

# A Qualitative Model to Optimize Lessor Profit Through Lease Syndications

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The secondary market for seasoned leases is vibrant. Low interest rates, active portfolio management, profit taking, and equipment diversification are just a few of the factors responsible for the groundswell of activity in the lease secondary market that provides an opportunity to sellers and purchasers.

Whatever the reason, the market has demonstrated seasoned leases will continue to be sold at a brisk pace. Seasoned leases are defined here as those that have one-third or less of the original term remaining. This article addresses investments whose underlying equipment has a low technological obsolescence factor. Such assets include locomotives, aircraft, barges, ocean tankers, rail cars, drag lines, and production plants.

A number of articles exist to explain whether this activity will continue and how to manage the legal and tax issues arising from these secondary market syndication efforts. What is equally—if not more—important for executive managers and syndicators to appreciate is the syndication process: how to obtain the best price from prospective purchasers via a well-defined syndication and marketing strategy regardless of whether the transaction is an asset sale, stock sale, or like-kind exchange. This management process is a critical factor affecting the profitability of a lease/portfolio sale, yet it is often taken for granted.

This narrative will attempt to explain the present generic procedure in marketing a seasoned lease, offer an alternative method to maximize the sale price, and propose a model that every lessor may employ to maximize the profitability from a seasoned lease sale or trade in the secondary market. Lessees looking to sell equipment under a sale leaseback will also benefit by employing these standards.

Today's procedure of syndicating a seasoned lease is generic and all too often lacks a well-defined marketing strategy. This procedure consists of preparing an offering memorandum and distributing it to a wide array of prospective investors. Two major problems arise from this typical procedure. First, the generic seasoned lease offering memorandum commonly consists of three main components: the transaction summary (lessee name, cash flows, end-of-lease options, transfer provisions, etc.), lease contract, and lessee's financial statements.

While this information is important to include in the memorandum, it is only a compilation of factual historical information. These components do little to explain the important merits of the investment that ultimately drive the prospective investor's offer price.

Second, limiting the distribution of the memorandum to prospective investors is insufficient if the objective is to obtain the optimal price. This is due to the fact that the lease secondary market is inefficient. Offer prices are impacted by third-party appraisers and other third-party asset managers who are not presented with—and do not otherwise have—all the relevant information regarding the asset and lessee.

**The market has demonstrated seasoned leases will continue to be sold at a brisk pace. A well-defined strategy is essential to marketing them and maximizing the sales price.**

## THE MARKETING TOOL

The offering memorandum is the syndicator's primary marketing medium, yet its preparation is often treated as an administrative necessity. The preparation of an offering memorandum should be considered a marketing opportunity to maximize profit or minimize a loss. It must be strategically crafted by the syndicator to provide information that concisely, credibly,

accurately, and comprehensively allows the reader to recognize and understand the merits of the lease investment.

The memorandum must do much more than identify the lessee, the equipment, remaining cash flows, end-of-lease options, and lease provisions. It should be more than the starting point for the prospective purchaser to prepare an analysis on the underlying asset. The seller should prepare this analysis and present it for the purchaser's critique and modification, if applicable. The syndicator should act as a marketer, not a sales administrator.

To strategically prepare an offering memorandum for a seasoned lease, the seller must understand (1) the most important component driving the offer price of prospective purchasers and (2) the residual forecasting process followed by most prospective purchasers.

### THE CRITICAL FACTOR

Seasoned leases are tax-exhausted investments with relatively few rentals remaining. The present value of the remaining known pre-tax free cash flows might be 0 to 50 percent of the bid price. The only unknown and critical cash flow left is the residual that is estimated by the prospective purchaser's equipment manager. It follows that the equipment manager—not the credit analyst, originator, or executive manager—is the most important person determining the offer price of a seasoned lease. Accordingly, the syndicator should market the investment with a wealth of information and analysis regarding the asset and the market for the asset, in an effort to answer all the questions an equipment manager might have to promptly and properly estimate the residual.

Since the seller is the owner of the asset, it should present an accurate case to forecast, not guarantee, the likely residual and share this information with the market. However, this requires much more than a third-party appraisal if the seller's objective is to maximize return.

