We return what we can and we extend some leases as we complete the return. After having paid extensions for a long period of time the lessor sells us the equipment at a nominal price. As a result while it looks like we return 100% of our equipment and bring leases to conclusion without any costs beyond the monthly rentals – it's actually more expensive than that. The numbers work within our budget and I have not found it necessary to talk with the folks in treasury about these additional costs."

Below is an analysis of a lease portfolio which was described as working perfectly – returning 99.7% of equipment on time with no additional cost. The analysis showed the company had committed to pay $62 million for $50 million worth of gear through extensions and "rolled" leases AND THE COMPANY STILL DOES NOT OWN THE EQUIPMENT when the currently active leases end. If Most companies returned 100% of the leased equipment on time, leasing would not be such a highly profitable business.



Conclusion: Your lease portfolio is almost certainly not performing as you initially planned – even if your budget has not been affected. Flexibility in the relationship with a lessor is valuable – but the cost of this flexibility should be measured. The best way to do this is to evaluate the all-in cost of the lease program with each lessor.

Top 10 Equipment Lease Myths

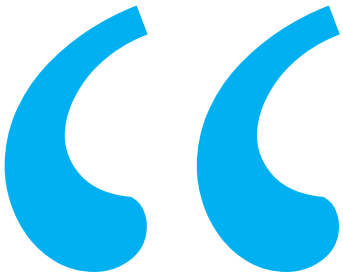
Myth #6

“Going into default on a lease shifts the risk to the lessor since the equipment isn’t worth much and not worth repossessing”

While it is true that IT and other assets experience such a steep reduction in value that repossession is less attractive to the lessor than other options in the case of client default, virtually all equipment leases contain numerous attractive options, and combinations of options in addition to repossession, for the lessor in the event of default. In addition “cross default” provisions create additional risks of default the implications of which are not commonly appreciated.

This topic often comes up during an end of lease negotiation of an “open-ended” lease (Fair Market Value / Operating). At the end of lease the clock works against the lessee. The lessee is obligated to continue to make payments until the lease has come to conclusion. The lessor does not typically have any reason to rapidly collect all the equipment and stop the payment obligation. The incentive is quite the opposite. The responsibility is typically the lessee’s to return the equipment so the lease can come to conclusion and the lease payments can be stopped. If the lessee fails to make payments just about every equipment lease in existence throws the lessee into default with expensive results for the lessee.

That the lessee holds the cards because the lessee can simply stop paying and the lessor must try and collect equipment is the kind of unmitigated balderdash that pushes clients into expensive avoidable default situations. In addition many equipment leases are structured so that a lessee may fall into default but be unaware of their default status.



Cross default language in many leases can trigger onerous penalties”

This is because many leases do not require that the lessee be informed in a timely manner that any particular event – such as being late on a payment - is an event of default. For all these reasons gaining a thorough appreciation of default and its implications in the context of each firm’s equipment leasing contracts is important.

Other important issues in default include “cross-default” provisions (Lessee defaulting on any other material financial obligation triggering a lease default), whether Lessor has to notify the company that they are in default, and the length of the cure period.

Example: The following are examples of default, notice and extension provisions which create a material risk for the Lessee and are slightly modified examples of real language from various contracts.

- Cross Default would kick in if *“Lessee defaults under or otherwise has accelerated any material obligation, credit agreement, loan agreement, conditional sales contract, lease, indenture or debentures;”*

Other provisions which trigger Default in the same set of lease documents from various Lessors included examples like the following:

- "*Lessee fails to pay any Rent or other amount due under any Lease within five days after it becomes due and payable;"*

"Most leases do not require the lessor to inform the lessee that an event of default has occurred."

- "*Lessee fails to perform any other covenant, condition, or agreement made by it under any Lease, and such failure continues for 20 days;"*

Nothing in the above requires the Lessor provide the Lessee notice of a Default event AT ALL, including at the time of the infraction. That notice can be made at any time – even an inconvenient time like end of day December 24th. And when notice of the event is provided the Lessor is not obligated to highlight that the event triggers Default.

