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Equipment Finance Market Forecasting

By Blake Reuter

It is often assumed, but has never really been confirmed, that capital equipment spending (capex) is a driver of equipment finance volume. This article helps validate that assumption and, furthermore, demonstrates that equipment finance volume can be forecasted over the short term using capex and statistical regression techniques.

TRAC Vehicle Leasing

By Edwin E. Huddleson

Terminal rental adjustment clause (TRAC) vehicle leasing is the most popular means of leasing cars and trucks to commercial end-users. Occasionally, criticism and litigation still challenge the true lease status of vehicle leases. This article summarizes the legal and public policy rationale for the TRAC/state laws and demonstrates that the majority of court decisions now recognize the true lease character of these transactions.

Equipment ABS Today: New, Improved!

By Stephen T. Whelan

Securitization of equipment leases and loans is on the upswing. Transaction volume has jumped over the last two calendar years. Moreover, delinquency performance has improved. Based on a recent Foundation study, this article evaluates some potential threats to continued growth of equipment asset-backed securitization.

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Equipment ABS Today: New, Improved!

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Securitization of equipment leases and loans is on the upswing. Transaction volume has jumped over the last two calendar years. Moreover, delinquency performance has improved. Based on a recent Foundation study, this article evaluates some potential threats to continued growth of equipment asset-backed securitization.

Editor's note: *This article is based on the September 2015 Foundation study* Securitization: A Renaissance for Equipment Finance? *researched by Stephen T. Whelan. The study is available at www.leasefoundation.org.*

Securitization of equipment leases and loans has evolved in many significant respects since the Equipment Leasing and Finance Foundation published its study in 2011.[1] Not only has annual transaction volume jumped during the last two calendar years (see Figure 1), but also loss and delinquency performance has improved.[2] This article will discuss recent changes in the equipment asset-backed securitization (ABS) marketplace, evaluate some potential threats to continued growth, and hazard a guess at some future developments.

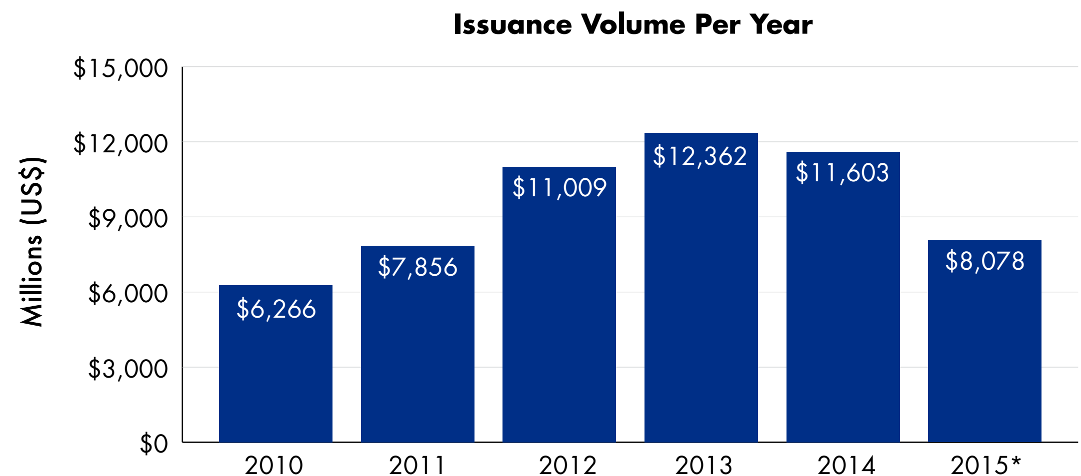
RECENT CHANGES

Industry participants have observed several developments since the Foundation's 2011 study: securitization of equipment residual values, resecuritization of equity cash flows, and the emergence of new equipment ABS asset classes.

So-called "true" leases contain two assets: the rentals payable by the lessee and the residual value of the equipment at expiration of the lease. When the first equipment ABS financings were closed in April 1985, investors and rating agencies would not finance any of the projected equipment residual values. Not surprisingly, they insisted that all proceeds of disposition of the equipment — whether at expiration or following default by the lessee — be deposited into the collection account (for all cash flow from the securitized assets) to be allocated in accordance with the securitization waterfall. This insistence resulted in moving the issuing lessor's residual cash flow to the final allocation in the cash flow waterfall, only after all other expenses, interest, and principal due that month had been paid.

