A practical guide to operating leasing

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With low corporate profits, stuttering equity prices and an increasingly globalised market, financial decision-makers are under intense pressure to improve corporate performance. For many companies, operational profits and key financial ratios can be enhanced through the articulate use of off-balance sheet structures, primarily operating leasing.

Let me offer a hypothetical example. As part of a value realisation programme, an international engineering firm carries out a sale and operating leaseback on a series of manufacturing plants across Europe. Over €100 million of cash is generated for corporate restructuring and working capital, while an equivalent value of assets are taken off the balance sheet to significantly enhance ROCE and RoE ratios. The operating lease element of the leaseback means that ongoing rentals are reduced, while a transparent fair market value purchase option optimises the company's financial flexibility.

Individual asset transactions tend not be so dramatic, but their treatment can nonetheless make a valuable contribution towards a desired corporate performance, especially when an agreed financial strategy is developed.

Key features and benefits

Different organisations use operating lease structures for different purposes, but a number of core benefits tend to prevail:

Improved profitability ratios

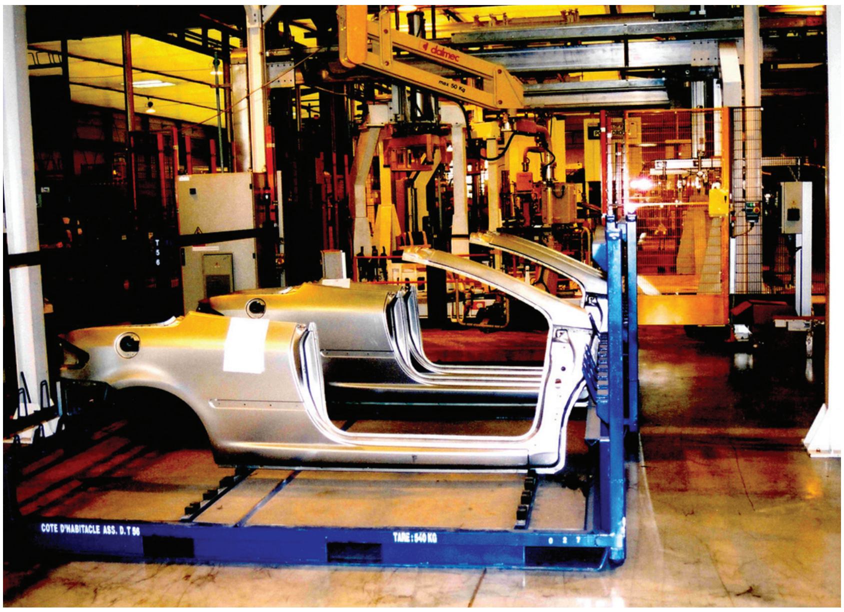
Because the leasing company remains the owner of the equipment, there is no balance sheet impact for the customer and as a result, measures such as RoE and ROCE are optimised. This has particular appeal to public companies, international businesses and other organisations where performance, investment and remuneration are based on or driven by profitability ratios. The P&L cost line should also be improved, as rentals are lower than an equivalent finance lease.

