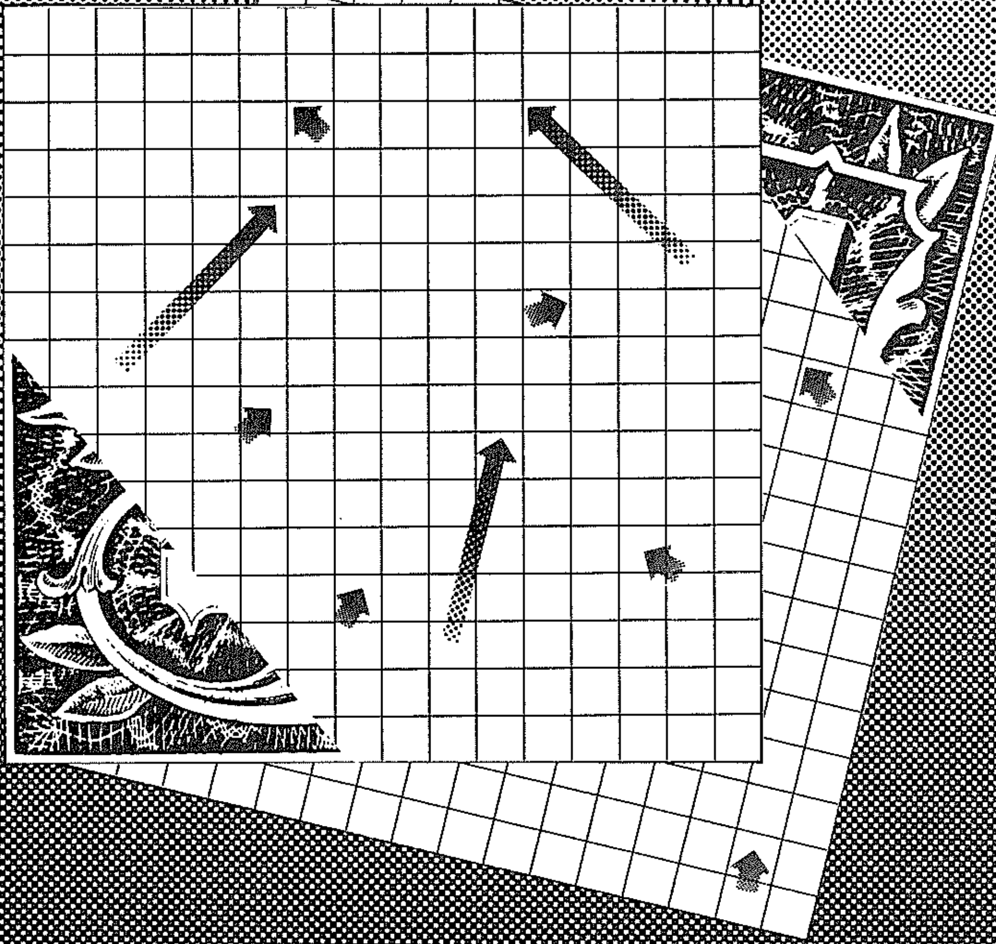
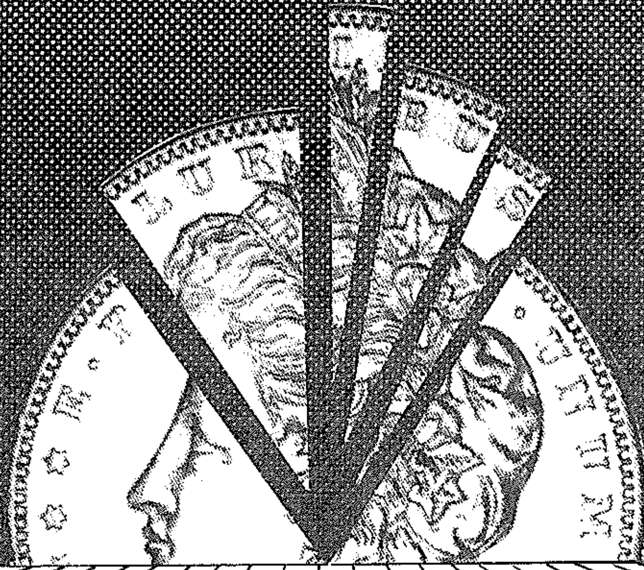
