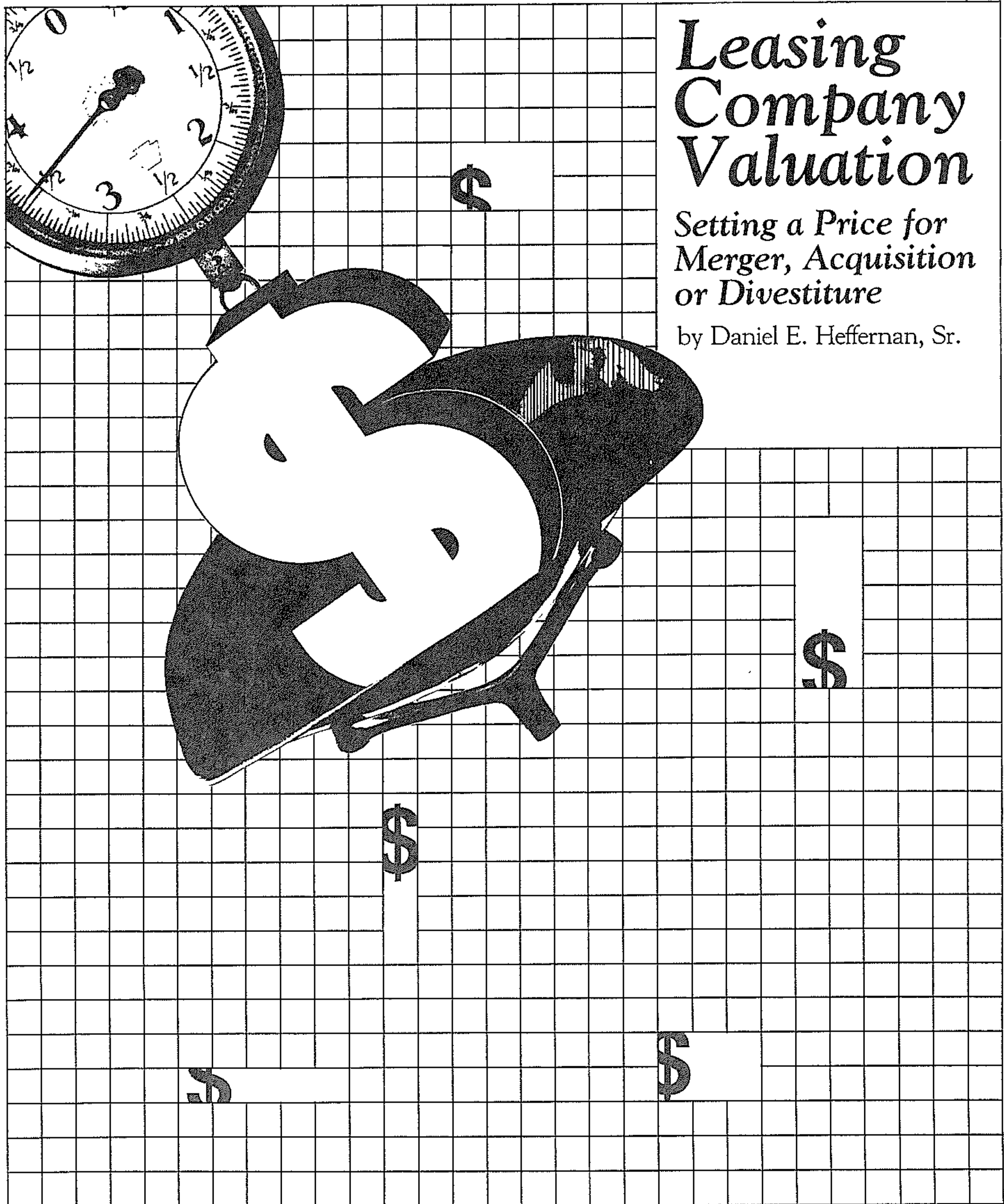


Leasing Company Valuation

Setting a Price for Merger, Acquisition or Divestiture

by Daniel E. Heffernan, Sr.

A major corporate industrial company announces the unexpected sale of its respected leasing subsidiary including its asset portfolio, personnel and offices, to a (choose one):

A. Commercial bank
B. Savings and loan
C. Insurance company
D. Management
E. Industrial corporation
F. Investment banking and brokerage firm
G. Major retailer
H. Foreign bank

The list of buyers and sellers, of course, could go on. However, the scenario above has been observed by participants within the leasing industry for about fifteen years with varying degrees of frequency and, to some, perhaps with varying degrees of wisdom. This latter point is significant, particularly with regard to the issue of valuation.

