

Preparation, Preparation, Preparation... *The Keys to Effective End-of-Lease Negotiations*

When you buy a house, everyone says it's about three things — location, location, location. Similarly, when it comes to end-of-lease negotiations, the three most important things to consider are preparation, preparation, preparation.

By Steve Harwood

There was a contest between a physicist, an aeronautical engineer, and a leasing portfolio manager. Each was given a very expensive barometer and challenged to determine the height of a building, using only the barometer. A week later they submitted their results. The judge opened the physicist's envelope, and read his answer: 500 feet. "Very good," said the judge, "how did you do it?" "Well," said the physicist, "I took the barometric reading on the ground floor and again on the top floor and, based on the difference in the barometric readings, I was able to derive an estimate of the height, using my knowledge of the laws of physics." Then the aeronautical engineer's envelope was opened. "520 feet! Even closer! How did you do it?" asked the judge. "Well," said the aeronautical engineer, "I took the barometer up to the top of the roof and dropped it off, and noted the elapsed time until it smashed below. Then, using my knowledge of aerodynamics, I was able to calculate the height." Finally, the portfolio manager's envelope was opened. "516 feet, 3 inches! Why that's exactly right!" exclaimed the judge. "How did you do it?" "Well," said the portfolio manager, "I found out the name of the building's architect, and called him up, and said, 'I'll give you this very fancy barometer if you tell me how high the building is!'"

The message of this story is that there often is a better way to approach a situation, and it pays to think outside the box. I hope the contents of this article might stimulate you to do so in your end-of-lease negotiations.

Even though my experience is with the big ticket transactions, those involved in middle-market and small-ticket leasing may be able to apply some of the principles to their negotiations as well.

Recently I was talking to a portfolio manager and asked him how he approached end-of-lease negotiations. He said, "We start to pay close attention to a lease during the last year of the lease. If the lessee exercises its option, we have an appraisal done, and sit down with the lessee to negotiate an extension or buy-out in a friendly manner. We strive for a win-win result."

What do you think of this approach? My view is that it might be OK. But I also think that this portfolio manager might be leaving a lot of money on the table.

The win-win theory of negotiations is nice, but I'm not sure it applies to end-of-lease negotiations. I think it is better to approach end-of-lease negotiations as if you are preparing for war. In war there are major objectives to be achieved by strategies and tactics. Small victories may add up to a major advantage and it is possible to win the battle and lose the war. Information is critical to success. The troops must be well prepared before going into battle.

Two of the main driving forces behind true lease structures have been the desire to shift tax benefits to the lessor and to achieve off-balance sheet financing. Lessees haven't liked the idea of fair market value options on core assets, but were required to accept them in order to get the tax and book treatment desired. Now, as the lease is coming to its end, the lessee wants to minimize the amount it pays for the residual and the lessor wants to maximize it. The win-win model applies if the parties can walk away if no agreement is reached. But here the parties are locked in.

So, man the battle stations!

Appraisals

Let's turn first to the subject of appraisals. Almost all big-ticket leases contain an appraisal mechanism that is to be used if the parties cannot agree to terms. Often, there is what I call the "battle of the appraisers" appointed by each party. Consequently, it's important to have an appraiser who will fight for your position. It's also important to have an appraiser who can be persuasive and can get along well with others.

An example of a negotiation where the appraiser played a major role involved peak power generators that Cypress owned. Used generators like the ones in this transaction sold at about \$1 million each at auction, but on a refurbished and installed basis they sold for as much as \$5 million. The initial position of the lessee was that the total FMV for 6 generators was about \$5 million while our initial position had the FMV in excess of \$20 million. After a long, complex and costly process, the FMV was deemed to be \$16 million, and we were glad we had an appraiser with thorough and meticulous ways in our corner.

So the selection of an appraiser is an important step. We typically seek appraisals from numerous appraisers before selecting the one to represent us. Our goal is not to find the one with the highest value, but rather the one with the most thorough analysis. We also think it important to get multiple views, and seek analysis from different types of appraisers. It's not uncommon for us to combine the efforts of multiple parties, where we have one lead appraiser, but then incorporate elements from other consultants, such as a detailed supply/demand study, a replacement cost estimate, or a comparables analysis. After the appraiser drafts his report, we typically critique it, and have the appraiser bolster it in weak areas, with the goal of ending up with a report that will withstand withering scrutiny. Experience has shown that any weakness in the report will undercut its credibility.

