Product Overview

What do we do?

2011 ELFA Lease Accountants Conference

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Leasing 101
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Our Business – Leases and loans to finance customers’ assets

– Assets that customers sell (indirect finance - vendor finance, dealer finance, franchise finance)

– Assets that customers use (direct finance)
Leasing Companies

Loans
- Retail
  - CSA
  - $ Out
  - Loans
- Wholesale
  - Working Capital Loans
  - Floor planning
  - Franchise financing
  - Asset Based Lending

Leases
- Tax
  - TRAC
  - FMV
  - Leveraged
- Non-Tax
  - Synthetic
  - Municipal Lease
  - Non-leveraged
  - Leveraged
Loans

- **Loan** A financing for tax & accounting purposes. The obligor owns the asset, books it as a purchase and takes tax benefits.

- **Retail Loan** A financing of an end user customer’s acquisition of a piece of equipment from a vendor or dealer. The end user is the obligor.

- **Wholesale Loan** A financing provided to a dealer or vendor to finance a portfolio of assets. The assets can be assets available for sale or assets that are financed to end users via leases or loans. The obligor is the dealer/vendor.
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Leasing Company
Retail Loans

- Conditional Sales Agreement (CSA)

- What is it:
  - A form of sales finance contract in which the seller reserves title to the goods until the buyer completes all payments for the goods and fulfills all conditions of the contract.
  - The payments include a finance component.
  - After payment has been concluded, the title to the goods passes to the buyer.

- Why would a customer want this: Small businesses who have limited access to capital & little concern about accounting or tax benefits
Retail Loans

- **Dollar Out**

- **What is it:** It is a lease that contains a bargain purchase option of $1 at expiry. It is considered a financing because of the bargain and the fact that the lessee is obligated for virtually 100% of the cost of the asset.

- **Why would a customer want this:** A small company that has limited access to capital and is not concerned about accounting or tax benefits.
• Loan

• What is it: It is a financing where we lend the money to buy an asset to our customer. The customer repays the principal under the terms of the loan. The customer owns the asset and is entitled to the tax benefits (depreciation) from ownership of the asset.

• Why would a customer want this: A company that has limited access to capital, can use the tax benefits and is not concerned about the accounting impact.
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Leasing Company

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Wholesale Loans

• Working Capital Loan

• What is it:
  – An loan made to a business to finance its working capital.

• Why would a customer want this: Dealers of equipment borrow from banks and finance companies to fund their working capital needs.
Wholesale Loans

• **Floor Planning**

• **What is it:**
  – Financing the inventory of a dealer in capital goods. Terms generally 90 days, interest only followed by amortization over a fixed term.

• **Why would a customer want this:** A dealer would use this product to finance its inventory of equipment available for sale or lease.
Wholesale Loans

• Franchise Financing

• What is it:
  – Providing business loans to franchisees to allow them to buy franchises and the assets necessary to run their businesses.

• Why would a customer want this: Small businesses who use banks or finance companies to fund their purchase of a franchise.
Wholesale Loans

• **Asset Based Lending**

• **What is it:**
  - Providing borrowing based secured business loans. The loan to value ratios depend on the assets being financed. Assets typically are receivables, inventory and PP&E.

• **Why would a customer want this:** Non-investment grade businesses who cannot issue public debt. They use banks or finance companies to fund their business.
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Leasing Company

Leases

Tax
  - TRAC
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  - Leveraged

Non-Tax
  Non-leveraged
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  - Leveraged
    - Municipal Lease
Lease A contract by which the owner of property (lessor) grants to another (lessee) the right to possess and use the property for a specified period of time in exchange for a stipulated periodic payment (rent).

Tax lease A lease in which the lessor takes on the risks of ownership (based on IRS criteria) and is entitled to the benefits of ownership, including tax benefits.