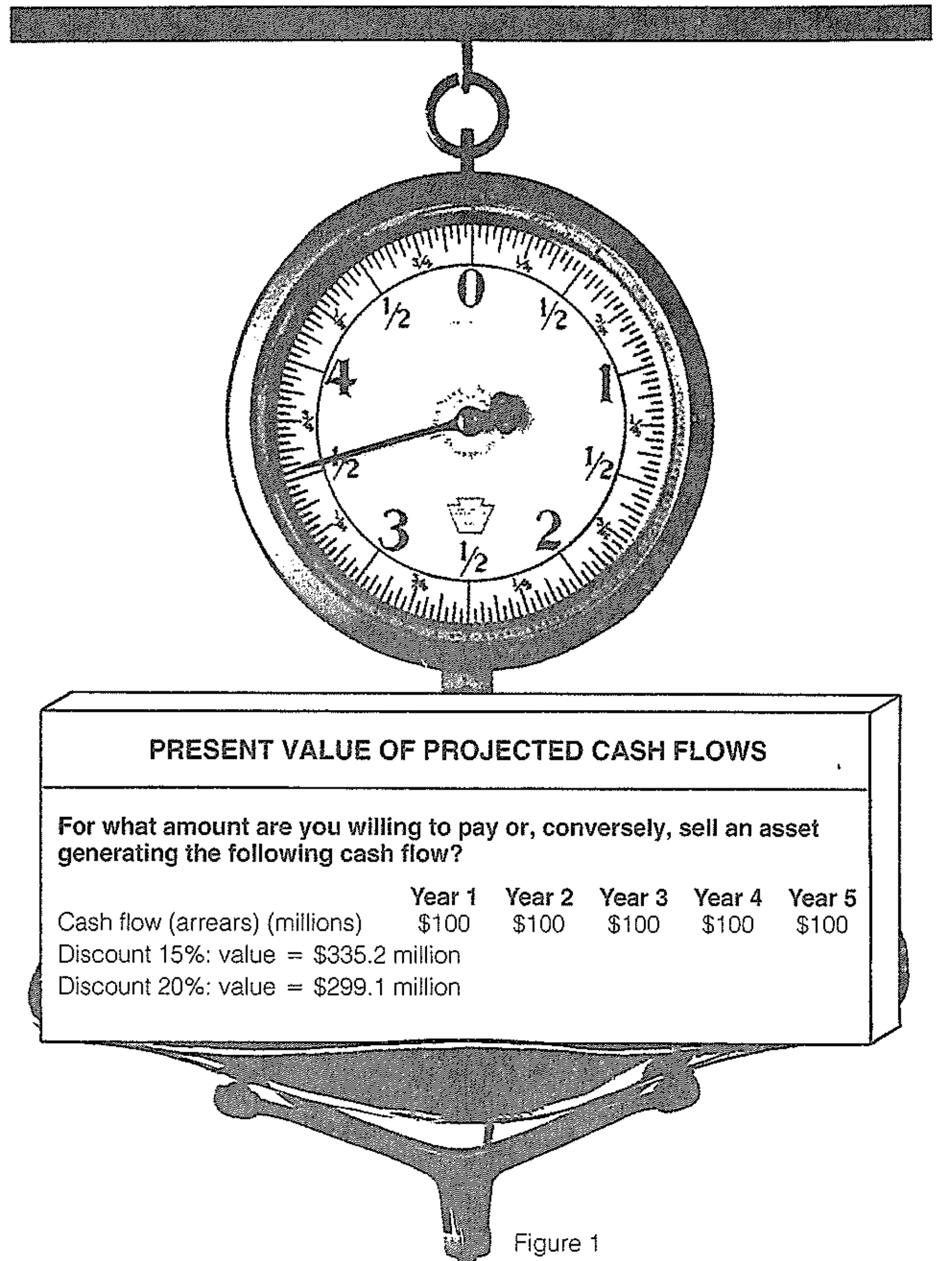
In the present climate—where leasing once again has been "discovered" due to ERTA, TEFRA, and a trend to build broad product line financial services companies—how is a leasing company's value established and translated into an acceptable price between both buyer and seller? Who are the key participants in this process? What are their roles? What are the generally accepted financial elements and valuation techniques used within this process? Finally, are these techniques different from other valuation procedures?