The results of Default are usually substantial and allow the Lessor to "*pursue and enforce, alternatively, successively and/or concurrently..."* many of the following:

- *Accrued and unpaid Lease charges due and owing*
- *Lease Charges as and when becoming due*
- *Accelerate all Lease Charges and other amounts due and/or likely to become due from the date of default to the end of the lease term (sometimes using a discount rate)*
- *Cause to become immediately due and payable and recover from Lessee the Casualty Loss Value*
- *Terminate any or all of the Lessee's rights, but not its obligations*
- *Retake possession of the equipment without terminating the Lease Schedule*
- *Require Lessee to deliver the Equipment*
- *Proceed by court action*
- *Pursue any other remedy*

Conclusion: Always pay rents as due and satisfy other contractual obligations related to leasing. Under no circumstances does it make sense to pursue options that will put you at risk for being placed in default. The best approach to negotiating with a lessor is to do an analysis of the all-in cost of leasing with the vendor so that you can understand the full cost of the program and the sources of that cost, and use this information as leverage during the negotiation on the items which can be negotiated such as Fair Market Value.

Top 10 Equipment Lease Myths

Myth #7

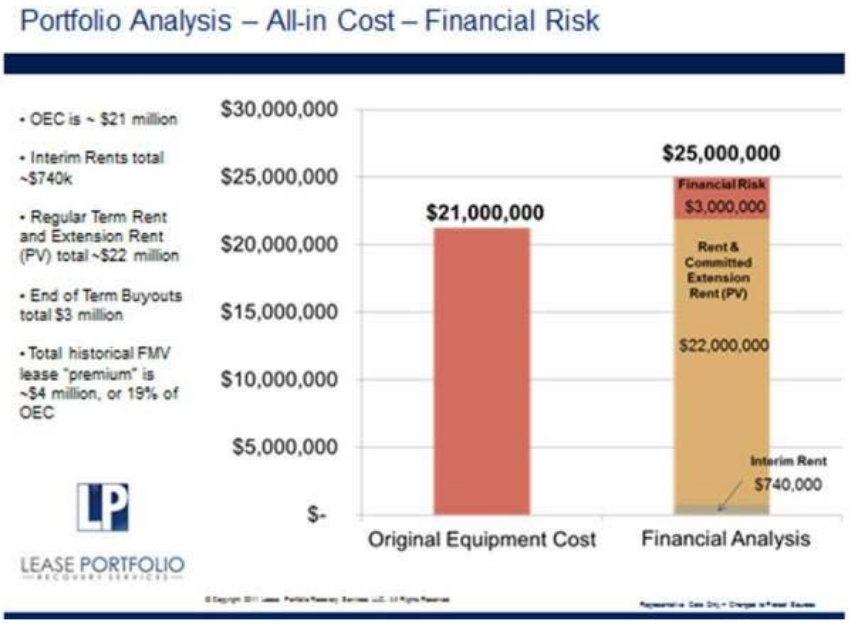
“Like-for-like return is a powerful tool for eliminating end of term costs”

Like-for-like return, also known as “serial-number substitution,” can be very dangerous when it is a part of a gentleman’s agreement with your leasing representative but is not captured in your lease contracts. When defined in a contract, like-for-like can solve some problems associated with end of lease costs but is no panacea for reducing all-in lease costs.

Like-for-like return allows a lessee, instead of returning the precise piece of equipment listed on the lease documents for a specific expiring lease, to return another piece of equipment – usually similar or almost identical to the piece of equipment listed on the lease. Often, equipment from leases which are still active and have not come to conclusion is returned in the place of lost or un-returnable equipment on leases which have come to term. In some extreme cases “like” equipment may be purchased by the lessee and sent back to the lessor in place of un-returnable equipment.