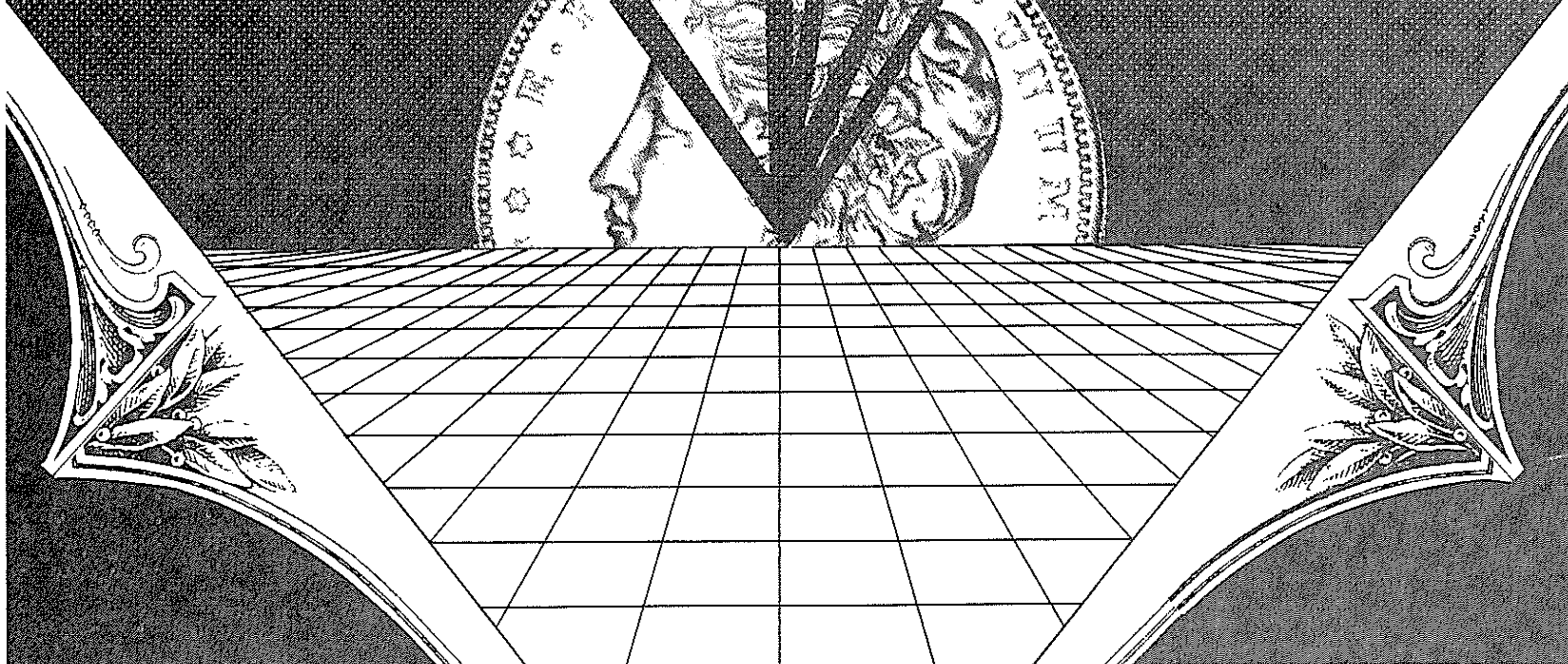
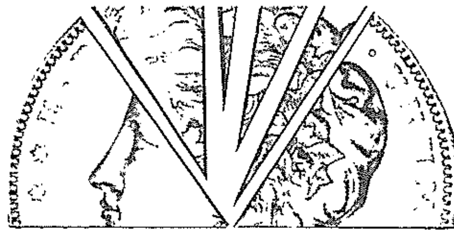