This article will provide some insight to the above questions and other issues surrounding this valuation process which the author has directly observed or participated in over the past nine years. The first significant issue is the valuation computation process utilized in most situations involving merger, acquisition or divestiture. That process is identical to pricing procedures utilized and, to some extent, developed within the leasing industry. Simply stated, valuation or price, is the present value of projected cash flows to be received over time, discounted at a target rate.

This basic concept is illustrated in Figure 1.

Theoretically, assuming a no-tax world, the buyer would pay $335.2 million or $299.1 million depending on its current capital yield (return) requirement. The seller would sell now at its valuation threshold or hold the asset until liquidation.

This simple process is a final step in the development of final value or price in any rational transaction involving merger, acquisition or divestiture.


PRESENT VALUE OF PROJECTED CASH FLOWS

For what amount are you willing to pay or, conversely, sell an asset generating the following cash flow?

	Year 1	Year 2	Year 3	Year 4	Year 5
Cash flow (arrears) (millions)	$100	$100	$100	$100	$100

Discount 15%: value = $335.2 million
Discount 20%: value = $299.1 million

Figure 1

The author is an investment banker and principal with Allen & Company Incorporated, a private New York investment banking firm. Currently heading the merger and acquisition area for Allen & Company Incorporated, during the last eight years he has been active in various capacities in the leasing industry as a director, officer, and commercial and investment banker to both public and privately held leasing companies.

Among all the issues of buying and selling assets or companies, most participants will ultimately focus on the cash flow generation characteristics of the entity being bought or sold. Price or value will ultimately settle around this core concept. The process of deriving acceptable cash flows is the basic objective of both buyer and seller, and the most difficult part of any analysis. It is a process driven by historical data and future assumptions. The key here, of course, is determining future cash flows and their certainty because it is here that the buyer and seller meet to strike a price. This is the point where a leasing company valuation becomes very different from an industrial or manufacturing operation due primarily to the asset characteristic of the leasing company versus the aforementioned. Briefly, the leasing company for sale today has created a core asset base consisting of perhaps: (a) Finance lease receivables; (b) Operating lease receivables; (c) Leveraged lease receivables; (d) Loan receivables (money on money); (e) Other assets.