At a minimum, the appraisal should carefully tie to the lease language, and approach the evaluation according to ASA appraisal standards, using the market, income and cost approaches.

You can spend from \$3,000 to \$50,000 on an appraisal. Why might you spend more? The answer is that there are a variety of audiences that might ultimately be considering the appraisal. There's yourself, so you can properly educate yourself for one-on-one negotiations with the lessee. And, as part of your negotiations, you may want to give it to the lessee. Then there's the lessee's appraiser, potentially a third appraiser, and possibly a judge or jury.

My view is that if there are several million dollars pending on the outcome of negotiations, paying to have thorough appraisal work done is well justified.

Part of the preparation process is also to anticipate the lessee's position and prepare a rebuttal. For example, in the case of the negotiations over the renewal rate for an oil storage facility, we obtained the appraisal used by the lessee in a similar, prior negotiation, and had our appraiser carefully prepare a rebuttal. When the same appraiser was used by the lessee, we were positioned to quickly update the rebuttal, which we delivered to the third appraiser along with our appraisal.

When the appraisal structure calls for the FMV to be set at the average of the two closest of three appraisals, we have gone to the extent of using a game theory consultant to help select the optimum valuation for our appraiser to submit. I think most appraisers are willing to be flexible as to the final valuation amount submitted in this context, as long as it is not in excess of the upper end of the range of their valuation.

Legal Issues

Let me now turn to another area of preparation — the legal side. The first step here is a very close review of all of the relevant provisions of the lease documentation, most notably the maintenance provisions, end-of-lease options, return provisions, appraisal mechanism, and dispute resolution language, and the mechanisms for decision making if there are multiple owners.

Along with the review of the documents is the identification and analysis of any legal issues related to interpretation of lease language or the legality of some provisions.

For example, there was a highly publicized case a few years ago of a computer lessor being sued by a number of lessees, that claimed the lessor's marketing personnel had systematically led them to view their computer leases as 36 month leases, when in fact the so-called "ABC"

end-of-lease options required that they could only get out if they upgraded with the leasing company.

In the case of an electrical equipment transaction which Cypress owned, the lease called for FMV to be defined as what a used dealer would pay. We had determined that to be about \$200,000. We also knew that it was prohibitively expensive for the lessee to replace the equipment. When the lessee failed to give notice exercising their option to buy as required six months before the expiration, we immediately had counsel research how strong our case was to deny them the option. The answer he brought back was that, since the transaction was governed by New York law, which had provisions protecting consumers from being hurt by inattention to proper notices, we had a weak case. Nevertheless, we took the strategy of sitting tight. Finally, we sent a fax to the lessee about a month before the lease expiration, asking when and where we should pick up the equipment. When they quickly responded that they didn't want to return the equipment, we said we'd be happy to negotiate a lease extension, but that they no longer had a purchase option. To our delight, they didn't contest this, and we put a nice long term extension in place, with a present value of \$800,000.

In summary, I like to have counsel prepared for battle on any issues we think might arise.

Remarketing

Even though you might fully expect to negotiate a lease extension or sale with the lessee, it is also important to be fully prepared from a remarketing point of view. This will strengthen your appraisal and guide you as to how strongly you can play your hand.

Steps that might be taken include engaging a remarketing agent, having the agent develop a detailed remarketing plan, and possibly doing a market survey. Also, you may want to establish a relationship with an operating lessor. For example, Cypress has a management agreement with a rail operating lessor that allows us to add cars as they come off other leases. This gives us the option of putting the cars back into service on a full service leasing program if that appears more attractive than sale.

Equipment & Lessee Information

Certainly you want to be prepared with complete information relating to the equipment, such as the specifications, any modifications, past and projected maintenance expenses, the condition, any regulatory issues, and differences from newer equipment.

Also, certain lessee information can be important. Most significantly, how critical is their need for the equipment, and what are the economics of their alternatives to retaining the equipment? Examples of other useful information are the cost and feasibility of returning the equipment, the company's financial status, and industry trends.

One of the best ways to obtain both the equipment and company information is through inspections. We plan regular inspections, so we can obtain this type of information prior to the posturing that often accompanies end-of-lease negotiations.