Like-for-like return usually locks a lessee into some sort of buy-out when the lease portfolio as a whole comes to conclusion. This is not necessarily a bad thing but it is an exposure which lessees need to understand and prepare for. In addition if these “like-for-like” arrangements are not formally agreed to in the lease documents there can be exposure to additional costs including default and the related costs.

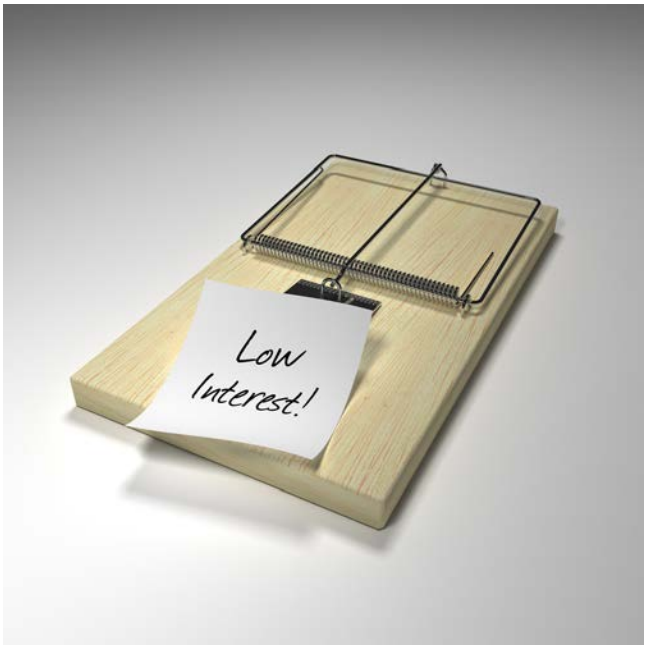
Example: The lease portfolio below included a gentleman's agreement around like-for-like return. The company 'stole from Peter to pay Paul' for many years returning equipment from one lease to fill a gap of last or un-returnable gear on another lease. When the company decided to stop leasing the lessor changed its approach and would no longer accept the like-for-like return (which was not supported by the contract) which left the lessee with only two options – buy out the remaining leases or pay extension rents forever. What had started as a few servers missing from a lease here and there had turned into a $3 million problem.



Conclusion: First, make sure that your like-for-like / serial number substitution language is in your Master Lease Agreement. Second, even if it is, often times this language solves the short term problem of returning gear on an individual schedule but virtually ensures that when the portfolio is brought to conclusion there will be substantial end of lease costs – most commonly realized in a buyout. To prepare for the buyout companies should conduct an analysis of the all-in cost of leasing to determine the full cost of the program. This information provides context and leverage in buy-out negotiations with lessors.

Top 10 Equipment Lease Myths

Myth #8



“Lease extensions at end of lease are uncommon and should not be considered in a lease vs. buy analysis”

End of lease (month-to-month and longer) extensions are not in any way unusual. In fact most lessees struggle to return leased equipment and end up paying some version of extension rents on the majority of their equipment leases. Lessors know, at lease inception, that some extensions are likely. Lessees – if they have evaluated the all-in cost of leasing would also know this and could include an estimate of extensions in their lease vs. buy analysis. However, each lease extension is commonly viewed by lessees as a one-off unique event – which is a costly mistake.