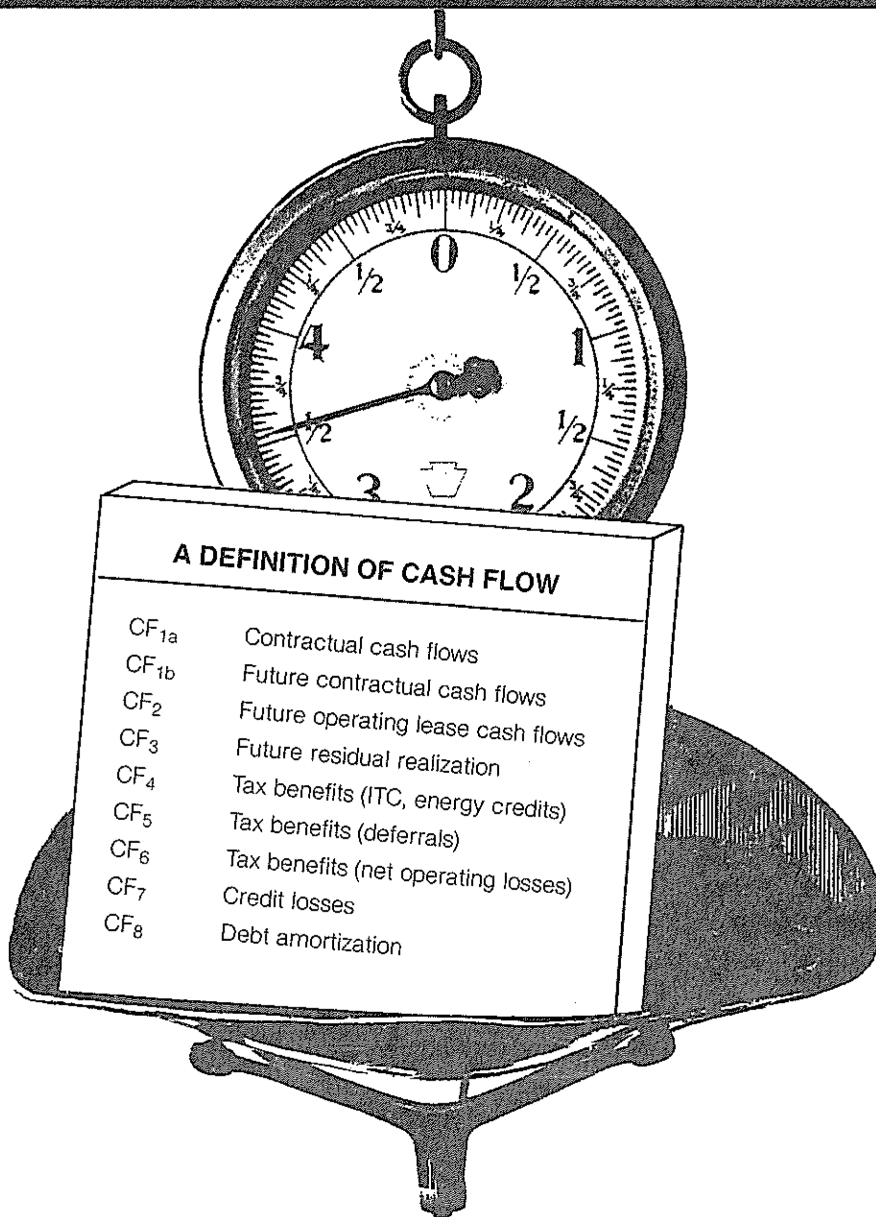


Figure 2

The above assets will generate an inflow of cash over a period of time with degrees of certainty such as contractual firm term receivables, as well as projected continuing rentals of operating lease assets, residual value realization, utilization of tax benefits, etc. On the liability side, certain cash outflows will occur with ranges of cost and certainty—the result being a net cash flow upon which to base valuation.

Unlike the industrial or high-tech manufacturer for sale today, the leasing company has relatively certain future cash flows, can theoretically shut down and expect to receive the contractual flows in its core portfolio.

If, on the liability side, the contractual debt is less than the contractual revenue, the problem of valuation with certainty, theoretically, is easier. However, this is not often the case. Therefore, residual value expectation and valuation of future cash flows in those instances wherein a significant assumed residual inflow awaits, the new owner needs to investigate any operating lease business dependent upon future-year rentals to produce cash flows. This latter point should require an analysis of each manufacturer in the case of operating lease programs contracted by the leasing company being bought or sold.

Why? So as to determine the reality of future operating lease rental expectations. A bankrupt vendor or one with clearly defined rental equipment problems should be a negative, identified and defined in the valuation process. Conversely, a quality vendor program should be a plus.

If, on the other hand, the industrial is theoretically shut-down today, an orderly liquidation of its assets such as receivables, inventory and fixed assets would occur—hopefully in amounts and in a time frame sufficient to cover outstanding debts.

Each of the above actions requires a distinct liquidation transaction which might yield in cash a portion of the asset's book value. The going-concern industrial valuation problem, therefore, is focused on the future activity of management and assets.

This analysis assumes a future world wherein the process of building, pricing

and selling of product will yield probable future cash flows upon which to base the valuation.

The leasing company valuation, given an existing portfolio of assets, focuses with a greater degree of certainty upon the present asset base as well as the future asset generation characteristics of the leasing company.

This process of analyzing a leasing company's asset base, credit quality, product and equipment mix, residual assumptions, and operating lease expectations could subsequently be reduced to a definition of cash flows as shown in Figure 2.

A pre-tax valuation matrix can then be developed as shown in Figure 3.

Various discount rates are then applied to the resultant cash flows to derive, for example, a pre-tax value matrix. Subsequent adjustments of above cash flows by existing and projected debt amortization and interest cost assumptions, add-backs of ITC realization and other tax benefits such as interest deductions, deferrals, and net operating losses allow a valuation matrix to be derived that resembles a leveraged operating lease cash flow analysis.

