

# The Growth Potential for Equipment Leasing Derivatives

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Equipment leasing derivatives is a topic which hasn't had much attention in the past, but it's an intriguing one, since there is the potential for this area to grow dramatically in the future.

## Definition

How should equipment leasing derivatives be defined? In general, derivatives are something that derives its value from something else. But that definition is a little too general to be helpful. Another definition is it's something you can't understand, but your broker says, "Trust me, it's okay," and then you buy it and lose millions!

The definition suggested here is: transactions involving components of the interests of parties to existing leasing transactions other than conventional equity syndications or lease discountings.

## Examples

What are examples of equipment leasing derivatives?

A relatively active area has been transactions involving residuals in

some way. Call options are transactions in which the owner of the residual, presumably the lessor, sells an option to a third party granting that party the right to buy the asset at lease expiration for a fixed price.

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Selling call options to lessees involves the lessee paying the lessor to add a fixed price purchase option to their lease. Forward asset sales involves paying currently to buy the residual, where title is transferred at lease expiration. Sales of remarketing rights and related fees or sales of residual shares usually relates to interests that have been retained by arrangers. Finally, there are transactions involving the purchase of puts or residual insurance.

There are a variety of other kinds of transactions, which can also be called equipment leasing derivatives. Interest rate hedges have been actively used for many years. Sales of tax ownership while giving up minimal residual rights are a small niche. Tax rate hedge and credit insurance transactions have been done but are relatively rare. Finally, the sales of existing fixed price options by lessees is an area where transactions have not been done, but where a market is expected to develop in the future.

## Motivations

What are the main lessor motivations for derivative transactions?

The main appeal of call options and forward asset sales is a book income while deferring taxes without reducing receivables. This can permit capitalizing on hot markets, when an asset sale might result in a book loss.

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## Call Option Issues

With each type of derivative, unique issues tend to arise. For example, with the call option structure, some of the issues are:

- 1) The consequences in the event of casualty, termination and default;
- 2) Seller provided financing for the end-of-lease purchase price or the option premium;

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