#### ***Typical Asset Information***

Let's look at the typical asset information presented today in most offering memorandums. This information usually consists of a brief statement identifying the type of asset under review, such as a 70-ton boxcar, when it was built and by whom, its original unit cost, and its marks (equivalent to a serial number or N number for aircraft). This information is important but insufficient to

accurately estimate the residual. First off, although forecasting residuals is not an exact science, the more information the asset manager has the better he can assess the likely residual value. Insufficient information breeds uncertainty, which usually leads to conservative residuals.

Second, residuals are not exclusively a function of original cost, age, and so on, so why present only these variables? Other variables such as whether a boxcar is grandfathered or a 727 aircraft hush-kitted are equally important variables to consider.

Third, the investment asset is usually described insufficiently: "70-ton boxcar or 727-200 aircraft built in 19XX." This is grossly inadequate information to assist the equipment manager in determining the residual. It can have a detrimental effect on the residual assumed and the resulting offer price. For instance, the same 70-ton boxcar would be better described as "a 70-ton, plate C, single sliding door boxcar equipped with 50K nailable steel floors, all smooth interiors, 15-inch end-of-car cushioning unit, 84 lading anchors boxcar."

Offer prices by prospective purchasers vary widely, both because the market is inefficient and the modicum of asset information typically provided by the seller doesn't allow the asset's residual to be accurately assessed.

#### ***Determining Residuals***

Knowing how equipment managers determine residuals from the limited information they receive is crucial for the syndicator to understand in order to properly market a seasoned lease for optimal results. One must recognize that equipment managers are busy working on a myriad of different asset types ranging from locomotives and tankers to aircraft for a host of salespeople under severe time constraints. In reality, equipment managers don't have the time or human resources to be an expert in all fields, ascertain the exact attributes of an asset, or thoroughly research the market for that asset unless this information is given to them by the syndicator.

Unfortunately, generic memorandums don't present an analysis of the underlying asset. As a result, equipment managers use the limited information presented and rely on their own experience, other equipment managers, and several third-party appraisers via telephone conversations to estimate the asset's value and underlying market trends. The drawback of this to the seller is that if the equipment manager and appraisers don't know the in-depth details regarding the asset—how important is it to the lessee's business, was it just rebuilt, and so on—then how can anything but a conservative residual forecast result?

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Furthermore, assets such as locomotives and ships are often upgraded during the lease term by the lessee, but the original equipment specifications won't highlight these upgrades, which can have a positive impact on the asset's value. Lastly, if the equipment manager doesn't have specific details regarding the asset, he unknowingly forces the appraiser to make random assumptions regarding the asset's condition, commodity carried, miles/cycles/hours on the asset, and so on—assumptions that may or may not be correct. When this occurs the syndicator loses control of its marketing effort, because random and unknown information ("interference") is entering the residual estimation process.

We know the residual estimate is the most critical component affecting the bid price of a seasoned lease and that residual forecasts are often conservative because the syndicator provides incomplete information to the prospective purchaser. Can the syndicator manage the expected residual assumption and generate a consensus for the equipment manager to assess? Yes.

## THE SOLUTION

The solution resides in following a market-ing strategy of preparing a comprehensive marketing memorandum, which presents the typical generic components (transaction summary, lease, and lessee financial statements) along with an analysis of the asset, its market, and its likely importance to the lessee. This should be complemented by a recent appraisal and inspection report obtained by the seller from a reliable source as well as current photographs of the asset and legible maintenance records. This in turn will generate a consensus of the asset's value for equipment managers to evaluate.

Providing these essentials allows the syndicator to control the flow of information and minimize the interference that often accompanies the generic syndication effort.

As with any marketing program where one is attempting to influence a prospect's decision, the objective of a marketing oriented syndicator, via its offering memorandum, is to provide critical (not just generic), incremental information to those individuals who bring the most to bear on the decision-making process.

### ***Involving Appraisers***

But this comprehensive memorandum alone isn't enough. This information must be disseminated by the seller not only to prospective

investors but also to appraisers who might be contacted by equipment managers for their opinion. Moreover, the information should be sent to appraisers one or two days before it is sent to the investment community. The appraisers thus have a chance to review the information before questions are asked of them by prospective investors. By sending this information directly to the appraisers they all have the same information and will not have to make random assumptions regarding the asset's condition, usage, and so on.