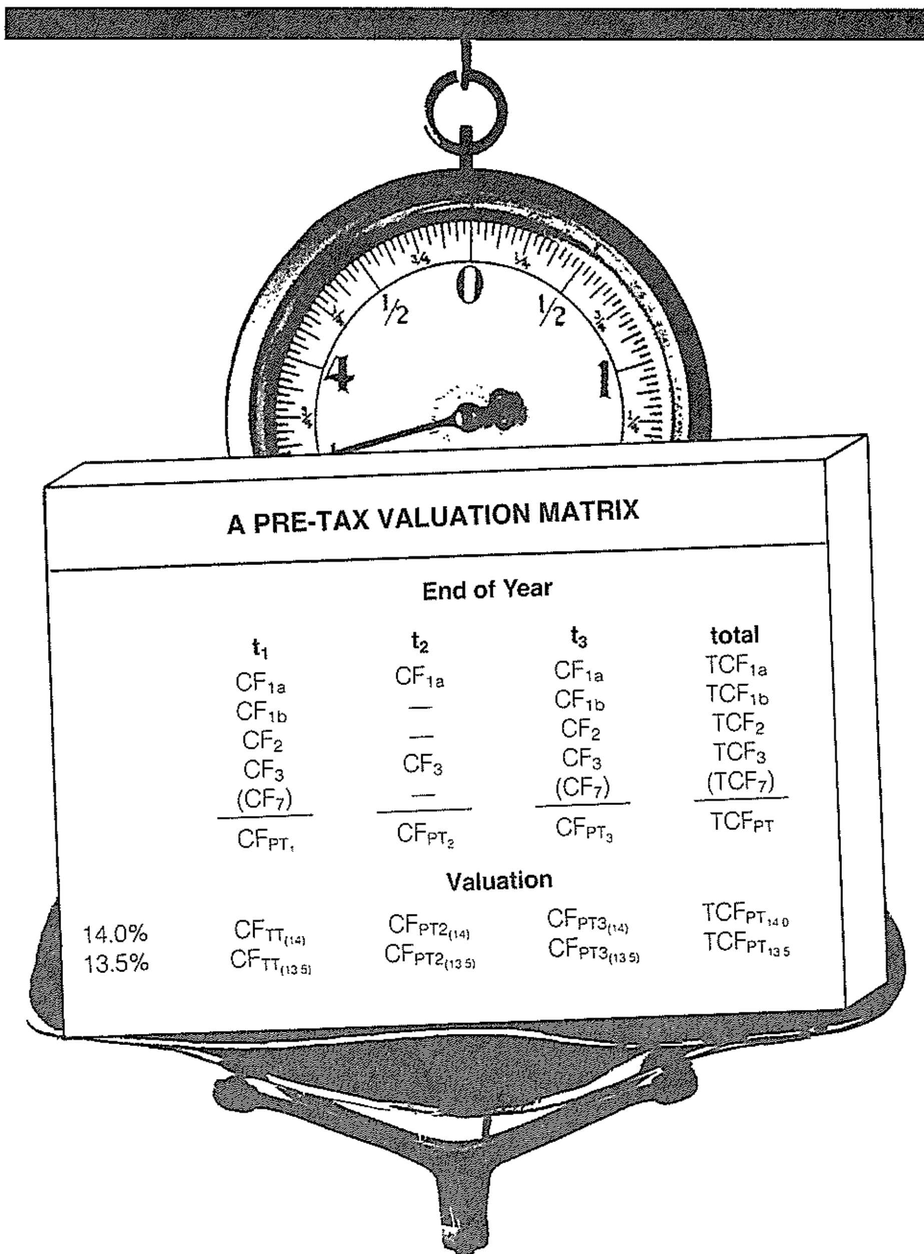
Clearly, this is a process driven both by fact and assumption—assumptions which, given the very nature of a leasing company, are credit-driven. However, there are several other important elements to be considered within this "assumptive" process including liability management; namely, capital sources and cost, and risk factors such as people, offices, industry or equipment specialization, tax position, to name just a few of the major areas to be included within this process.

This above-described process will properly culminate in a very detailed credit write-up. This, in turn, becomes a part of an offering memorandum relating to the company being sold.

So far, a basic valuation model and a description of quantifying cash flows has been presented. The schedules of cash flows derived in leasing company valuations must of course include the projected results of sophisticated sales programs, credit policies and practices, operational controls, and complicated flow projections generated from the leasing portfolio.

It is now appropriate to comment on the key participants in this leasing company valuation process. They are the key members of the leasing company itself. Whether the leasing entity is being bought or sold, key leasing company personnel are responsible for creating the data base upon which the offering memorandum will be prepared. They will answer the questions, provide additional data, and, generally, by their actions/reactions, provide the basis upon which price, terms and conditions are negotiated.