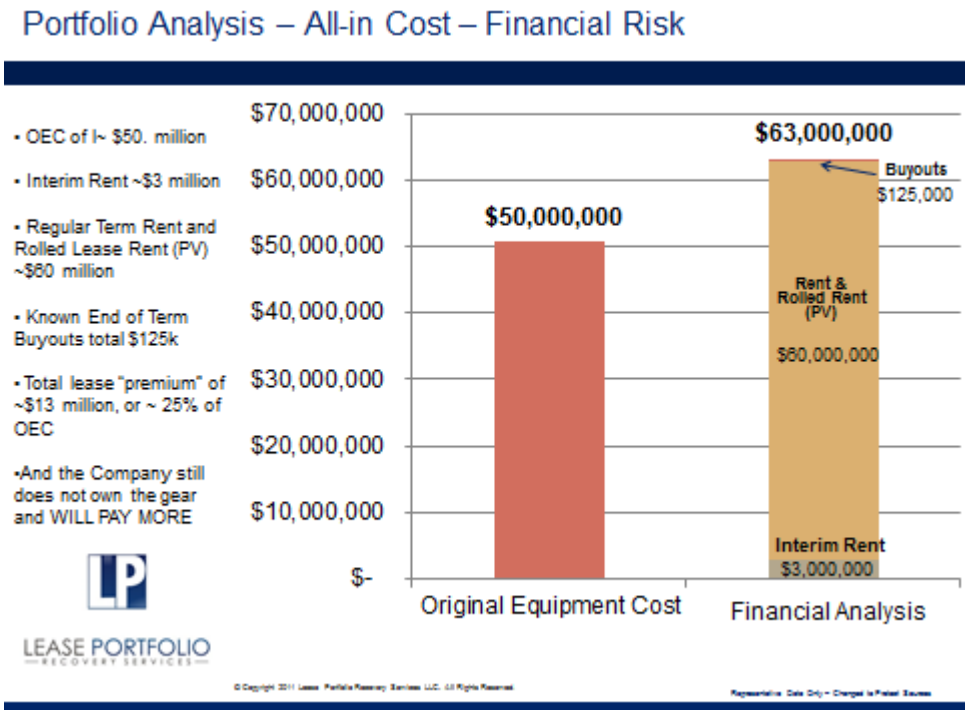
Returning equipment per the terms and conditions of the master lease is usually contractually and operationally difficult. At end of lease extending the lease often makes short-term, or budgetary good sense, since prior payments are sunk costs and these should not be considered in a financial analysis to support a decision at the current time zero. The decision is usually driven by either the desire to give more time to operations to find the gear and return it, to give IT or another asset owner more time to make an upgrade or some other business decision, because notice provisions were not met or because it will take more time and effort to meet contractual return requirements. For all these reasons any individual equipment lease extension are often easily justified.

However, although the monthly budget impact may be relatively minor, an all-in cost analysis may show that extensions rapidly change the economics of the lease. Looking at the extensions as part of a whole rather than on their own may cause a company to reevaluate the relative importance of the short-term budgetary impact of the extensions.

Long extensions or rolling the remaining unreturned equipment into a new lease should be analyzed closely since at end of lease the equipment still must be returned or purchased.

Regardless of the business decision or other driver at the end of the extension period, the up-front lease vs. buy analysis used to evaluate future leases should be updated taking the likelihood of future extensions into account.

Example: In the example below an analysis of the all in cost of leasing showed that due largely to a track record of consistently extending and rolling leases the lease program was far more expensive than expected. Each individual extension decision may have had a sound rationale but in the end this pattern of decision making created an expensive program. The company paid or were contracted to pay $63 million for 50 million worth of equipment and still did not own the equipment at end of lease term.



Conclusion: A detailed analysis of the all-in cost of leasing to date should be performed. The lease vs. buy analysis should be modified to include extensions and other costs that are likely to occur as shown by the analysis.

Top 10 Equipment Lease Myths

Myth #9

“All we have are capital leases – we have no risk in our lease portfolio.”

The upcoming lease accounting changes, as well as various reporting requirements, are driving many CFOs to stop all "off-balance sheet" leasing activity. Many CFO's sent the message to all departments – "no more operating leases – only capital leases from now on." For lessors offering low priced but high risk operating lease contracts, this posed a real threat to their business. If companies would no longer sign anything but low risk straight financing deals – $1 out or other defined bargain purchase price capital leases – demand for the low rate / high risk lease business would dry up.