Also, by sending this information directly to the appraisers, the syndicator removes the possibility for incomplete communication or errors in communicating via telephone between the equipment manager and appraiser (who is not being paid at this juncture). The seller should call the appraisers after they receive the information to further reinforce the asset's features and reiterate the appraised value in the appraisal report obtained by the seller to establish a consensus on the asset's value.

The end result is that the flow of information is controlled by the seller, who establishes a common opinion to be accepted or challenged, as opposed to every prospective purchaser originating its own opinion based on erroneous assumptions.

The secondary lease market is inefficient but it can be made more efficient by a marketing oriented syndication program. Numerous studies on the stock market have shown that the cheapest stocks, relative to their intrinsic value, are those where limited information is known about the company (assuming the company is fundamentally secure). Once more information becomes available about the company its stock price tends to jump to and above its intrinsic value. By providing and properly disseminating greater information regarding the leased asset the syndicator improves the efficiency of the market and will realize more attractive offers.

### ***Specifications***

This does not mean that providing more information about the asset, such as equipment specifications, is the answer. While providing equipment specifications is helpful, it is not the all-purpose remedy for several reasons. More often than not the equipment specifications are base specifications from the manufacturer that do not include the options and features of your specific asset. Moreover, specifications are absolute. Even if they detail the base features plus options, not every equipment manager will understand what the

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options are and whether these features and options are valuable or not.

Accordingly, the syndicator must present an analysis and explain (not just identify) the significant features and options to assist the equipment manager in focusing its attention on what the seller believes to be the important features that will likely justify a higher residual. With this information equipment managers, in consultation with their advisors, have the opportunity to agree with or reject the observations of the seller.

## THE COMPREHENSIVE MARKETING MEMORANDUM

The following model is presented to replace the generic memorandum. The comprehensive marketing memorandum should consist of:

1. Disclaimers, confidentiality agreements, and securities issues
2. Transaction summary
3. Asset and market valuation
4. Lessee fleet/operation analysis
5. Recent physical inspection report
6. Current appraisal
7. Maintenance records
8. Equipment specifications
9. Recent photographs of the equipment
10. Lease contract
11. Lessee financial statements

### ***Disclaimers, Confidentiality Agreements, and Securities Issues***

These three items are for the benefit and protection of the seller.

**Disclaimer statements** are mandatory to protect the seller, especially when an analysis of the asset and market is presented. A summary statement might read:

“The seller makes no representations or express or implied warranties as to the accuracy or completeness of the information contained herein, and all bidders should rely exclusively on their own advisors and experience before reaching any conclusions regarding the investment contained herein.”

**The syndicator must assist the equipment manager in focusing its attention on what the seller believes to be the important features that will likely justify a higher residual.**

Disclaimer statements are unlikely to dilute the credibility of the comprehensive marketing memorandum's contents, assuming the contents are accurate, because the marketing memorandum invites prospective bidders and their experts to challenge the seller's observations.

**Confidentiality agreements** control and discipline the flow of information to the syndicator's target market. Furthermore, the syndicator is assured that all, and not less than all, of the intended information reaches prospective investors and their advisors.

**Securities issues** can also arise. It should be referenced that the investment is not registered under the Securities Act of 1933 as amended and that the investment is intended only for sophisticated institutional investors who qualify as “accredited investors” within the meaning of Regulation D of the act.

### ***Transaction Summary***

The transaction summary provides the basic business terms such as pre-tax cash flows and renewal options. Present the rentals and debt service in dollar terms and sum them. Do not use lease rate factors, especially if you have a sawtooth structure or portfolio of leases. By using dollars, not lease rate factors, you minimize the possibility of data input error by prospective purchasers. Besides the generic lease information the transaction summary should provide a brief summary of the appraisal and inspection results, as well as any significant items in the lease that may affect the residual value.

In practice the transaction summary is relied upon for pricing purposes. By providing the guaranteed cash flows as well as an indication of the residual value in the beginning (second section) of the comprehensive marketing memorandum, you assist the originator in immediately obtaining preliminary pricing and begin to provide residual information that will help define the market.

### ***Asset and Market Valuation***

The asset and market valuation section presents information about the asset; an analysis of the market for the asset, trends, comparable secondary market trades, and so on. This section is for the benefit of the equipment manager and any appraiser whom the equipment manager calls for residual estimates. This information is especially handy since it is segmented in the memorandum and can be readily telefaxed by the equipment manager to appraisers without providing ancillary information often found in a

transaction summary such as trustee details, debt rate, and equity transfer provisions.