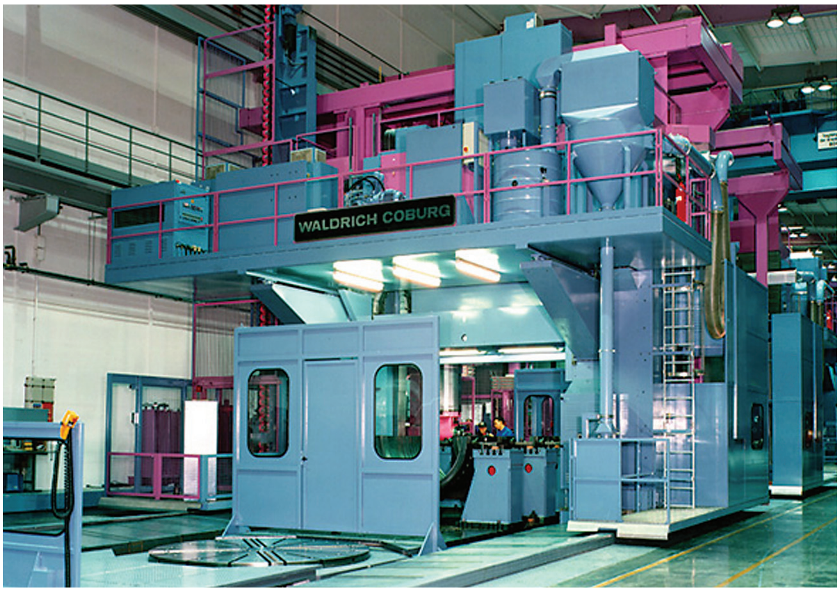
Lower rentals, better cashflow

Cashflow is optimised within an operating lease, due to the residual value position assumed by the leasing company. A typical operating lease structure may result in the leasing company agreeing to take a 25 per cent residual risk position on a five-year term. As a result, lease rentals will be calculated on the assumption that only 75 per cent of the original equipment cost has been amortised on the leasing company's books at the end of the primary lease term, rather than the full 100 per cent. When acquiring large capital assets, the impact can be a significant improvement in the company's liquidity position.

Increased operational flexibility

At the end of the primary lease term, the equipment can be returned to the leasing company. While various options may be available to rehire or purchase the equipment, the ability to return the equipment without having paid its full cost offers significant benefits for companies aiming to cost-efficiently match service or supply contracts, such as engineering, construction or outsourcing businesses. Companies may also be attracted to this financing solution if they wish to focus on core competencies, lack equipment disposal expertise or wish to avoid either technical obsolescence, regulatory risk (for example, environmental directives relating to the disposal of IT equipment) or the increased





maintenance burden associated with older equipment.

Increased financing flexibility
Companies investing large sums in capital equipment are often aware that upgrades and enhancements will be required throughout the life of the asset. An expert asset manager, either employed directly by the leasing company or a contracted specialist, can not only provide a commercially reasonable residual value as part of the lease structure, but can also establish the basis for future asset upgrades. This can be essential in fast moving and project-driven industries where equipment modification is necessary to maximise its useful operation. TEAM recently developed just such a structure for a major engineering firm, establishing the basis for a flexible payment structure, upgrade budgets approved over the next five years and an agreed set of equipment modifications that were acceptable to both leasing company and customer.

Assets without the capital expenditure process
At this stage in the economic cycle, those companies managing to invest in new machinery find themselves well-placed to improve efficiency, win contracts and serve customers better. However, capital budgets remain extremely tight, with government figures showing a year-on-year decline in UK capital investment.

Since the operating lease – even for the largest capital assets over the longest possible time period – is fundamentally a 'rental' product, repayments are considered revenue not capital items. This gives businesses the opportunity to preserve scarce capital budgets and avoid lengthy capital investment decision processes, whilst acquiring the equipment necessary for immediate operational requirements.

Restructuring the balance sheet
Over time, financial priorities change. There may be significant capital value items already sitting on the balance sheet, which, if acquired in today's market, may be more appropriate on an operating lease. By developing a sale and operating leaseback package, it is possible to quite fundamentally restructure the balance sheet, strengthening the cash position and creating increased working capital, while still retaining use of operating assets. Another benefit, not unusual with longer life assets, is that it may be possible to achieve a disposal profit over the book value of equipment being sold and leased back.

Benefits for international businesses
Operating leasing can be attractive for international organisations for a variety of reasons. Subsidiaries of an overseas parent company often find that as capex approvals are not necessary, operating leasing is the most expedient way to acquire major assets. When the subsidiary of a US industrial company (in general, US companies are well versed in operating leasing) recently acquired machine tools at a cost of £11 million by means of an operating lease, the main driver of its decision was that the transaction preserved the group's capital expenditure budgets.

