

# Capital Contraction and the Future of Leasing Funds

*Individual investor funds are growing and can be an attractive alternative source of capital for certain types of transactions.*

By Stephen R. Harwood

In the last several years there has been a pronounced reduction in capital available to the equipment leasing industry. As ELA President Michael Fleming summed up the current situation recently in ELT, “For all but the very established companies, the capital sourcing and management picture is grim. To a degree the lack of liquidity is structural—today there are simply fewer sources of funding. In fact no one sees structural illiquidity, (or for that matter, the tougher underwriting standards that also choke capital) improving within the next year.”

Some view this as a liquidity crisis, asking, “What can we do to correct it?” Others say, “Finally we are getting the correction we’ve needed; finally we won’t have so much equity chasing deals.”

This reduction in liquidity is the result of forces that are long term in nature and are not likely to reverse themselves in the next few years. Some of the forces bringing about the current situation are the uncertain outlook for earnings, the flight to quality, Wall Street’s view of equipment leasing, and industry consolidation.

For some lessors, who have certain types of transactions to fund, individual investor funds may prove a viable alternative to the ever-shrinking traditional sources.

## Uncertain Earnings Outlook

Looking back over the last thirty years of the equipment leasing industry, the 1970’s and 1980’s represent the “golden era.” A typical large ticket transaction in this period was a leveraged lease of fifteen years, with fair market value

options, where the lessor realized a healthy return assuming a conservative residual.

In the late 1980’s and 1990’s the pendulum swung in favor of lessees, and a typical transaction had a longer term than in the past, the lessee had an early buyout option, capped purchase and renewal options, and the lessor realized a marginally attractive return assuming a high residual. Many in the lessor community shook their heads in dismay at these transactions, wondering why other lessors were willing to take credit, equipment and tax risk in transactions where there was a low return and no potential for upside. But leases continued to be structured on this basis, in large measure because there was so much equity chasing a limited supply of opportunities.

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1990's because leasing company earnings were attractive. To a large degree, however, earnings were driven by factors unrelated to the quality of new bookings. These factors included the strong economy, which generated a high volume of transactions and relatively low write-offs; the run-off of transactions from prior decades which generated strong book gains as the residuals were realized; the growth of securitization, which reduced funding costs and allowed companies to front-end earnings using gain-on-sale accounting; and the growth of LILO and other cross border structures, which also allowed for the front-end booking of earnings.

Starting in the late 1990's, many of these sources of earnings began to drop away. The downturn of the economy reduced the volume of new business and increased business failures; the run-off of low booked residual deals diminished; securitization became less accessible; gain-on-sale accounting lost acceptability; and the IRS attacked the LILO structure and began aggressively pursuing other tax oriented structures.

Many other developments also have been pulling down earnings. Equipment surpluses in many of the principal leasing sectors, such as aircraft, hopper cars, locomotives, and containers, will make realizing booked residual amounts difficult for many companies. In addition, the post-Enron reaction to off balance sheet financing is reducing the appeal of synthetic leases and other off balance sheet structures, which have historically been one of the industry's major financial products.

All this makes the outlook for the earnings of many leasing companies

highly uncertain. Consequently, many banks and finance companies are allocating less capital to their leasing subsidiaries, or they are extracting their capital by selling the entity. Some in the industry view this as a liquidity crisis, asking, “What can we do to correct it?” Others say, “Finally we are getting the correction that has been needed for a decade; finally we won't have so much equity chasing deals.”

### The Flight to Quality

The leasing industry has also been affected by a trend affecting all sectors of finance, namely a “flight to quality.” In 1998 there was a dramatic break in the financial markets triggered by a set of factors unrelated to equipment leasing. Financial markets became more risk averse in general and capital for higher risk situations became harder to find. Once again during the last year we have seen the financial markets take a conservative turn, this time in reaction to 9/11 and the terrorist threat, and more recently to the loss of confidence in corporate America in the aftermath of high profile management and accounting scandals.

The flight to quality has cascaded down into the equipment leasing industry in various ways. A specific example is in the world of securitization. During 1990-1998 securitization became more and more accessible, and by the end of the period even smaller independent leasing companies were able to use this form of finance. However, in recent years, securitization has become available only to larger, well-established companies.

