Lending To Lessors: An Insiders View

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Once again it appears that the banking industry has completed an economic cycle and beefed up its balance sheet coffers for growth opportunities. Whether or not more banks will deploy their excess liquidity and invest in the leasing industry is quite another issue. Having worked both sides of the table as a leasing company borrower and lender to the business, I have a greater appreciation of the challenges of both borrowing from banks and lending to the business.

The quality of the leasing company's management team remains the leading criteria in lending to a leasing company. The next most important focus of a warehouse lender involves the leasing company's ability to raise permanent capital on a consistent and cost effective basis. Securitizations are currently the "darling" of the permanent funding vehicles and have served as a type of reincarnated version of the short lived income funds.

Lessor's should seek to help the lender understand the risks of the business rather than insulate them from it. A pragmatic lender with a clear grasp of the risks not only improves a lessor's chances of approval, but more importantly, enhances their ability to finance future growth. Due to the specialized nature of the business, some non-specialized account officers may "hear" more than they comprehend. The best lender is one who understands the business, identifies the material risks and structures a transaction that is fair to both sides.

Warehouse lines are typically formula driven, asset based facilities secured by leases, the underlying equipment, receivables and inventory. Typical advance rates on leases amount to 90 percent of the present value of the stream of payments discounted at either the implicit rate or the borrowing rate. Advance rates on residuals are much more diverse depending upon the nature of the equipment, availability of independently reported realization results and the quality of the asset management department.

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Trade receivable advance rates are generally in the 75 percent to 80 percent range on accounts under 90 days past due. Inventory advance rates can be anywhere from 10 percent to 50 percent depending upon the marketability of the equipment. Progress payment financing is available depending upon the strength of the underlying documents, nature of equipment, complexity and length of the equipment installation process.

Covenants are very common requirements. Debt service, leverage and liquidity ratios are the most frequently used ratios. In addition, all lessors should conduct a portfolio liquidation analysis under both a "most likely" and "worst case" scenario. A lessor can impress a lender by developing frank and realistic projections.

The analysis should include a projection of both charge-offs and recoveries over the remaining portfolio life. Charge off data needs to be accompanied by policy information explaining the criteria for write-offs and restructures. A minuscule charge off ratio is only as meaningful as the aging period in which it is written off and the extent of restructuring activity.

When a lessor runs the liquidation analysis and comes up short as compared to outstanding debt, it usually implies a need for more permanent capital. Lessors should openly discuss their opinion as to why they believe the business may not require a capital injection or conversely, explain the current plans to raise capital to cover the shortfall.

Lessors should always request a term out conversion in order to minimize the possible trauma of a refusal by a bank to renew the existing warehouse line. Conversion features allow both the lender and lessor to rationally pursue other solutions to correct capital shortfalls.

Permanent Debt

Banks focus on a number of criteria in approving the funding of permanent fixed rate debt. Pricing spreads, term, equipment type dollar size, and credit quality are typical conditions for approval. Geographic location requirements should be discussed up front with a lender. High rate lenders and lenders within the lessee's geographic location are fairly responsive to weaker credits.

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Generally speaking, the more structural control a lessor can negotiate in a weaker credit, the greater the probability of approval. Controlling lease payment streams with a lock box agreement can both raise the probability of approval and reduce the lessors debt cost.

The standard rule applied by a lender is that it generally takes as much time and overhead to underwrite a $100,000 as it does to underwrite a $1,000,000 deal. Consequently, thinly priced, rated credits, can generally be placed easier in larger rather than smaller amounts.

Offering progress payment funding opportunities to lenders at prime and higher floating rates is another method of offering a lender a higher all-in yield on tightly priced, fixed rate debt. Offering partial recourse to a lender is yet another method of defraying debt cost on weaker credits.

Due Diligence

Most lenders to leasing companies perform both process and collateral audits in underwriting warehouse lines of credit. Funding of permanent debt does not require the same level of due diligence due to the transactional nature of this activity. Responsibilities for documenting, billing and collecting are the primary concerns of a permanent debt source.

Process audits evaluate the flow of procedures across functional responsibilities from origination through end of term residual negotiation. The following 7 departments are evaluated for procedural handling of a lease: sales, credit, documentation/lease administration, funding, collections and asset management/residual negotiation. The results are then compared to lessor policy statements to test the various internal controls implemented by the lessor.

Cross-Selling

Cross-selling of bank services remains a buzz word in the banking industry and unlike past banking trends, appears to be a permanent focus for relationship lenders. I have found that lessors historically underestimate the power of providing a debt source with additional non-credit services. While non-credit banking services cannot make a lender comfortable with a challenging credit, it does allow a lender to develop a longer term perspective with a lessor and definitely contributes to the overall profitability of the relationship. ▲

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