The asset should be described in detail and the syndicator should provide an explanation of the significant features that benefit the asset. Then technological and other market trends should be identified with the objective of supporting a residual forecast. By citing actual secondary market trades, you provide information that establishes a market consensus favorable to the lessor.

### ***Lessee Fleet/Operation Analysis***

An analysis of the lessee's fleet is crucial and also benefits the equipment manager. This will have a dramatic impact on the equipment manager's residual forecast. The purpose here is to make relative comparisons within the lessee's comparable asset base to establish a favorable residual forecast. For example, think how different the residual estimate will be if the equipment manager knows the aircraft under consideration is the youngest, fastest, and most fuel-efficient unit in the airline's fleet, as opposed to the slowest, oldest, most fuel-inefficient aircraft.

It is easier for the syndicator to obtain this information than it is for outside parties, and by providing this analysis the syndicator provides direction for the prospective purchaser to follow and review. Finally, this section provides an opportunity for the syndicator to manage and resolve any market problems that may exist with the asset.

### ***Recent Physical Inspection Report***

A recent inspection report is mandatory and enhances the credibility of the package. An old inspection report is classified here as over one month old. This report identifies whether or not the equipment is in good condition.

Get the inspection report first and then have the asset appraised. This avoids conservative residual estimates because the appraiser "isn't aware of the asset's mechanical condition." Finally, it is probable the successful bidder will waive an inspection contingency because of the recent inspection report, assuming the results are favorable. This expedites and simplifies the close.

### ***Current Appraisal***

A recent written appraisal report setting forth the likely residual value is required and should be prepared by an individual well known and

respected in the particular asset category. Before engaging the appraiser make sure he understands the asset category generally, and your asset specifically. For example, some aircraft appraisers have more experience in wide body aircraft while others are more well-versed in turbo props.

This section of the memorandum is an important link in generating a consensus on the asset's residual value among all readers who impact the residual forecasting process, meaning other equipment managers and appraisers.

### ***Maintenance Records***

Maintenance records are a must. Almost every equipment manager asks for them; sometimes they are made available while other times they are not. Making them available immediately simplifies the review process for prospective bidders.

### ***Equipment Specifications***

Provide accurate and complete equipment specifications as well as line drawings if available.

### ***Recent Photographs***

Take numerous photographs of the asset's external appearance as well as the internal mechanical components if possible when inspecting the asset. But don't keep these photographs to yourself—incorporate them in the memorandum. The objective is to demonstrate that the asset is in good physical and mechanical condition and is being maintained.

To enhance the credibility of the package, use a camera that electronically dates the photographs so there is no question as to when the pictures were taken. Provide an index to the photographs to aid the reader in understanding exactly what he is reviewing.

### ***Lease Contract***

A copy of the lease is prudent. No commentary is necessary by the syndicator regarding the lease unless something is extraordinary that affects the asset's value, such as if the lessee must rebuild the asset just prior to lease expiration. This is significant, and the seller should not assume every prospective purchaser will identify such a requirement in a 50-plus page lease contract.

### ***Lessee Financial Statements***

**It is probable the successful bidder will waive an inspection contingency because of the recent inspection report, assuming the results are favorable.**

Discuss the lessee's financial position if the lessee's financial statements aren't representative of the true creditworthiness of the lessee. Small "feeder" airlines, cooperatives, and shortline switching railroads often need explaining since their expenses (such as lease rents) may be unconditionally reimbursed by their investment-grade parents in accordance with long-standing formal operating agreements. These executed operating agreements must be provided to prospective bidders, and the investment-grade parents can confirm and acknowledge the terms of these operating agreements to the successful bidder.

Remember, the purchase of a seasoned lease is an asset play not a credit play. If the lessee is a poor credit and its financial statements reflect this, don't attempt to justify its financial position.

### CONCLUSION

Executive managers must recognize that syndicating a seasoned lease or lease portfolio is a strategic marketing opportunity, not just an administrative sales function. This is the time to reap the equity type returns that lessors expect. The optimal return won't materialize by reproducing historical information and following clerical procedures.

By incorporating the proposed model, implementing a comprehensive marketing program, properly disseminating this information, and speaking to prospective purchasers and their advisors, lessors will increase the efficiency of the market and recognize better results upon the sale of their leases and lease portfolios.

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