Recent successful securitizations have relied on the ability of lessors to produce several years of residual realization data to support cash flow projections from equipment resale or re-lease. This data has enabled once-skeptical rating agencies

Figure 1. U.S. Equipment Leasing Securitizations



Source: Asset-Backed Alert.

*Issuance amount only for second quarter of 2015.

Because government cash grants and tax credits for solar energy are set to expire in the near future, solar energy providers have turned to securitization for financing.

to include a reasonable percentage of projected residual cash flows in the principal amount for an equipment ABS issue in April 2015. Earlier this year, a DBRS-rated note issue monetized a portion of the lessor's booked residual values, using the assumption that 30% of the projected residual value would be received six months after expiration of each true lease contract, hence enabling the sponsor to receive a portion of expected residuals at closing rather than over time.

Similarly, lessors have encountered greater investor acceptance for resecuritization of equity cash flows from prior equipment ABS financings. Resecuritizations (or resecs) involve each issuer of earlier securitizations selling to a newly formed special purpose entity (SPE) its rights to "bottom bucket" cash flow. The new SPE will issue notes collateralized by those cash flows. The size of the note offering will depend on the lessor's loss, delinquency, and residual realization experience.

Because the resec investors will need reassurance that this equity cash flow actually will be paid to the trustee or paying agent for the resecuritization, it is desirable that the financial institution playing that role be the same one that acts as indenture trustee for the underlying securitizations.

The creativity of securitization finance has been demonstrated as the equipment ABS market has grown from small- and middle-ticket office equipment to include titled motor vehicles, marine containers, and alternative energy equipment (see Figure 2). Recent transactions have highlighted the growth of this market segment to include alternative energy receivables and have increased attention to aviation equipment.

Alternative energy equipment, especially rooftop solar panels and football-field-size solar arrays, has grown as an asset class because businesses, consumers, and government agencies increasingly seek to reduce their energy costs as well as the dependence of the U.S. economy on fossil fuels. PricewaterhouseCoopers has estimated that residential and commercial capacity for photovoltaic energy is expected to grow at a 22% annual rate between the years 2010 and 2020.[3]

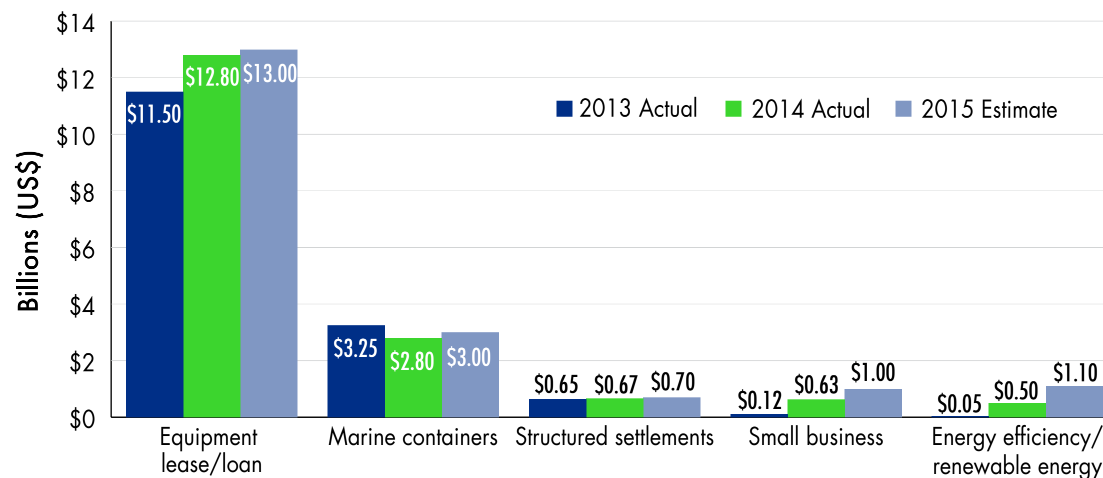
Because government cash grants and tax credits for solar energy are set to expire in the near future, solar energy providers have turned to securitization for financing.

Solar energy receivables chiefly arise from leases and power purchase agreements (PPAs). SolarCity, a California-based company, has completed several successful alternative energy ABS financings with both leases and PPAs comprising the underlying contracts. The first deal, in November 2013, was rated only BBB+ by Standard & Poor's but nonetheless was sold at an attractive interest rate of 4.8%.

Demonstrating the staying power of this emerging equipment ABS segment, SolarCity has issued several other solar ABS financings, with investor interest heightened by inclusion of a six-month interest reserve account and the underlying equipment averaging only one year old since manufacture. S&P's reports on the SolarCity financings emphasized the importance of the sponsor's ability to address any equipment functionality issues, any obligor defaults, and remarketing of the related equipment.