Non-tax lease A lease in which the lessee will, is obligated or is compelled to become the owner of leased equipment, and therefore has substantially all the risks and benefits of ownership. The lessee is therefore entitled to take the tax benefits (MACRS depreciation).
Leasing Company

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• **TRAC/Split TRAC**
  • **What is it:**
    – A tax lease in which companies acquiring equipment can exchange tax benefits for a low financing rate with an investor wanting tax shelter.
    – Strictly limited by law to the financing of vehicles registered as over-the-road vehicles (autos, trucks & trailers).
    – The lessor takes the tax benefits associated with ownership of the vehicles even though the lease gives the lessee the upside & requires the lessee to “guarantee” (via a rental adjustment) a specified residual value of the vehicles at the end of the lease term. For accounting purposes a TRAC is a capital lease for lessee & finance for the lessor unless structured as a Split TRAC. A Split TRAC is structured the same as a synthetic lease and as a result is an operating lease for the lessee.
  • **Why would a customer want this: A customer who can’t use tax benefits.**
Operating lease achieved because the present value of the rents and residual guarantee PV is below 90% of equipment cost

Lessee’s options:
- Purchase at the TRAC amount
- Sell asset & keep upside or pay shortfalls up to residual guarantee
- Negotiate a renewal
• **Fair Market Value (FMV) Lease**

• **What is it:** A lease where the lessee’s options at expiry are to buy the equipment at FMV or renew at FMV rents. The lease can contain an early buyout option (EBO) or a fixed price purchase option (FPO) that is at least equal to the expected FMV. Most often the lease is an operating lease to the lessee.

• **Why would a customer want this:** A customer who can’t use tax benefits and wants on operating lease.
Tax Lease Profile

[Diagram showing Equipment Cost over Years with Early Buyout Option (EBO) and FMV]

- Stipulated Loss Curve (SLV)
- Early Buyout Option (EBO)
- FMV
- Residual
Tax Leases

• **Leveraged Tax Lease**

• **What is it:**
  – A three-party lease transaction which involves a lessee, a lender and a lessor (equity participant). Financing is provided by the lender and is non-recourse to the lessor (although the creditor has recourse to the leased property, rent payments and other obligations under the lease).
  – The rental stream is first used to repay debt.
  – The lessor receives the tax benefits of ownership. The lease is typically an operating lease to the lessee

• **Why would a customer want this:** For big deals as fees & costs are high. The low cost debt, tax benefits & leverage lower the rate to the lessee.
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Leasing Company
Non-tax Leases

- Synthetic Lease

- What is it:
  - A lease that is an operating lease for accounting purposes yet a financing for tax purposes. The lessee is considered the owner of the equipment for tax purposes.

- Why would a customer want this: A customer that wants off balance sheet financing yet can use the tax benefits of ownership.
Non-tax Leases

• Non-leveraged Synthetic Lease
• What is it:
  – A synthetic lease that is an operating lease (off balance sheet) for accounting purposes, but a financing for tax purposes. Usually done for small ticket equipment via a master lease. The lessee gets the upside & gives a capped first loss residual guarantee. The residual guarantee is included in the PV classification test and the PV must be <90% of the fair value at inception.

• Why would a customer want this: A customer who wants the tax benefits and off balance sheet treatment.
Non-tax Leases

- **Leveraged Synthetic Lease**
- **What is it:**
  - A synthetic lease that it is leveraged with 3rd party non-recourse debt.
  - Usually done for real estate and large ticket equipment.
  - Must be a large ticket deal to justify the legal expenses.

- **Why would a customer want this:** A customer who wants the tax benefits & off balance sheet financing. Real estate deals have interest only rents that improve the P&L treatment versus ownership.
Non-tax Leases

• **Municipal Lease**

• **What is it:**
  
  – A tax-exempt lease with a public entity, generally a state, town or city, where the public entity automatically becomes the owner of the property at the end of the term.
  
  – The "interest" charge is tax-exempt for the lessor.
  
  – A unique feature is that in the event that a public entity does not receive sufficient appropriations to make the lease payments, it can terminate the lease without recourse.