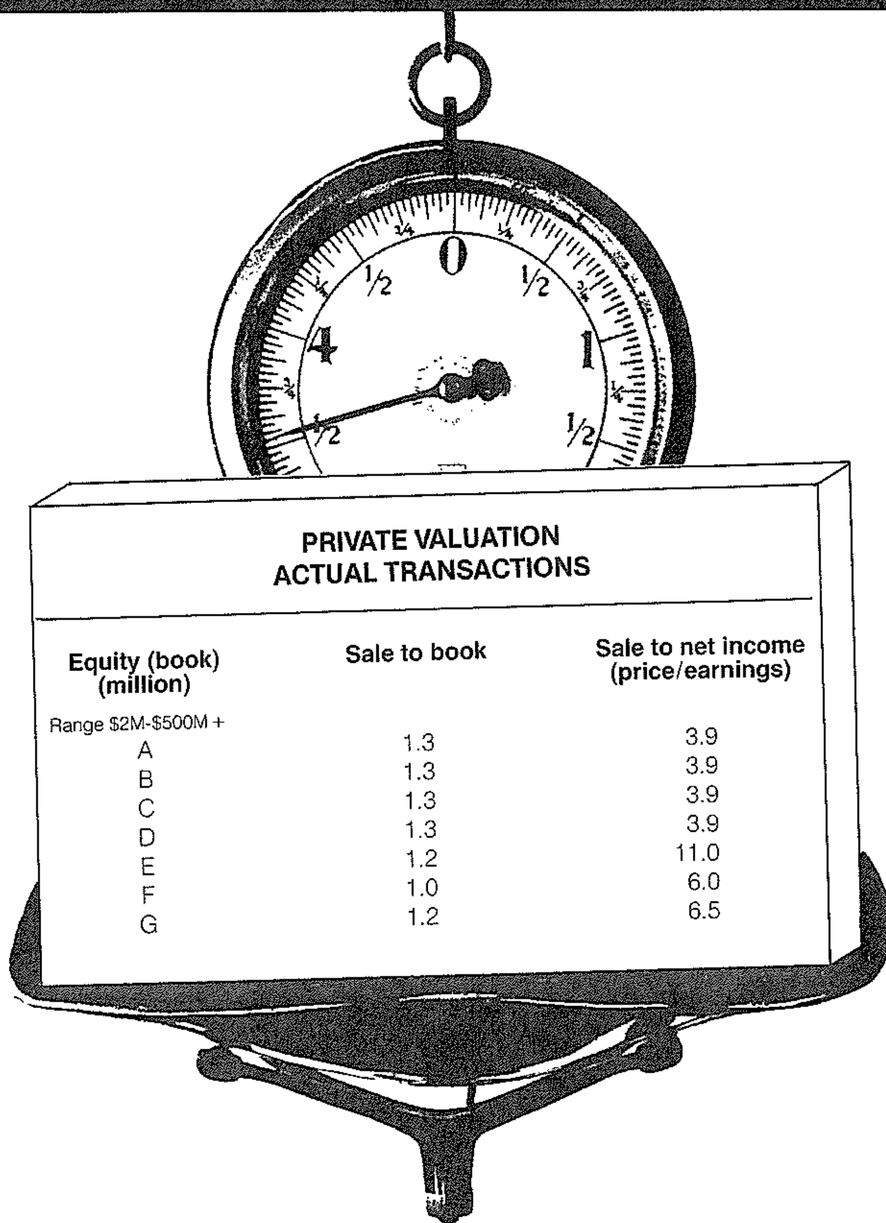
The valuation process is credit and operational intensive in that it tests the soundness of past credit decisions by examining the historical performance of the receivable base, and reviewing pricing efficiency by measuring the spread and operating cash characteristics of the historical and projected portfolios. The valuation process measures the soundness of controls, documentation, and delinquency management. Marketing and sales historical results and future



A PRE-TAX VALUATION MATRIX

	End of Year			
	t_1	t_2	t_3	total
	CF_{1a}	CF_{1a}	CF_{1a}	TCF_{1a}
	CF_{1b}	—	CF_{1b}	TCF_{1b}
	CF_2	—	CF_2	TCF_2
	CF_3	CF_3	CF_3	TCF_3
	(CF_7)	—	(CF_7)	(TCF_7)
	CF_{PT_1}	CF_{PT_2}	CF_{PT_3}	TCF_{PT}
	Valuation			
14.0%	$CF_{TT_{(14)}}$	$CF_{PT2_{(14)}}$	$CF_{PT3_{(14)}}$	$TCF_{PT_{14.0}}$
13.5%	$CF_{TT_{(13.5)}}$	$CF_{PT2_{(13.5)}}$	$CF_{PT3_{(13.5)}}$	$TCF_{PT_{13.5}}$