For example, in the case of a coal processing plant investment, we were able to learn the total related coal reserves, the fact that the union agreements made it more attractive to operate the mining operation at a loss rather than shut it down, and that the company's budget projections included the purchase of the coal processing plant at a healthy price!

Another interesting way to get key information is seek out former employees of the lessee and hire them as consultants. Of course there is also information that is in the public domain and accessible on the Internet, such as annual reports, SEC filings, and articles.

Management & Partner Considerations

An important part of preparation is to make sure as a portfolio manager, you are in sync with the goals and preferences of management and partners. For example, it may be that the lessee is a key customer, and management doesn't want to do anything to ruffle their feathers. Or, it may be that management is risk averse, and will get weak knee'd at the idea of playing hardball. Or maybe management wants to keep life simple, and doesn't want to find the company becoming an operating lessor.

Often there are multiple owners in a transaction, or a party with a residual share. Here again, it is critical that all parties be in sync. Obviously, the way to avoid getting out of sync with either management or other partners is through thorough communication.

Negotiating Team

As you go through your preparations, you will be assembling your team. In addition to appraisers, inspectors, counsel, remarketers and other consultants, you might want to engage a third party as your negotiating agent. This might be particularly appropriate if you want to take a hard line, which may not be your personal strength.

Strategy

When should you set your strategy? We preliminarily plan our strategy when the acquisition is made, and then revisit it periodically, as new information is developed. Certainly you want to have it clearly thought out prior to commencing any dialogue with the lessee.

When is it best to initiate discussions with the lessee regarding the end of lease? Usually later is better, as lessees will have reduced flexibility, and fewer options. However, sometimes an early negotiation makes sense. For example, if you see the lessee's earnings slide, the lessee might find a lease extension with reduced current rentals appealing.

What process should be used to set the strategy? I recommend brainstorming where different approaches are considered. This might include role playing, or having one individual serve as the devil's advocate, finding fault with various plans. Preparing a written statement of the negotiating strengths and weaknesses can also be a helpful exercise. Finally, a strategy will begin to emerge.

Here are some examples of strategies. Country Boy is an informal approach. By the Letter is highly formal. With Gopher the lessor goes underground, and waits for lessee to initiate discussions. New Rules seeks to revise the end-of-lease procedures.

Strengthening Your Negotiating Position

In the process of evaluating your negotiating position and developing your strategy, you should strive to identify areas of weakness that might be strengthened.

You might ask yourself, "What information would I ideally like to have?" and then figure out how to get it. As an example, in the case of our paper plant black liquor boiler transaction, there was quite a bit of uncertainty as to the replacement cost. We then commissioned the engineering firm that originally designed the plant to prepare a replacement cost estimate, which increased the credibility of our appraised value.

Thinking back to our portfolio manager in the barometer contest, now is the time, too, to press yourself to think outside the box. Let me give you some examples from our experience.

In one transaction, we were in the midst of negotiations and we wanted to pursue a hard line, riskier strategy, while our partner wanted a more certain, quicker exit. We bought him out in the midst of the negotiations with the lessee.

In another transaction, we joined forces, at an information sharing level, with another lessor that had a similar negotiation going on with the lessee.

In another situation, we were dealing with SD 45 locomotives, which had a high maintenance risk, which the lessee didn't want to take. As a result, we structured a power by the hour arrangement with the lessee.

Tactics

Finally we come to tactics. Strategy sets the broad game plan; tactics set the detailed approach. Some familiar examples are "good guy/bad guy" or using humor.

Even when it comes to tactics for a meeting, I believe in preparation. I like the approach of NFL coaches, where the initial plays are scripted and responses are prepared for every situation.

Negotiations

At this point, after all this preparation work is done, you're ready to sit down and talk with the lessee.

If you're well prepared, the execution of negotiations comes easily and generally results in good outcomes. In my experience, much of the time lessees are well-prepared, skillful and worthy adversaries. But in a surprising number of cases lessees make major blunders either in preparation, strategy or execution, and there is the opportunity to realize significant residual upside.

As a final closing note, if there are any lessees reading this article — and if any of you have occasion to negotiate with me — please take it easy, I'm just a pussycat that just wants to be your friend. **m**

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