In contrast, aircraft and engine securitization has been a market segment for more than 10 years, despite significantly suffering during the 2007 financial crisis. In May 2014, S&P reported that "[A] revival of aircraft ABS issuance is underway … the most since 2007."

Figure 2. ABS Issuance, 2014 Actual versus 2015 Estimate



Source: DBRS, Inc.

In January 2015, Kroll Bond Rating Agency (KBRA) released a research report, concluding "that the overall credit quality of aircraft lessors will continue to strengthen," and in May 2015 Fitch Ratings released a lengthy report on aircraft operating lease ABS. The headwinds that this asset class encountered appear to have subsided.

Consequently, panelists at the February 2015 Structured Finance Industry Group (SFIG) discussion of aircraft securitization provided an upbeat viewpoint, noting that the current fleet of commercial aircraft is expected to double over the next two decades, with capital markets anticipated to provide roughly 35% of the financing needs for new aircraft.

The panelists also observed that aircraft ABS typically offers investors attractive interest rates compared to the risks that are unique to this asset class. Those risks include greater concentration of values among the underlying contracts; the disconnect between the usual lease terms and the much longer aircraft useful life; the greater length of time required to refurbish off-lease aircraft before it can be sold or re-leased; fuel price volatility; and technological obsolescence, especially after a particular model of airframe has been manufactured for more than 10 years.

POTENTIAL THREATS

Like all securitized asset classes, equipment ABS faces several threats, both economic and regulatory. Industry professionals, surveyed for the 2015 Foundation study of securitization, identified inflation and rising interest rates as threats to Equipment ABS. Specifically, they noted that the U.S. economy has experienced a significant secular decline in long-term interest rates since 1982, and predicted that the Federal Reserve Board will increase the federal funds rate, starting in late 2015 or early 2016.

Countervailing considerations include the KBRA forecast that the dollar yield curve is likely to flatten, thereby reducing the immediate impact of any Federal Reserve Board increase in short-term interest rates. Other commentators believe that any inflation in asset values would have the effect of increasing nominal equipment residual values, thereby making equipment ABS more secure.

The greatest source of uncertainty, though, arises from whether the exceptionally good lessee and borrower performance of recent years can continue, especially if competitive pressures prevent leasing companies from hiking rental and borrowing rates to compensate for a higher interest rate environment.

Regulatory threats arise from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, specifically its provisions for risk retention, obligor data disclosure, and random assignment of rating agencies for all securitized issuances.

Risk retention is required under recently issued Regulation RR, effective December 24, 2016, for equipment ABS and other nonmortgage securitizations. A person who organized and initiates an ABS transaction by selling or transferring assets, either directly or indirectly (including through an affiliate), to the issuer of the ABS must retain the aggregate credit risk equal to 5% of the fair market value of the assets underlying the equipment ABS issue. This can occur through horizontal ownership (ownership of the unsecuritized cash flow, including equipment residual values, and one or more of the most subordinated classes of ABS) or vertical ownership (ownership of the same percentage of every class of the ABS interests, including the equity in the issuer). An eligible reserve account, as has been used for many years in most equipment ABS, also can contribute to satisfying the risk retention requirement.

Thanks in large part to advocacy efforts by the Equipment Leasing and Finance Association, Regulation RR did not contain certain pernicious elements which, however inadvertently, would have disadvantaged equipment ABS. However, the final regulation requires that the sponsor of an ABS deal disclose the methodology by which it has calculated how its risk retention for that deal complies with the required level. These calculations would involve projected default and recovery experience for the collateral pool, along with an explanation of how the anticipated residual values were estimated, and hence implicate the sponsor's proprietary formula for estimating residual realization.

All this data would be revealed to potential investors and inevitably could be shared with other investors and competitors of the sponsor — a source of considerable discomfort to sponsors. Some clue regarding how this disclosure might be accomplished can be discerned starting in December 24, 2015, when Regulation RR becomes applicable to mortgage-backed securities issued on or after that date.

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Another dilemma under Dodd-Frank relates to the possibility that sponsors may have to disclose to potential investors data on each lease and loan in the collateral pool. When the

Software lease and license agreements both involve scheduled cash flow, often utilizing a hell-or-high-water installment payment agreement to enable vendors to finance receivables with institutional investors that are familiar with equipment finance.

