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Lease structuring brings together business, technology, finance, law, and taxes, making it a complex financial application. Not only are different disciplines involved, but there are multiple parties, each with its own perspective and motivation. Progressive lessors seeking a market advantage try various structuring and marketing techniques, some of which prove their worth and take hold, while others are cast aside. One might call these the tactics of the trade. Tactics that become established over time may become strategies. One such new strategy appears to be the continuing trend toward more precise analysis and allocation of transaction costs.

The increased availability of industry information has accelerated this trend. The ELA publishes an annual survey of cost statistics gathered from its members. On-line services provide market quote information on specific segments. Interest rates are updated electronically. Risk factors, no longer just abstractions, are being quantified. Given all this, the emphasis on cost analysis is not surprising, but a second related area of interest has emerged as well, that of measuring the value added of a transaction. These techniques include special yield or profitability measures, such as the contribution value added. The computing power and flexibility of personal computers has also encouraged experimentation with new calculations and methods.

The measurement of cost of funds has been a fruitful area for creative leasing minds, although it has not always been that way. In the early boom years fueled by ITC, a company could do just fine pricing all its deals with a single rate (often a portfolio or pool rate), adjusted periodically to keep in step with the market. Then ITC went away and competition tightened up, disciplining the pricing process and forcing a closer look at this major cost component. Also, new financing instruments emerged for managing risk, such as swaps and derivatives. To be sure, financiers have long realized that a relationship exists between term and cost. Determining the details of that relationship, on the other hand, has not been so simple.

The first step up from a single cost of funds was to use a rate based on the lease term---the longer the term, the higher the cost (assuming a positive yield curve), with full numbers of years initially providing adequate precision. This method, while certainly an improvement over a single rate, opened the way to further considerations in selecting both the term and the index.

Using the lease term for the debt term, while convenient, is not very accurate. The average life of equity is a better measure. The rationale for this is that the equity---the amount of capital that the lessor/investor actually puts up---is not outstanding for the entire lease term, but rather is repaid well before the end of the lease through cash and tax-flows. Therefore, the average life of equity, which is typically less than 2/3 of the lease term, is a reasonable surrogate. This principle applies

particularly well if one considers delayed equity funding structures. In such a case not only the equity repayment schedule but also the delayed funding are taken into account, further shortening the average life of equity and possibly justifying a still lower cost of funds.

On the other side, honing the fineness of the index values is a natural step: 3 months is fairly common, but 1 month on shorter terms is also used. Increasing the frequency of updates is another technique; banks particularly are in a position to know and apply the latest rates. A further tactic is to use a floating rate index, possibly with a choice of instrument. The floating rate values are updated whenever those rates change, so that the pricing always reflects market rates.

The layered money cost is probably the most refined technique in money cost analysis. In this technique, each cashflow is analyzed separately to determine the duration of the funding it requires. A table of values gives the cost for each term, and intermediate values are interpolated. The total money cost, then, is the sum of all of the pieces. This is a good example of a technique made feasible by computing power combined with specialized software.

Techniques in the value added realm are designed to compute an overall financial benefit of a transaction by combining in a single measure all significant costs, including capital, risk, inflation, fees, and other operating expenses, with the profit that the transaction produces. These methods received their impetus from the economic

value added (EVA) theory, which came into vogue in the early 90s as a tool for managers to analyze and understand the economic performance of their businesses. The consulting company of Stern Stewart in New York actually trademarked EVA as a business performance tool. Subsequent variations came to be called CVA, with the C standing for Contribution, Controllable, or Customer, depending on the company and the context. Lately it has been seeing experimentation as a tool to measure the economic benefit of individual leasing transactions.

One progressive company in the use of CVA is Bank One Leasing, headquartered in Columbus, Ohio. They have developed their own CVA calculation, which, although still evolving, is already producing tangible benefits. According to President & CEO Rick Ballantine, "the CVA enables us to maintain our focus on return on equity throughout the lease pricing process. It is helping us to make better and earlier decisions about our transactions." Their method is based on return on equity and includes up-front, periodic, risk, and capital components.

Another profitability-related technique is the spread yield, which computes the difference between a base yield and an index yield as the spread. Typically the base yield will be the multiple investment sinking fund (MISF) on after-tax cashflows. The index yield may be a custom calculation, or it may be a table of values. If it is a table, the index is usually a statistic relating to the MISF yield, such as the average life of equity. Let's assume an example where the MISF is 8%

nominal after-tax. Let's further assume that the average life of equity in that MISF calculation is 30 months. If the table (or custom calculation) produced an index yield of 6% (using the 30 months), then the spread is 8% - 6%, or 2%. This is in essence the premium actually achieved over a hurdle rate for investments of that maturity. [This spread can be targeted by software, even though both yields, both the index and the base, change when the transaction is adjusted. This is because the financial behavior is usually well mannered, meaning that changes in the base yield cause nearly proportionate changes in the spread.]

Rod Hurd, Senior Vice-President of Financial Analysis at BankAmerica Leasing and Capital, believes that this approach is already producing benefits in terms of higher quality initial pricing. "This is a step forward in the evolution of a process to better link pricing activities with corporate initiatives intended to maximize shareholder value. One of the immediate benefits will be improved communication between finance and marketing on risks assumed and costs incurred."

A major benefit of the value added analysis is the awareness of cost and profit components that it instills. To increase the EVA/CVA, staff will have an incentive to increase revenues that help it and reduce costs that hurt it. A natural next step is the link to individual commissions. After all, if EVA/CVA is successful at measuring and creating economic success at the organizational level, then

encouraging behavior patterns at the individual levels which support it should further promote that success.

These techniques are being implemented in software, minimizing the number-crunching drudgery and enabling the analyst to stay focused on the bigger picture. Even so, precise cost analysis is not an "end-all-and-be-all" solution, no matter how convinced its proponents may seem. "Costs for certain activities in departments such as Accounting, Corporate Services and Planning do not lend themselves to precise allocation," suggests Boni Buringrud, Vice-President of Planning and Analysis at Metlife Capital Corporation. "In addition, while the argument can be made that no cost is fixed in the long run, on a going-concern basis there are costs in a organization that will exist whether a particular transaction is entered into or not. These types of costs must be considered at a higher and broader level."

Many lessors are revisiting the ways that they do their pricing, with an eye toward quantifying and including more of their risk and transaction costs early in the structuring process. Some are implementing "financial benefit" measures. Increasingly, profitability targets are structured as "after-cost" numbers. Although opinions differ on how valuable a strategic tool this will be in the long run, many are interested in its potential. Will the industry collectively reach new standards of cost-based pricing? That remains to be seen.

**By David Holmgren (Published in the March/April 1997 Leasing
and Financial Services Monitor)**