For head office decision-makers, central control over the asset portfolio and financing activity can be a key driver. This can be particularly relevant when an organisation wishes to fundamentally shift the financial strategy of the business, or where decentralised business units lack the necessary financial acumen or resources to make major capital acquisition decisions. A TEAM client recently financed heavy industrial equipment across five different European countries, as part of a single transaction. Using a single arranger to coordinate transactions across multiple countries where there is a need for more than one lessor can be an extremely efficient approach to a complex problem. In such cases, it is important to choose an arranger conversant with the appropriate national and international leasing environment, accounting standards and legal practices.

ISSUES FOR USERS OF OPERATING LEASING

Choose your suppliers carefully
As observers of industries as far ranging as car contract hire and commercial aircraft will note, the future value of even well understood, highly tradable equipment presents a significant commercial risk. In reality, few financial institutions have the mindset or expertise to take and manage asset risk effectively, so selecting the right operating lease provider is not as straightforward as for a simple money-over-money transaction. Lenders without the necessary experience or skills are likely to set residual values inappropriately, with unreasonable return conditions unacceptable to an auditor, or be unable to support customer requirements outside highly liquid, tradable asset categories. As a result, significant effort should be placed in locating the appropriate finance source.

By way of an example, TEAM was recently engaged to develop a UK GAAP conforming operating lease structure for a major automotive components manufacturer, after the proposals from two large international leasing organisations had failed to satisfy the risk transfer requirements of their auditors. Such was the success of the structure that the manufacturer has re-used it in a different European jurisdiction, and the auditors have recommended TEAM to another of their clients seeking to optimise its financial position.

Understand your own goals and needs
To optimise the value of an operating lease

structure, it is important to consider both financial and operational goals. The default position in an operating lease is that the equipment is returned to the leasing company at the end of the primary lease term. In many cases, however, since the main business driver is the off balance sheet accounting treatment, there may be a preference to retain the equipment for a further period. A fair market value sale option can be incorporated into the lease structure, or a secondary lease period may be appropriate. Whatever the desired outcome, the customer should be conscious of the equipment return conditions and charges applied within the lease structure, as these can vary considerably.

Multiple transaction partners

Especially for larger transactions, the structure of the operating lease may include a number of specialist players supporting the residual value risk, as well as the leasing company. The most cost-effective residual position may be achieved through a combination of a buy-back guarantee and insurance. In some cases, the equipment manufacturer may be prepared to take a 'slice' of the residual value risk, to encourage the sale of equipment, although many manufacturers are constrained due to potential revenue earning recognition restrictions. Structuring a complex operating lease structure, with multiple transaction partners, can be time consuming and require the support of a specialist arranger.

Maintain equipment integrity

Maintaining equipment integrity ensures compliance to the lease obligation, and avoids costly penalty charges that may be applied by the leasing company (who have committed to receiving the equipment in a given condition, after a given number of years of use). To unsuspecting financial decision-makers, these penalty charges can come as an unwelcome surprise. The best solution is to avoid these charges altogether, either by maintaining an appropriate equipment inspection and monitoring programme, or by using a third-party to undertake this for you. This may be at a single, perhaps overseas location, or across a series of sites, either in the same jurisdiction or on a cross-border basis.

Inspections of this type can provide additional benefits, such as validating the asset register, identifying under-utilised or redundant assets and establishing areas of potential operating concern. They also play well to finance companies, when organisations request additional funding lines.

Consider using a specialist arranger

On larger transactions, many companies now use specialist arrangers such as TEAM to act on their behalf. Their expert knowledge and well-honed skills represent an extremely cost-effective solution for extracting best value from the transaction, whilst freeing up senior resources within the business. A good arranger should offer a track record of excellent lease negotiation skills, technical expertise, an ability to generate financial structures specific to a range of financial and operational requirements, and the tenacity needed to get the very best deal available. To make the most from operating leasing, the arranger must also have deep industrial and equipment expertise, relevant to the customer's industry.

As a specialist in this field, the arranger should prove extremely valuable in structuring the best-structured deal, with the optimal transaction partners, at the right cost. ■