SEC promulgated its asset-level data requirements for certain securitization transactions, it hinted that consideration was still underway regarding whether asset-level data would be required, at a later date, for equipment ABS.

ELFA and SFIG have protested that this disclosure could enable competitors to reverse-engineer that data to identify proprietary trade metrics of the sponsor, to determine particular clients of the sponsor, or to invade the privacy of those obligors — and in any event would increase compliance costs. In the industry survey that was part of the 2015 Foundation study of securitization, one company protested that "if loan-level disclosure is required by the SEC for equipment ABS, it will cause a major disruption to the sector due to competitive issues with releasing confidential marketing data."

A third threat to equipment ABS that could arise under Dodd-Frank is the mandate under the Restore Integrity to Credit Rating Amendment (the Franken Amendment) that the SEC issue rules requiring random assignment of rating agencies to provide the "initial" rating for any mortgage-backed or asset-backed security, unless (as Dodd-Frank states) the SEC were to declare that another system would provide superior protection for ABS and MBS investors than the Franken Amendment.

Observers have perceived the disruption that could result from the Franken scheme, not only because the assigned rating agency might not possess the expertise with equipment ABS that the agencies mentioned in the 2015 Foundation study have demonstrated, but also because the assigned agency would possess veto power over the sponsor's legal right to obtain a rating from any other agency until the assigned agency had issued its opinion. That veto power arguably could enable the gatekeeper agency to insist on legal opinions that never had been given in equipment ABS transactions or that might not even be accurate as a matter of law.

CRYSTAL BALL TIME

Securitization is complex, time-consuming, and expensive — especially for a sponsor's first equipment ABS transaction. New regulatory requirements are expected to increase the cost of this kind of financing. Plus, it takes only one transaction participant (such as counsel for one of the trustees) to drive up overall deal expenses, by raising issues (not encountered in previous securitizations) that all deal players have to confront. The sponsor's inside counsel and CFO will have to devote considerable time and problem-solving effort to managing issues as they arise, or else the external costs of securitization will balloon. Especially in the titled equipment sector, a sponsor must have the foresight to document ownership of and security interests in its financed vehicles, in order to accommodate a future equipment ABS transaction.

Nevertheless, the opportunities presented by equipment ABS financing outweigh these regulatory and cost concerns. For one thing, the growing acceptance of electronic chattel paper (ECP) leases and loans holds the promise of facilitating both the contract checkin process as well as the transfer of document control from the sponsor to the SPE, and then to the equipment ABS indenture trustee.

ECP also streamlines the substitution or release of contracts from the ABS collateral pool. DBRS examined this advantage in its May 11, 2015, weekly alert, "Use of E-Contracts in Asset-Backed Securitization," noting that e-contracting can reduce fraud risk and improve access to real-time information on contract modifications.

Other opportunities abound. In addition to the aircraft and alternative energy classes, observers have identified several emerging asset classes for equipment ABS. Businesses increasingly have insisted that leasing companies provide bundled solutions encompassing software and services as well as equipment. Software lease and license agreements both involve scheduled cash flow, often utilizing a hell-or-high-water installment payment agreement to enable vendors to finance receivables with institutional investors that are familiar with equipment finance.

Recently, limited amounts of software receivables have been included in the collateral pool for equipment ABS transactions. Many commentators predict that the software proportion will grow (based on demand from business users of equipment), and they speculate that eventually an entire ABS collateral pool will consist of receivables under software installment payment agreements. One rating agency has mused that future ABS may even include equipment service fees (from reputable service providers) as securitization collateral.

Equipment ABS issuance has surged since 2011, fueled largely by favorable loss and delinquency experience and by the perception that equipment ABS is one of the safer ABS classes. Despite the daunting

costs and potential regulatory hurdles, the emergence of new equipment ABS classes, coupled with the creative uses to which securitization can be applied, suggest a robust future for equipment ABS.

Endnotes

1. Levon Goukasian and Scott Miller, *Equipment Lease Securitization Performance Versus Other Asset Classes* (Washington, DC: Equipment Leasing and Finance Foundation, 2011). Available at www.store.leasefoundation.org/cgi-bin/msascartdll.dll/ProductInfo?productcd=SecPerf2011.

2. RatingsDirect, Standard & Poor's Rating Services "U.S. Asset-Backed Securities Had High Credit Stability and Low Default Rates In 2013" (March 10, 2014).

3. PricewaterhouseCoopers "Solar Securitization; A Promising Financing Opportunity for Solar Developers" (November 2013).

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