But lessors have found an ingenious way to leverage the current accounting rules to maintain and extend their profitable businesses. Under current accounting rules (FASB 13) capital leases are nothing more than leases which fail to meet one of the operating lease bright line tests:

- The lessor does not transfer ownership of the asset to the lessee at the end of the lease term.
- The lease does not contain a bargain purchase option
- The life of the lease is less than 75% of the economic life of the asset.
- The present value of the minimum lease payments is less than 90% of the fair market value of leased property.

Therefore, a capital lease may still contain all of the risky terms and conditions (end of lease return, interim rent, etc.) contained in a current fair market value operating lease. Lessors have leveraged the details of the accounting rules to sell these high priced and also high risk "capital" leases to CFO's and Treasurers who went looking for zero risk equipment leases

“Capital leases can contain options and notice requirements which generate significant risk”

It’s a fascinating story of self-preservation, ingenuity and unintended consequences:

First let’s examine a couple of ways in which leases are structured to receive operating lease treatment under the current accounting rules. Most operating leases are priced so that the PV of the rental stream equals less than 90% of the value of the equipment. Also most operating leases do not contain a bargain purchase at end of term – such as a $1 dollar out – and instead usually contain end of lease options which are profit centers for lessors. Three typical end of lease options are (1) return the equipment under certain terms and conditions (this can be difficult or impossible in many cases), (2) extend the lease or (3) buy the equipment at a Fair Market Value – often structured so that the FMV will be determined by the lessor. The extensions and potentially high cost of the FMV buyouts allow lessors to offer low rates because they can count on receiving some extension rents or a high priced buyout at end of lease term. Lessors essentially take a bet that the lessee will extend the lease in most if not all cases and offer a low rate as a result.

Properly structured $1 out capital leases, by contrast, are rent to own financings with no extensions or other end of lease charges. As a result, capital lease rates are typically much higher than operating lease rates because lessor profit is largely or entirely built into the rate.

"Capital leases are simply NOT operating leases. Capital leases are not by definition $1 out leases."

For the purposes of this discussion these low risk capital leases will be referred to as "properly structured capital leases". Lessors that, due to their business model (investor return expectations and or other factors) cannot offer properly structured capital leases soon realized that based on the current accounting standard capital leases are nothing more than "not operating leases". To meet the CFOs "only capital leases" directive lessors could offer high risk Capital Leases: For example leases which were priced to break the "less than 90%" bright line test and therefore failed to meet the standard for operating treatment or leases which contained an option to buyout at end of term for $1 but with restrictive notice and other provisions which made exercising that option difficult or impossible and an option to extend. In short lessors began offering high risk capital leases.

Let's break this down a bit – due to anticipated accounting changes which were to eliminate the operating lease category and bring leases on balance sheet, CFOs wanted no risk "$1 out" lease-to-own lease arrangements and they called these "capital leases." But under current accounting rules capital leases do not need to be low risk – they only are required to fail to qualify as operating leases. So what has been happening for years now is companies have been putting in place high risk leases which the CFO views as zero risk. As these leases come to term and go into extension companies will face unexpected costs. And to make things worse, these leases are usually priced higher than they need to be – a case of not having your cake and not eating it too.

Conclusion: If you think you have only Capital Leases - that may be true – but it does not mean they are risk free at end of term. An analysis of the all-in cost of leasing will determine your lease portfolio has material end of term financial risk.

Top 10 Equipment Lease Myths

Myth #10

“Our Company Negotiated a Good Master Lease and Therefore We Have No Equipment Lease Risk”

There are some exceptional Master Lease documents which can be negotiated with certain lessors. These documents are an excellent start when putting in place a low risk and cost leasing program but only a beginning. A best practices- based program includes both:

- Negotiation of ALL lease documents
- Measurement of Financial Performance Going Forward

Negotiation of ALL lease documents

Virtually all Master Lease documents defer to the individual transaction documents generally called “Lease Schedules” in the case of conflicting terms. This makes sense since many Master Leases are intended to cover varying types of equipment. As a result certain terms such as “Interim Rent” or “Fair Market Value” may be incompletely defined in the Master Lease or if well-defined subsequently over ruled by the terms as defined in schedule. The Schedule and other lease documents can lead to increased lease cost and risk and should be the focus of lease negotiations up-front in the process AND monitored going forward to ensure terms do not change to the disadvantage of the lessee.

