

APPLES AND ORANGES: COMPARING LEVERAGED LEASE TENDERS

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Leveraged leasing still has an aura or mystique about it to the extent that its detailed workings are not well understood by many corporate treasurers. As a result, when seeking tenders, treasurers often proceed on a simplistic basis and can then be surprised when the end results are significantly different from the awarded mandate. Fortunately with a little care and planning this can be avoided.

Seeking Tenders

The bid seeking process most commonly asks for quotations on what is called a base case. This involves a standard set of assumptions and it is hoped that these will make the decision-making process easier by limiting the number of variables. A treasurer assumes that he can then simply pick the lowest lease cost and this will give the most advantageous result. The normal assumption is that by this approach the decision will only depend on two variables — the efficiency of the leveraged lease packager's computer model, and the size of his fee.

However, and regrettably, in many cases by carrying out an evaluation in this way the desired result will not be achieved.

To seek tenders on the basis of a set of criteria that have not been carefully thought out is only valid with knowledge of how to control what the bidders are doing and there are perhaps few corporate treasurers who can do this.

Because leveraged leasing is not something that a corporate treasurer does every day — he may do one, or he may do three or four leases in his lifetime — and because the marketplace is intensely competitive, packagers will respond to the tender often in an interpretative way so as to achieve the lowest lease cost, given the constraints that have been set. Some packagers' interpretation or creativity is greater than others and lessees must be aware that it is common to seize on any aspect in a tender that has been forgotten or not clearly specified. If the specification is not

precise it is reasonable for a packager to use whatever he can to lower a quotation in the expectation that in the evaluation phase the treasurer will not be able to identify that discrepancy.

Where any vagary exists, a lease packager will obviously assume the most aggressive interpretation to give his bid a competitive edge. The result can be that a packager's skill and creativity can be often used to battle the ultimate lessee rather than working to his advantage. A packager can win simply because his numbers are the lowest but these numbers might bear little resemblance to the actual or intended transaction.

Some Examples

As an example of variations in assumptions that may have a greater impact that is first apparent, a lessee might specify equipment to be delivered on the first day of October. But a packager might bring that back one day and mention in his proposal that delivery is assumed to be on the last day of September, or to be on or about 1st October. Bringing the delivery date back that one day would place it into another tax year for some lessors. That means the lessor can claim the benefit of any investment allowance a full year earlier that if delivery was to be a day later. So the lessee is perhaps not being misled, but he is not getting what he expects, that is, all bids to be on precisely the same basis. A simple variation like this can impact base rates.

Another example is the debt rate. Typically a client will specify the debt rate to be, say, 14 per cent per annum. He may overlook or be unaware that there are a number of ways of calculating an annual interest rate, but those packagers who live in this very precise world are very much aware of it. A rate of 14 per cent could be either an effective or a nominal debt rate. It would normally be a nominal rate so that if interest is paid half-yearly, it would amount to 7 per cent per half year. The 14 per cent is just twice the half-yearly rate. A 14 per cent effective rate is calculated on a compounding basis so the calculation from the half-yearly rate to

annual rate is quite different. By a strict comparison, a 14 per cent effective debt rate is the approximate equivalent of 13½ per cent nominal. Thus if a lessee specifying 14 per cent does not say whether it is to be effective or nominal, the aggressive packager may calculate it as 14 per cent effective. But when he goes to place that debt with, say, a bank, the basis of the rate would change and in fact be calculated on a 14 per cent nominal basis and so, again, the lessee would not obtain the cost he anticipated in the awarded mandate.

The point is that where any assumption in a tender document is not clearly and precisely specified, some lease packagers could assume an interpretation that was not intended. Their objective will be to minimize their quoted lease costs, often in the knowledge that the lessee will not understand the subtleties of slight variations in an assumption or in terminology.

Relationships

So, from the start, the lessee must be aware that whilst some packagers might appear to be working in the lessee's best interests to offer a low lease rate, it could be interpreted that the result is rather not to mislead, but to obscure certain points in the lessee's eyes in order for the packager to win the mandate.

It is important therefore to build rapport between the client, i.e. the lessee, and the packager, so that there is mutual trust and so that the packager is truly always working in the client's interests — and can represent a lease structure that can and will be achieved.

A basic problem at the bidding stage can occur if the lessee wants to specify how the transaction should be put together, when it should be up to the expert to do this. It should be the packager's objective to work with a client, to find out what his needs are and then to structure the transaction to suit his client's needs. The packager is the expert and should make suggestions for the lessee's benefit.

There are other seemingly trivial examples of situations in which a lessee must exercise care. Changing depreciation rates is such an example. A lessee might specify that his company generally depreciates an item of equipment at a particular rate. The lease packager might suggest to the lessee that, if an argument is presented to the Tax Office along certain lines, he could obtain a higher rate and only this higher rate is included in the bid. It has sometimes occurred that the more aggressive approach might have no more than a 10% or 20% chance of being accepted by the Tax Office, but the lessee can easily be swayed by the view

that the packager, in nominating a more aggressive depreciation rate, is working in the lessee's interests. What might seem to be a constructive suggestion may be in reality, a waste of time because the chance of success is so slim.