• **Why would a customer want this:** Tax exempt entities enjoy the low cost of the lease.
The Lease Product

Why Customers Lease
Overview

• The Leasing Market

• Corporate Finance Needs

• Why Do Customers Lease?
Public and Private Business Fixed Investment (BFI) in Machinery and Equipment* ($ Billions)

* Includes BEA's nonresidential investment in equipment & software, state and local government investment in equipment, and federal non-defense investment in equipment

Source: U.S. Department of Commerce Bureau of Economic Analysis, National Association for Business Economics, Global Insight
What is Financed?

- 2011 Survey of Equipment Finance Activity

Type of Equipment

- Agricultural
- Amusements
- Computer – Mainframes and Servers
- Computer – PCs and Workstations
- Computer – POS, Banking Systems and ATMs
- Computer – Software
- Computer – Networking
- Computer – Storage
- Computer – Other
- Construction
- Energy
- Environmental Controls & Elect. Dev.
- Energy – Other
- FF&E – Office Furniture & Equipment
- FF&E – Restaurant Equipment
- FF&E – Retail Equipment
- FF&E – Other
- Industrial / Manufacturing – Machine Tools
- Industrial / Manufacturing – Plastic Extrusions
- Industrial / Manufacturing – Water Poll. & Waste Mgmt Trtmt.
- Industrial / Manufacturing – Other
- Materials Handling
- Medical – Imaging & Electronic Devices
- Medical – Hospital & Other Furniture, FF&E
- Medical – Other
- Mining, Oil & Gas Extraction
- Office Machines
- Printing
- Telecommunications
- Transportation – Aircraft – Commercial
- Transportation – Aircraft – Corporate
- Transportation – Autos (Commercial / Fleet)
- Transportation – Buses / Motor coaches
- Transportation – Containers / Intermodal
- Transportation – Fresh and Saltwater
- Transportation – Railroad
- Transportation – Trucks & Trailers
- Other *

2010 New Business Volume (in $000s) = $81,364,544
2009 New Business Volume (in $000s) = $78,484,417

* 2011 Survey of Equipment Finance Activity
Corporate Finance Needs:

– Raising cost-effective capital

– Tax planning/minimization

– Financial structure management

– Efficient asset deployment

– Regulatory constraint management

– Convenience/service
Corporate Finance Solution: Leasing

- Raise capital
- Reduce cost of capital
- Manage taxes
- Manage accounting
- Manage assets
- Manage regulatory issues
- Gain convenience/service
Why Do Customers Lease?

Raising Capital

**Problem**
- Borrowing capacity
- Liquidity
- Capital budget constraints

**Leasing solution**
- Additional financing source
- 100% financing
- Low payments
- Longer terms
- Costs in operating budget
Why Do Customers Lease?

Reduce cost of capital

Problem
– Unfavorable tax position
– High equity cost

Leasing solution
• Payments reflect tax benefits
• Off-balance sheet financing leverages capital
Why Do Customers Lease?

Manage taxes

**Problem**

- Net operating loss (NOL)
- Alternative minimum tax (AMT)

**Leasing solution**

Reduces after-tax cost of borrowing
Lease vs. Buy Analysis

– Analysis done by the lessee to determine if a tax lease financing is more cost-effective than borrowing to buy the equipment

– The dilemma is that the tax lease rent rate looks better than the loan rate but the lessee is giving up potentially valuable tax benefits

– The new lease accounting project adds intangible issues to the LvsB analysis as leases will be on B/S and the accounting is different than buying
The calculation is a discounted cash flow analysis:
- Calculates the PV of the after tax cash flows of the lease
  - Rent to be paid less the tax benefit of deducting the rent
  - Tax deductions are adjusted for impact of NOL & AMT

- Calculates the PV of the after tax cash flows of a loan
  - Loan payments to be paid less the tax benefit of deducting the interest on the loan & the depreciation on the asset net of the after tax gain on sale of the asset
  - Tax deductions are adjusted for impact of NOL & AMT
  - Must assume the asset is either sold under the loan or bought under the lease assumptions to be comparable

The lowest PV of the 2 choices = the lowest after tax cost & therefore it is the best choice
Lease vs. Buy Analysis

- Intangible factors:
  - Capitalization means the asset and liability are on B/S – BUT usually at lower amounts than borrowing to buy
  - Returns on assets are lower
  - The lease cost pattern is front ended
Why Do Customers Lease?