Other documents such as certain riders, Master Schedules or addenda as well as simple documents such as Acceptance Certificates should both be negotiated up front with the Master Lease so that all parties agree on definitions.

Actual Master Lease Examples:

"Each Equipment Schedule shall incorporate the terms and conditions of this Master Lease Agreement and create and constitute a stand-alone lease which shall be separate and distinct from any other Lease, Equipment Schedule, agreement, arrangement or understanding that has been or may be entered into between the Parties, whether or not incorporating the terms and conditions of this Master Lease Agreement."

"In the event of a conflict between provisions of this Agreement and a Schedule, the provisions of the Schedule shall control."

Lease Documentation to Monitor and Negotiate:

- Master Lease Agreement (MLA)
- Certificate of Incumbency
- All MLA amendments / addendums / riders
- Initial Lease Schedule Document (prior to equipment take-downs)
- Certificate of Acceptance Documents
- Countersigned Final Lease Schedule Document
- All Schedule amendments / addendums / riders
- Stipulated / Casualty Loss Tables
- Equipment Lists / Schedule Exhibits
- Sales Agreement(s)
- Schedule Termination Documents

Measurement of Financial Performance Going Forward

Some lease terms and conditions work together in surprising ways. For example being 10 days late on a payment may constitute "failing to meet all obligations" as required by the lease triggering default. Default may require no notice from lessor to lessee meaning the lessee could be in default and be unaware of that fact until it is mentioned by the lessor at end of lease. Such events should trigger a renegotiation of the Master Lease and other documents to reduce this risk going forward.

Measurement of the financial performance of leases which have come to conclusion may expose that deposits are frequently retained, or 6 month extensions are common or 30+% end of lease FMV buy-outs occur with some frequency. These outcomes should be measured and also kick off negotiations to improve the Master Lease and other documents to reduce program cost and risk.

Conclusion

Simply having an apparently "clean" or reasonable Master Lease is a good start to a best practices Equipment Finance program. Driving continuous improvement through monitoring for the consistency of language on all negotiated documents, measuring the financial performance and using that data to drive continuous improvement are the next steps.

CHAPTER 3:

Measuring the All-in Cost of Leasing

Reality Check: How Equipment Lessors Make Money

Leasing myths are based on a lack of understanding of how equipment finance operates in the real world. This last chapter lays out the basics of how leasing actually works and how lessors make money.

Top 10 Equipment Lease Myths

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 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 major 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 are 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 number of extension rents a client is likely to pay. Extensions, 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 lessors look for on extended and rolled leases.

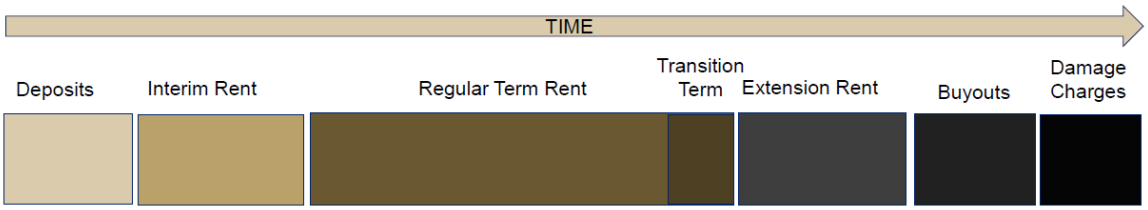
Casualty / Damage Charges: Depending on the lessor, damage charges can have a material impact on the lessor overall profitability. Many large Vendors and their captive leasing arms charge higher and more frequent damage charges than banks or independent leasing companies. Banks and Independent lessors 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 as a part of evaluating the financial performance of equipment leasing drive lessor financial performance

Anatomy of an Equipment Lease



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.

THANK YOU

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