Managing a Diversified Portfolio

by S. Ronald Stone

This article offers observations regarding management of a diversified portfolio and comments upon the problems and opportunities dealt with by a multi-product leasing and finance organization on a day-to-day basis.

First, let us define a multi-product portfolio as lease/secured-loan receivables which include (i) commercial, industrial, professional, and municipal lessee/debtors located throughout the U.S. involving leased assets/collateral consisting of all types of equipment (and in some cases real estate), from the so-called big-ticket items (i.e. aircraft) down to items under $10,000; (ii) all types of transactions such as working capital loans, leases (both tax-oriented and lease/purchase transactions), sale lease-backs, portfolio acquisitions,[1] revolving loans[2] and vendor programs all written at rates which are fixed, floating or a combination of both.

Defining the Market

By definition then, a diversified company can theoretically undertake *any type* of term *financing* with *any customer*. As a practical matter, however, such is not the case. Several factors may affect where effort is placed. In the case of a corporate subsidiary or division, various *corporate objectives* must also be considered, such as realizing a specified rate of return on the assets employed within the subsidiary or division. Also, inherent in every company are factors which limit the areas in which it can *effectively compete* in order to meet its *corporate objectives*. For example, (i) the cost of funds (or the cost that a division is charged for use of company funds); (ii) a company's need for tax shelter; (iii) legal restrictions (such as those that restrict subsidiaries of a one bank holding company from entering into operating leases); (iv) company policies (i.e. thou shall not enter into transactions in excess of five years *or* offer fixed rate financing or book residuals or have more than 10% of your outstandings invested in any one customer or fix purchase options as a percentage of equipment cost). Illustratively, a company policy that precludes booking residuals of any amount will severely limit its ability to *effectively compete* in the leasing of equipment with high residual values (i.e. aircraft).

To summarize, then, the diversified leasing/financing company, while theoretically a "full-service" organization, in fact is not, and its first objective is to *identify those areas in which it can effectively compete*, taking into consideration corporate objectives and company limitations.

Prioritizing Efforts

Having defined, in a general way, the areas in which you can effectively compete, the next step is to prioritize those areas in order *to concentrate efforts and resources. This is an ongoing process* and priorities can and should change. Always:

(a) Consider corporate objectives; for example, if a corporate goal is to increase the return on assets, the generation of *fee* income may take on added importance; on the other hand, if the immediate corporate goal is to build assets or dollar earnings, portfolio growth may take priority.

(b) Analyze the markets having the most growth potential keeping in mind that entry into a market at the wrong time can prove costly and counterproductive.

(c) Consider existing strengths. For example, if a company has traditionally been successful as a big-ticket lessor, this market would ordinarily continue to enjoy a top priority *viz a viz* that company's total activities unless there is a compelling business reason to redirect efforts. In other words, identify strengths and exploit them.

Organizing

Having identified the products that are intended to be offered and the areas in which the firm can effectively compete, it's obvious that the company must obtain and organize the people and other resources needed to meet its objectives. As an example, a broad product mix could include among other items, (i) tax-oriented leasing transactions and money on money transactions; (ii) municipal lease/purchase financing; (iii) specialized financing in the communications areas (cable, T.V. and radio); and (iv) a variety of fee income programs.

The author is vice president/operations, of the Heller/Chandler division of Walter E. Heller & Company, a diversified financial services firm.

Sales

One strategic approach for firms with a variety of products to sell, requires that salespersons although specialists, must also be generalists. The sales staff should have a detailed knowledge of the products they are primarily responsible for selling and a working knowledge of the total products offered by their own and other divisions of the parent company. They should be trained to spot opportunities in every area and, when appropriate, to refer the matter to the particular salesperson that specializes in that area. A sales compensation program can be designed to encourage such referrals. Training, initially, and on an ongoing basis, is an ingredient crucial to the development of an effective multi-product sales force. Establishing a comprehensive in-house training program for new sales personnel is a must, providing an overall perspective of product mix, an exposure to the credit philosophy of the company, as well as documentation policies and procedures. Equally important, the salesperson who may ultimately be in the field far from the workings of the home office should have the opportunity during the training program to meet the people in the home office who will ultimately be handling his transactions and to follow the flow of paperwork with respect to a deal.

Sales territories are often divided geographically with a regional manager heading each region. Sales personnel can specialize by product line or industry or they can be organized to reach a broader spectrum of clients. In any event, even a nonspecialist will tend to develop a product expertise in a market in which he is particularly successful. For example, if a sales person penetrates the machine tool market with good results, an expertise in that area will naturally develop.

A word about incentive sales compensation programs: While you should strive to maintain a consistency in the plan from year to year, the incentives can be varied depending upon the direction toward which you desire to move the company. Thus, if you desire to penetrate a certain industry, or emphasize a particular kind of business, you may increase the salesperson's compensation in that area, perhaps on a temporary basis, to redirect his efforts.

Credit

Credit responsibility may be centralized, localized or a variation of both. In many companies, credit decisions are made at the regional level within certain dollar limitations and thereafter at corporate headquarters. Likewise, credit personnel often qualify as generalists. This usually works well, except in certain areas, such as agricultural lending which is an area requiring a particular expertise. For a diversified company, it's important that the sales and credit mesh. For example, it's a waste of resources for the sales force to generate agricultural transactions if you lack the credit expertise to properly evaluate those applications.

Specialists

It is impossible to effectively compete as a middle-market diversified leasing company without a number of other specialists and specialties.