Manage accounting

**Problem**
- Ratios/credit rating
- Covenant restrictions

**Leasing solution**
- Reduce leverage, improve ROA, ROIC
- Operating lease vs. debt
Current Lease Accounting Models

FAS 13:

- Risk & rewards model
- Leased asset either on balance sheet or off balance sheet based on 4 classification tests
  - Auto transfer of title?
  - Bargain Purchase option?
  - Lease term $\geq 75\%$ of leased asset useful life?
  - $PV$ of minimum lease payments $\geq 90\%$ of leased asset value?
- Lessee: either capital lease (on B/S) or operating lease (off B/S)
- Lessor: either direct finance lease (DFL) or operating lease
- Sales-type and leveraged leases are varieties of DFLs
- Sale lease back of R/E/integral property considers continuing involvement as classification indicator
- Gains in sale lease backs amortized or deferred
Current Lease Accounting Models

IAS 17:
- Risk & rewards model, but more judgment
- Leased asset either on balance sheet or off balance sheet based on 8 criteria
  - Auto transfer of title?
  - Bargain Purchase option?
  - Lease term = major part of leased asset useful life?
  - PV of min lease pmts = substantially all of leased asset value?
  - Asset specialized?
  - Lessee gtes lessor’s investment if lessee can cancel lease?
  - Lessee gets residual upside and losses at expiry?
  - Bargain renewal option?
- Lessee: either capital or operating lease
- Lessor: either DFL, sales type lease or operating lease
- Gains in sale backs can be upfront or amortized depending on lease classification
Comparing Current Lease Accounting Models

<table>
<thead>
<tr>
<th>Issue</th>
<th>FAS 13</th>
<th>IAS 17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk &amp; reward model</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Lessee classification tests</td>
<td>4 with bright lines</td>
<td>8 with more substance</td>
</tr>
<tr>
<td>Lessee subsequent accounting</td>
<td>Cap or op lease</td>
<td>same</td>
</tr>
<tr>
<td>Lessor accounting</td>
<td>DFL/LL/Sales-type or Op lease</td>
<td>Same ex. no LL</td>
</tr>
<tr>
<td>R/E &amp; integral equip SLB</td>
<td>Considers continuing involvement</td>
<td>No special rule</td>
</tr>
<tr>
<td>Gains on SLB</td>
<td>Amortized or deferred</td>
<td>Upfront or amortized</td>
</tr>
</tbody>
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THIS WILL ALL CHANGE DUE TO LEASE ACCOUNTING PROJECT!!
## Why Do Customers Lease?

**Manage assets**

<table>
<thead>
<tr>
<th>Problem</th>
<th>Leasing solution</th>
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</thead>
<tbody>
<tr>
<td>– Obsolescence</td>
<td>• Lessor assumes risk</td>
</tr>
<tr>
<td>– Uncertain need</td>
<td>• Terms negotiable</td>
</tr>
<tr>
<td>– Acquisition/disposition/</td>
<td></td>
</tr>
<tr>
<td>asset servicing</td>
<td>• Lessor’s responsibility</td>
</tr>
</tbody>
</table>
Why Do Customers Lease?

Manage regulatory issues

**Problem**
- Financial services - capital adequacy
- Utilities - rate pressures

**Leasing solution**
- Off-balance sheet, frees up capital
- Equipment costs recovered as operating expenses
Why Do Customers Lease?

Gain convenience

**Problem**
- Small ticket size
- Multiple takedowns
- Service

**Leasing solution**
- Service intensive, standard documents, quick & easy tied to vendor sales process
- Master leases, lease lines, centralize control
- Can include services e.g.: PC, Fleet
Who May Lease?