Figure 3



PRIVATE VALUATION
ACTUAL TRANSACTIONS

Equity (book) (million)	Sale to book	Sale to net income (price/earnings)
Range $2M-$500M +		
A	1.3	3.9
B	1.3	3.9
C	1.3	3.9
D	1.3	3.9
E	1.2	11.0
F	1.0	6.0
G	1.2	6.5

Figure 4

growth, given past performance, is evaluated. Past liability management strategies, their results, and existing credit relationships are reviewed and evaluated. Future financial strategy becomes a potential negotiating card for either buyer or seller for obvious reasons. Past tax planning and knowledge of the tax environment is reviewed and evaluated—the future tax position is again a potential negotiating card for the participant buyer and seller.

Key leasing company personnel are integral to this valuation process along with investment bankers, accountants, lawyers and equipment or industry specialists.

The finance professional who is retained to develop or analyze an offering memorandum plays a critical role in determining the establishment of an acceptable price relating to the sale. But, first, in developing the offering memorandum, the advisor typically should strive to understand completely the data collection process and test the resultant data and methods used to develop the base. That data should be tied to both the financial record and the planning system employed by the leasing entity to test the validity and coordination of operating and financial data within the system.

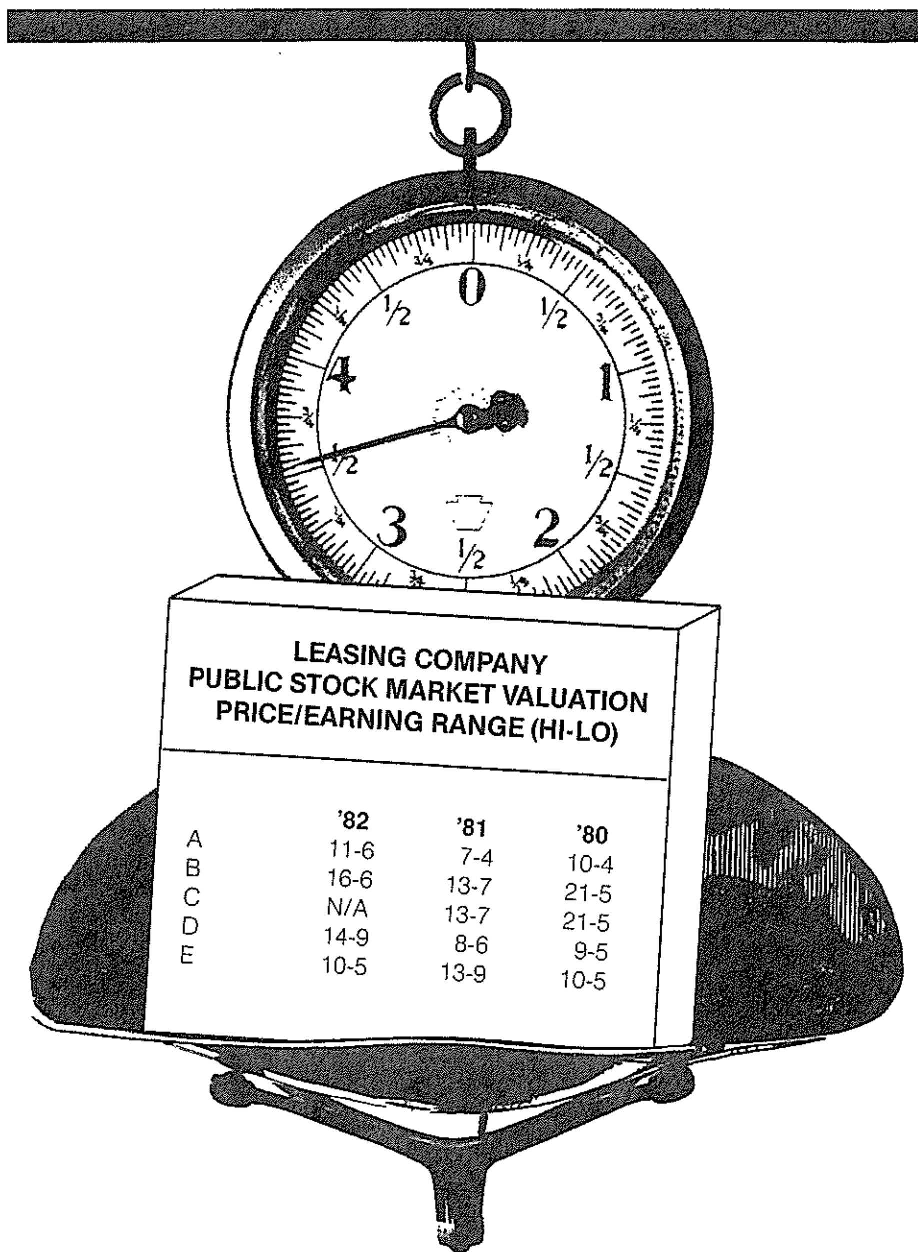
In summary, the financial advisor in concert with the key leasing company personnel, supported by outside accountants, lawyers and industry specialists (i.e. computer peripheral staff, transportation equipment analysts, to name but a few) can, prior to formal preparation of the final offering memorandum, report factually the ranges of probable price to be received; the terms; the assumptions; the value of retention and liquidation of the assets; the discount or premium (from book value) to expect upon sale; the probable buyers; the placement procedure; the notification of potential buyers; the contents of confidentiality agreements; and other vital pieces of information that should be understood by the selling entity before it begins the search for a buyer.

