



## GREASING THE *wheel*

### Ready for the Next Step? How About a Return to the Basics

BY SHAWN HALLADAY

**Indeed, there are opportunities for lessors** willing to offer operating leases. Successfully managing residual risks in today's market, however, requires a fundamental change in approach. Creating value for the customer in this manner will require new methodologies and rigor. The opportunity is there. Who's ready to take the step?



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**T**he past two years have seen the financial sector plunged into turmoil, including the equipment leasing industry. This turmoil has been felt on both sides of the leasing equation, as the paucity of deployable capital is affecting both lessors and lessees alike. The good news is that events like these generally foment change, either because new opportunities are created, or the market forces them to be made. In this column, I posit that a return to the basics of leasing is a necessary change whose time has come.

#### The Lease as a Commodity

The equipment leasing industry has drifted from its core competency of managing assets to more of a financial institution approach. Even the Equipment Leasing and Finance Association (ELFA) name change reflects this direction. This trend, in part, has been driven by a quest for additional markets and volume, but there also are other factors at play. These include a continued movement away from taking asset risk, increasing bank competition and bestowing leasing products, such as early buyout options (EBOs) with financing attributes.

This transformation has given away product advantage, market share and profits. On top of this, the U.S. equipment leasing industry has also matured, resulting in increased competition, commoditized products and narrowed margins. Conditions are such, therefore, that, if a company is to outperform in this market, or, for some, even survive, it will have to add value and differentiate itself and its products. Returning to equipment leasing's roots and taking managed residual risk is one of the few options available for financing companies to do so.

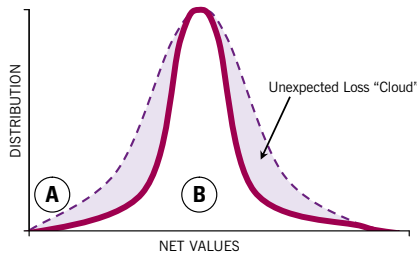
Other factors also support this core market shift. The coming changes to lease accounting, for example, will create a demand for shorter lease terms as lessees seek to minimize the balance sheet impact of capitalizing all leases. Lessees also will seek more usage-based leases and managed equipment services, all of which emphasize residual positions.

Most importantly, customers will continue to seek out the cash-flow benefits of operating leases<sup>1</sup> as economic conditions force them to do more with limited cash. One lessee, in recent comments about his leasing decisions, said, "This is a cash-flow analysis that I do based on pure economics, what generates the most value to the shareholder ... [e]ven if I have to put it on my balance sheet, I still get the same kind of cash-flow benefit that I just described."<sup>2</sup>

Customer motivations such as these place a premium on the lessor's ability to offer the cash-flow savings associated with an operating lease. Additional value is created for the customer when the lessor better matches his or her products to the customer's needs through knowledge of the assets. The lessor,

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FIGURE 1:  
**Residual Value Distribution**



on the other hand, is able to generate more volume through product differentiation, which, in turn, can create additional revenue streams.

### FMV Leasing

Just because the industry needs to return to its roots and offer more FMV leases, it does not mean that we should go back to doing business as before. When setting residuals, it's no longer acceptable to take past history and cloak it in a current market shroud. Today's market requires a dynamic pricing approach based on using more knowledge and better analytics to take out risk and improve returns.

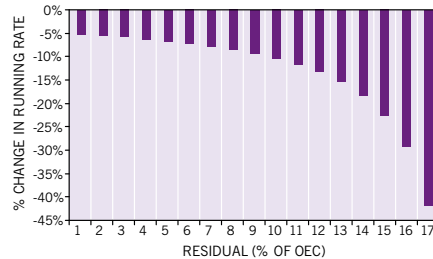
Currently, lessors regard residuals almost as if they are surrounded by an impenetrable cloud of uncertainty. This "cloud" is illustrated in *Figure 1* as the area under the curve represented by the dotted line. The traditional approach is to establish and then haircut the residual, with most lessors conservatively pricing residuals on the edge of the cloud at point A. The rationale for this approach is to protect against unexpected losses, even though point B is more representative of the median realized value.

Setting the residual at point B (or somewhere in between) would create a lower customer rate. *Figure 2* illustrates the acceleration of the reduction in the running rate as the residual is increased incrementally by one point. Being able to offer lower rates creates a competitive advantage for the lessor, which, assuming elasticity of demand, results in greater volumes. Increasing the residual only makes sense if the uncertainty surrounding the residual can be reduced or the dispersion around the mean compressed, however. Reducing the uncertainty cloud also creates additional pricing benefits, one of which is not having to allocate as much capital to the transaction.

Since the capital in a transaction is intended to cover losses, both expected and unexpected, any reduction in the risk means less capital must be allocated to that deal. As can be seen in *Figure 3*, the ROE of a transaction, given a constant ROA and cost of debt, increases as the amount of allocated capital declines.

Proponents of the status quo may point out the increased risk of offering more operating leases. I submit, however, that lessors need not, and should

FIGURE 2:  
**Residual Impact on Running Rate**



not, increase the amount of risk in a transaction but, instead, manage the risk more effectively. A higher residual does not necessarily mean a riskier investment if the asset risk is properly identified and managed, and risk and returns are correlated in the pricing function. Success in this area should come from better aligning risks, rewards and customers with the transaction structure.

There are lessors in the industry that are managing the residual risk of operating leases quite successfully, so we know it can be done. The key is in how the risk is managed. We measure and control credit risks with sophisticated analysis and models. Why not bring the same rigor to the asset management function? Better yet, why not combine the two into one global risk management function? The benefit of such an approach, *inter alia*, would be improved product definition and more efficient capital allocation.

### Conclusion

There are opportunities for those lessors willing to offer operating leases. Successfully managing residual risks in today's market, however, requires a fundamental change in approach. Creating value for the customer in this manner will require not only standard procedures, governance and controls relating to effective residual risk management but also new methodologies and rigor. The opportunity is there. Who's ready to take the step? ■

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### ENDNOTES:

1. I use the term "operating leases" in the industry, not accounting, since, that is, a residual-based, fair market value lease.
2. Interview with Ingemar Lanevi, vice president and corporate treasurer for NetApp, as reported in *The Lessee Advocate Newsletter*, December 2009.

FIGURE 3:  
**Capital Allocation & ROE**

