

MLPi **MANUFACTURERS'** **LEASE PLANS INC.**

Maximizing Residual Values in Portfolio Sales

By Roger R. Marce

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Trying to realize the residual value of leased equipment through a portfolio sale can often be like trying to sell a dairy cow to a butcher shop. Getting the buyer to pay for the value of the future "milk" production can be a real challenge.

Roger R. Marce is President of MLPi (Manufacturers' Lease Plans Inc.), a Phoenix, Arizona-based company specializing in portfolio purchases and vendor programs. Mr. Marce is also an attorney with 31 years experience in equipment leasing. He is a graduate of Alma College (BA, Cum laude, 1962) and the University of Michigan Law School (JD, with distinction, 1965).

But it's not impossible. Not every cattle buyer is purchasing for the meat content. There are those who buy livestock for their value as dairy cattle. And in leasing, there are lease portfolio buyers who buy – and who price what they buy – with a keen awareness of the importance of residual value.

By way of example, at MLPi (Manufacturers' Lease Plans Inc.), we offer an End of Term program that focuses on buying smaller, seasoned portfolios with strong emphasis on residual value. Once purchased, intensive residual management follows. This strategy, the company believes, allows a premium to be paid for the residual potential of the portfolios.

Of course, the potential of any portfolio depends on its makeup. A portfolio of aged but serviceable communications equipment may have a very substantial value; whereas a portfolio of similarly aged but regrettably obsolete notebook computers is speculative, at best. However, whatever the nature of the portfolio, simply following a handful of well thought out sales rules can help the seller maximize his selling price.

Define objectives and value

First and foremost, the seller needs to define his objectives, and identify the makeup of the sale that will best meet those objectives. For example, a seller seeking to boost current year's (or quarter's) earnings can usually do so through a sale of fully depreciated equipment (or items close to being fully depreciated). Virtually the entire sale price will normally drop directly to the bottom line. In contrast, if the sellers' objective is to improve liquidity, he should focus on equipment that can be sold without requiring a pay-down to lenders. (Ideally, a well-planned sale may produce both revenue recognition and cash flow.)

The seller also needs to have a clear understanding of the true value of what he is selling—not just the intrinsic value of the equipment itself, but also an understanding of the value of the leases that are being sold in tandem with the equipment.

The dialogue with prospective buyers should begin only after the seller has defined his objectives, identified the segments of the portfolio that he intends to sell, and developed a clear understanding of the value of what he is selling.

In dealing with prospective buyers, perhaps the most important piece of information to know is how each prospect is pricing the portfolio. Some buyers may place a premium on the newest items in the portfolio, whereas a buyer who is focused on residual values will more likely place a premium on the older items in the portfolio. Focusing on residual values simply reflects a buyer's appreciation that residual values are most significant with leases that are at or near the end of their base terms.

However, whether the leases have remaining terms of several years or have all reached month-to-month status, the seller should know the price each buyer is prepared to pay for each lease and, lease-by-lease, how each prospective buyer's price compares with what others are willing to pay for that specific lease.

Segmenting the portfolio

The seller should also be prepared to sell different segments of a portfolio to different buyers. For instance, MLPi has worked with more than one seller who maximized his price by splitting the portfolio between two buyers. One buyer's pricing was more beneficial for the newer leases in his portfolio, while our pricing structure was the most advantageous for his more "seasoned" leases – those that were at or near the end of their base terms.

The seller should also look with a critical eye at any pricing adjustment that is intended as a hedge against credit concerns. These concerns are legitimate, to be sure. Incautious credit policies have buried more than one leasing company. However, as a lease approaches the end of its term, credit concerns normally diminish. By the same token, in valuing leases that are at or near end of term, pricing adjustments based on credit concerns should be minimal.

Timing and taxes

Timing of the sale can also be important - every bit as important as what is sold. If the objective is to enhance current earnings, sale just prior to the end of the current fiscal period is likely to be the best timing strategy. A key ingredient to proper timing is advance planning. If the seller wants to close just prior to the end of the fiscal quarter, initial contacts with prospective buyers should begin early in the quarter.

And let's not forget about taxes (as if we could). While the accountants are telling us that we have to depreciate our leases over the realistic economic life of the equipment,

the IRS imposes tax depreciation schedules on us that are often unrealistically long. As a result, many lessors have leased – typically items they have held for more than three years – which is on their financial accounting books at one value while on their tax books at a dramatically higher tax basis. However, a sale of this equipment at a price falling within the delta between true book value and tax basis can produce a profit on the books of the selling company while providing a tax write-off at the same time.

Customer concerns

Finally, if protecting customer relationships is of concern, the seller should find out early in the discussions whether or not the buyer is receptive to an arrangement whereby the seller would have ongoing involvement in managing customer accounts. One thing the seller might propose is a private label arrangement, whereby customers would continue to be billed in the name of the seller. To further protect customer relationships, the seller should consider selecting a buyer who is receptive to a “hands off” agreement. This would ensure that the buyer will not compete with the seller by soliciting the customers for future business.

Bottom line

The bottom line? A well-planned portfolio sale can provide the seller with immediate benefits and provide a substantial return on the residual value of the portfolio.

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