### Wall Street's View

The outlook for accessing capital through IPO's or other equity offerings is now very poor. Stock market developments have made this true for all companies, but especially for equipment leasing companies. The performance of those leasing companies that issued IPO's in the 1990's ranges between dismal and disastrous. Leasing industry financials have never been easily understood, and the “train wreck” surprises of the last few years memorialized in the Equipment Leasing & Finance Foundation's “Perfect Storms” analysis, will make Wall Street leery of providing support. Also, the total capital of all public leasing companies is such a modest amount compared to other sectors that Wall Street is not likely to devote significant resources to follow the industry.

One might point to the CIT \$5 billion IPO of 2002 as an example of the potential for access to capital via Wall Street. But how excited can Tyco be with sales proceeds that were approximately 50 percent of Tyco's purchase price less than two years ago?

### Industry Consolidation

Looking back over the last thirty years of the leasing industry, each decade had its own dominant character. The 1970's were the entrepreneurial period; the 1980's saw the proliferation of leasing companies; and the 1990's were the period of consolidation. Symbolic of the 1970's was ITEL, making dramatic profits as a lease underwriter. Symbolic of the 1980's were the Baby Bells, using their newfound freedom to diversify into finance. Symbolic of the 1990's was GE Capital, continuously acquiring other major leasing companies. The leasing industry has become a world of whales and minnows, and the population of whales is diminishing. This has meant that independent leasing companies that may have depended on financing from a party with which it had a long-standing relationship may now find that a larger company with different ideas

about funding has swallowed up their customary source of finance.

For all the reasons outlined above, the equipment leasing industry has experienced a contraction of the supply of capital, and the situation is not expected to change in the next several years.

## Individual Investor Programs—Then and Now

From the mid-1970's through 1986, individual investor programs played an active role in the equipment leasing industry, primarily in the computer leasing segment. With IBM leaving the leasing activity to independent companies for most of this period, the members of the Computer Dealers and Lessors Association flourished. Computer leases were commonly financed by wraparound transactions where the equity was sold to individuals in structures that provided significant tax deferral. With the Tax Act of 1986 this type of tax-oriented financing came to an end.

During the 1980's and early 1990's leasing "income funds" were popular, and a variety of securities firms, including major regional and Wall Street firms, were active in offering programs to the public. These involved a full range of transportation equipment, computers, and middle market assets. During the 1990's many of these programs were discontinued as interest in direct participation programs declined, sponsors shifted to other sources of finance, and other reasons.

External developments during the last year have led to an increase in the interest in equipment leasing funds by securities firms and individual investors. The volatility of the stock market has reminded investors of the benefits of diversification. Asset allocation models now have an increased emphasis on including an allocation to "hard assets," such as real estate and equipment leasing, in addition to equi-

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ties and fixed income securities. Also, with interest rates at historically low levels, investors are more inclined to seek out higher yielding investments. Reflecting this increased interest in equipment leasing funds, the companies currently offering programs report that their monthly equity raise amounts are increasing.

## The Role of Funds

The use of individual investor funds only makes sense for certain specific niches in the industry. Investors typically prefer a relatively short holding period, so this form of equity is not suitable for longer term transactions. Also, the expenses associated with raising this type of capital are relatively high, making it less competitive in replacing such low cost forms of capital as debt.

Funds do make sense as a source of equity for transactions with moderate risk, where the conservative preferences of institutional parties allow for higher yields. Examples of these are residual oriented investments, including secondary market transactions, shorter term operating leases, and managed operating lease programs, as well as collateral based investments to credits that may not meet traditional banking standards.

Another very specific niche where the funds fit, are transactions where there are attractive economics but an unattractive booked earnings profile. Examples of these are call option and residual buy transactions, where there are no current booked earnings. While

these types of transactions are typically unacceptable to institutional lessors, which are driven by near term booked earnings goals, they are perfectly acceptable to fund investors, who are primarily concerned with cash flow, yield and the timing of taxable income, but not in the fund's booked results.

If the overall contraction of capital affecting the leasing industry continues, which is expected, it is logical that the role of individual investor funds will increase, simply because they represent an alternative form of equity.

The equipment leasing industry can expect to continue to face reduced availability of capital compared to the "easy money" of the 1990's. However, one area where capital may be more readily available is individual investor funds, where interest has been spurred by the reduced appeal of the stock and bond markets. Equipment leasing funds are an alternative source of capital that can be expected to play an increasing role in a number of specific niches in the industry. While funds will play a limited role in financing new equipment transactions, they will indirectly contribute to capital formation for the industry by purchasing secondary market transactions and freeing up capital for new investments by institutional lessors. **ELT**

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