The end result, the transaction that is signed, is a lease somewhat different than the lessee expected. It is usually vastly different from that envisaged when the tenders were requested and, surprisingly, the lessee will quite often not take the time to ensure that he ultimately receives the same deal that was proposed to him.

There can be uncontrolled events that result in a change in lease payments. If deliveries of equipment are expected to occur on certain months, and there are wharf strikes, deliveries can be delayed for many months. The lessee has no way of quantifying the effect that the delay will have on his lease rate. It could mean upwards of a quarter of a percent increase, or possibly decrease in the lease rate.

Payment of Fees

It can also occur that, with all these changes, some of the more unscrupulous packagers might be tempted to use this opportunity to increase their fee. Often the lessee even though he is the client, might not be directly aware of the fee because it is paid by the lessor. But the fee is always tied into the leasing rate, so the higher the fee the higher the cost to the lessee.

The packager's fee is always negotiable and should be struck as a fair reward for the contribution made by the lease packager. The saying "if you pay peanuts you get monkeys" applies to leveraged leasing perhaps more than anywhere else. It can, certainly sometimes, be counterproductive to negotiate very small fees.

Some factors such as withholding tax or additional tax risks have an impact other than in the numbers. For a standard leveraged lease the Australian Taxation Office has set out guidelines. With proposals that involve additional tax risks and increased benefits, it is normal for the lessee to absorb these risks in return for additional benefits. He has to weigh up the benefit received and the risk to see if it is worth taking. Most times these structures are well thought out. The lessee has the benefit of tax advice and legal advice to be confident they will work. But the onus is on the lessee and packager. When some lessees end up absorbing risks on withholding tax or creative tax structures which they had expected to be borne by another party, the relationship has clearly not been well based.

Some packagers offer performance-based fees. In a recent transaction, there were three different stages, each of which contributed to the overall benefit. If nothing went ahead the packager was only covered for reasonable costs and it was estimated what those reasonable costs would be. For each of the three parts, the packager was paid a profit margin which reflected the benefit he was providing to the client. If the packager was providing a total benefit of, say, a 4 per cent reduction in the client's financing cost and each leg of the transaction generated a third of that benefit, on completion of each leg, the packager obtained a third of his profit in fee, plus costs. If the packager was only to complete two of them, for whatever reason, whether a change in the tax laws so that the structure was no longer viable, or not being able to introduce financiers, the packager would not receive his profit margin for that part of the fee, but would be covered for his costs.

As long as the client knows that the packager is working for his best interests, he will be prepared to pay costs. Then there should be an incentive for the packager to complete the lease as proposed, to maximise the benefit to the client. In this instance the packager has a formula based on the client's expecting a 4 per cent reduction in financing cost. If 5 per cent is achieved the packager will get an additional quarter of his profit margin. If he only achieves 3 per cent then the packager gets three-quarters. In this way the lessee has been able to ensure that the packager is very really working in his best interests — because the packager also benefits.

In some cases, the risks are not fully disclosed. The market is well aware of a transaction that was recently signed in which the lessee thought that somebody else was bearing the withholding tax exposure. However, the clear indemnity in the documents put this risk with the lessee. It is always easy to apportion blame but, in the first instance, this was perhaps the fault of the lessee's legal advisers for not clearly pointing that out, but the packager must bear part of the blame. The packager must always clearly point out the risks involved. In this particular case he did not, and the lessee had no idea that he was bearing that risk. It is not good enough just to participate in an exercise in getting the fastest possible solution and a transaction completed as quickly as possible. These financings should rather be an exercise for a packager to represent his lessee so as to achieve the best transaction possible and truly earn his fee.

Choice of Packager

An efficient leveraged lease computer model can have a significant impact over an inefficient model but, generally, the five or six specialist packagers would present very little difference between their respective models. Most of them would be using models based on a linear programming debt optimiser and these should achieve basically equivalent results. There might be a few hundreds of a percent between the first and the sixth in their optimising capability — not a significant difference.

In selecting the right packager, it is best for a lessee to meet with a couple, somewhat like interviewing a prospective employee. The lessee needs to get a feel for the packager company, the individuals that will work on the transaction and then choose the one that he can best relate to and only then negotiate the fee — direct with the packager. If the fee is not fair then the packager will not put in the necessary effort.

A competitive tender can sometimes be counter-productive. In order to win the tender the packager might cut his fee substantially and then give the transaction less attention than he would to a more lucrative one.

The lessee should ask for a packager's credentials and references, and the names of other corporate treasurers he can talk to. He should try to evaluate from what he hears and from the presentation whether they are efficient and genuine people. The client is going to have to spend a lot of time with the packager in the assembly of a transaction. It can't be somebody with whom he has a personality clash. He has to be able to trust and rely on that person.

After the interviews have been carried out, references checked and a packager provisionally selected, the fee is the last consideration. This should be negotiated directly with the lease packager and represent a fair reward for the benefit to be received by the lessee. This fee should also desirably be performance based so that if the packager does not achieve all the promised benefit his fee will reduce and vice-versa.

The main objective must be to have the packager channelling all his abilities towards obtaining a better deal for his client.