- Customer profile
  - Limited ability to borrow
  - Asset intensive, large CAPEX budget
  - Capital constrained
  - Credit rating pressure, highly leveraged
  - Tax problems
Lease Project Overview

FASB/IASB Lease Accounting Project
**Acronyms**

- **FAS 13/IAS 17** – The current lease accounting rules
- **FASB** – Financial Accounting Standards Board
- **IASB** – International Accounting Standards Board
- **Off-balance sheet** = operating lease
- **Capitalize lease** = put lease on balance sheet
- **On balance sheet** = Value of “right to use” leased item is an asset, lease obligation booked as a loan & P&L shows depreciation & interest expense
Changes in Lease Accounting
FASB/IASB Project Update

Agenda

• Background information
• What is the proposed new rule?
• What is the time table?
• What are the possible and likely outcomes?
• Analysis/Impact
• Q&A
The FASB/IASB began project to replace FAS 13 & IAS 17 in July 2006

The lessee off-balance sheet accounting seen as major reporting deficiency

The stated objective of the lease accounting project is:

– to ensure that financial statements provide useful, transparent, and complete information about leasing transactions to investors and other users of financial statements.
Changes in Lease Accounting
FASB/IASB Project Update

Background

Project prompted by:

• Changes to conceptual framework, with revised definitions of assets and liabilities, supports accounting for rights and obligations

• Re-thinking the current accounting model
  – All leases give rise to the acquisition of an asset and incurrence of liability
  – Eliminate “all or nothing” approach based on concept of “substantially all of the risks and rewards”
  – Rules-based approach with bright line tests allows financial engineering

• Leasing as collateral damage of off-balance-sheet scandals.
Lessee off-balance sheet operating lease obligations viewed as the major reporting problem.

SEC estimates the total footnoted lease obligations at $1.25 trillion.

Worldwide equipment leasing market est. = $600+ billion, but many leases are capital leases (80% in US), and most operating leases are small-ticket short-term true leases.

Real Estate leases are the elephant in the room, with ELFA estimates that RE is over 70% of the problem.
Lease Project Analysis

Overall Model – For lessees - Capitalizes all leases complex calculations and adjustments front ending P&L cost

- Capitalize the PV of contractual rents, interim rents, bargain renewals, rate based contingent rents and estimated residual guarantee payments at incremental borrowing rate. Review & adjust estimates each reporting date.

- Treat leases as a purchase of an intangible asset and a loan. SL ROU asset amortization and imputed interest replace SL rent expense

- Leases with bargain POs or automatic transfers of title are considered financed purchases
Lease Project Analysis

Lessors will have 3 models:

- **“Receivable/Residual” or R&R**
  - Like DFL accounting

- **Short Term**
  - For terms of 1 year or less
  - Use current Operating Lease method

- **Investment Properties**
  - For certain commercial real estate lessors
  - Operating Lease method with fair valuing of residual

- **No Leveraged Lease accounting**

- **Sales-type up-front gross profit allowed for all R&R leases but profit on residual portion deferred**
What is the timetable?

- Second Exposure Draft to be issued soon with 120 day comment period
- Final rule target completion – expected to be mid 2012
- Transition date expected to be 2015
- Virtually all leases will be rebooked - no grandfathering
Implications for Lessees

- **EBITDA improves** *(strange result?)*
  - Depreciation/interest vs. rent expense (operating expense)
- **Capital needs increase** - Financial institutions impacted
- **Debt covenants broken – credit ratings unchanged**
- **Earnings/EPS erode if SL P&L eliminated**
  - 1st year lease costs increase dramatically (+7% in 3 yr lease, +21% in 10 yr lease)
  - Retailers impacted – after tax earnings hit of 5+% in US
  - Transportation & Banks impacted
- **Cost/Benefit**
  - Transition: all operating rebooked
  - New systems needed
  - Complex calculations with continuous adjustments
  - Lack of clarity, ignores economic reality
- **Traditional reasons for leasing continue**
Lease Accounting Project Impact

**Implications for Lessors**

- **Systems changes**
- **Leveraged leases eliminated**
  - Balance sheet grossed up
  - MISF earnings method eliminated
- **Transition**
  - All leases rebooked to R&R method except short term leases
  - Revenue adjustments for all leveraged & operating leases & most sales-type leases
- **Forecasted balance sheet and revenue changes**
Q&A

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