From the buyer's standpoint, the financial advisor or investment banker must strive to know what its counterpart knows. For example, in addition to the economic benefit of the subject sale, can the buyer fit with the people acquired? What are the weak assumptions relating to the buy? What are the strengths of the transaction? What is the value the buyer should expect to pay and why?

In summary, the questions and answers developed in the valuation process should be reflected on both the buyer's and seller's side of the transaction.

We now arrive at the point where buyer and seller agree on price. However, given a full range of leasing company products, all the risk variables associated therewith (particularly with regard to operating lease rental levels, residual value realization, tax benefit utilization, credit performance, etc.), the question is now raised as to payment terms.

This is where negotiation typically occurs. But again, several prices can and are typically offered pursuant to terms. Returning to the valuation matrix, higher or lower discount rates can attempt to capture the risk difference between an all-cash deal now or a part cash, part note cash later, or residual



	'82	'81	'80
A	11-6	7-4	10-4
B	16-6	13-7	21-5
C	N/A	13-7	21-5
D	14-9	8-6	9-5
E	10-5	13-9	10-5

Figure 5

performance (ultimate realization) deal. The variations are as numerous as innovative leveraged lease pricing.

Theoretically, a *rational* buyer will pay a greater price for greater certainty as to cash flow expectation, and a *rational* seller will demand a greater price for that certainty. This is the point where premiums or discounts are derived. But how do you measure premium or discount involving the value of a leasing company?

Traditionally, premium or discount is measured against book value. For example, there have occurred over the past several years sales of leasing companies that are set forth in Figure 4.

Reported premiums or discounts are the resultant product of the valuation process. Cash flows drive price; and if cash flows drive price, the above correlation to book value implies that FASB-13 isn't as bad as rumor would have it.

Currently, there have been several instances in the marketplace wherein sales price bore little relationship to an examination of current book value. Therefore buyers and sellers of leasing companies, particularly in those instances where liquidation is not the motive, will both concentrate efforts on deriving their value matrix and applying discounts or premiums to cash flows resulting from people, office locations, product capabilities, etc. within that matrix.

The above schedule and comments represent about 10 instances of sales or attempted sales of leasing companies (portfolio, offices, people, etc.) on a private basis.

Figure 5 shows what the public stock market valuation of several full-service leasing companies has been over the last several years.

The hi-lo price/earnings reported do not correlate with the reported private valuations cited in Figure 4 which are more conservative. Presently, three of the five are trading at premiums over book. The two which have portfolio concentrations in depressed industries are selling at discounts. This is what one would expect. Valuation reflects quality, stability and even conservatism. The public market valuation tends, by the nature of the information flow, to be more volatile than a private valuation, as might be expected.

The private valuation, particularly with regard to pricing a going-concern leasing company, tends to support a premium over book. Secondly, it tends to support a price that is a multiple of earnings. However, the driving force in determining price valuation is the underlying lease portfolio, with its cash flows and the people who have created it and will manage it into the future.

Premium, discount, or price/earnings observations are the result, not the cause, of valuation. There is no right answer when it comes to valuing a leasing company until the buyer and seller, based on informed fact and advice, agree on that certain price and the terms under which that price will be paid.