A sophisticated legal and tax capability is a must. Lawyers are required to grasp and document a wide variety of transactions within short time frames. Practicing preventative law is equally important. Fulfilling these tasks require an intimate knowledge of the business as well as the law, and therefore, I believe these needs are best served by in-house professionals, supplemented when required by outside lawyers. An in-house tax capability is also indispensable to leasing activities. The tax department, among other things, must manage tax appetite, handle compliance matters (i.e. personal property tax and sales/use tax returns for *all kinds* of equipment located throughout the U.S.) and should be constantly available to sales, legal, and credit personnel regarding all of the other tax aspects incident to tax-oriented leasing.

An in-house equipment department should also constitute an integral part of a leasing/financing operation. The department serves a number of indispensable functions. First, it should provide with each transaction a collateral[3] evaluation of each piece of equipment to be financed or leased. This evaluation should establish the liquidation value of the equipment throughout the term of the transaction, and, with respect to leased assets, an estimated fair-market value[4] of the equipment at lease end. The department also should handle the storage and disposition of all repossessed equipment and negotiates with existing lessees the purchase, re-lease, or return at lease end of all leased equipment. Managing the disposition of equipment at lease end is critical. The idea, of course, is to maximize income. Toward that end, companies can alternatively encourage the lessee to purchase the equipment or make it attractive to renew the lease. The value of the equipment at lease end and its remaining expected useful life determines which of these alternatives is marketed to the lessee.

A sophisticated electronic data processing system and an accounting department that understands the system are indispensable. Such a system should have the capability to generate billings, agings, financial statements, budget comparisons, payment histories, and a variety of other management reports (i.e. bookings broken down by type of transaction, salesman and area; equipment classification; equipment location; etc.) Naturally, a company must have the resources available to analyze, according to its specific criteria, the profitability inherent in any leasing transaction under consideration, be it a single investor transaction or a leveraged lease.

Controls

A brief word about controlling collateral: Different kinds of transactions require different checks. A leasing trans-

action, once booked, requires little administration, except perhaps an annual inspection of the leased asset. A revolving loan to a leasing company, on the other hand, requires hands-on management. This may include an analysis of periodic reports submitted by the borrower (including, but not necessarily limited to, financial statements), surprise examinations by a staff of field auditors, or a combination of both. The point to remember is that the "back room" (administration) must also mesh with your business objectives.

Additional Considerations

Let me briefly mention a few other important items. A subsidiary is often funded by the parent corporation on a matched funding basis. That is, if the division enters into a floating-rate[5] transaction with a lessee/borrower, the division borrows on a floating-rate basis from the parent. Likewise, for fixed-rate transactions, a division often borrows from the parent on a fixed-rate basis. The importance of matching assets and liabilities in an era of dramatic changes in the cost of funds is obvious.

Budgeting is also an important management tool. Budgets should be prepared on an annual basis for each profit/cost center, and budget-to-actual comparisons should be made on a monthly basis. Variations are, therefore, quickly identified so that corrective action can be taken.

This article attempts to deal with a broad topic with a broad brush. Management can sometimes be a maze with trial and error being the only alternative. Being ever cognizant of your objectives and the few basic principles outlined above will hopefully increase the chance of success.

Footnotes

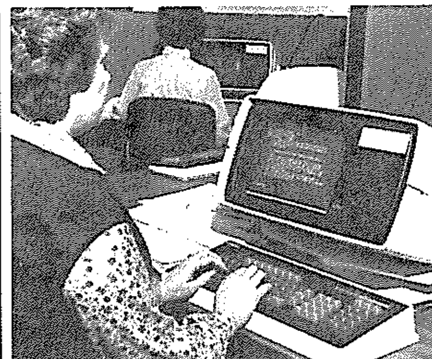
1. *A portfolio acquisition* is the purchase, from a lessor, vendor, or finance company, of equipment lease receivables and/or installment sale contracts. The purchase can be with or without recourse to the selling party.

2. *Revolving loans* are periodic loans secured by the borrower's equipment lease receivables (as well as the underlying leased asset) and/or installment sale contracts. The loan is referred to as a "revolver" because it is paid down as the lease/installment receivables liquidate and is increased as new advances are made against new receivables generated by the borrower.

3. *Collateral value* is the value to the lessor/secured party of the leased/financed asset. This asset represents a source of recovery to the lessor/secured party if the lessee/debtor is unable to pay its obligation in full and, consequently, a lessor-secured party will ordinarily be concerned with the asset's liquidation value (what the asset will sell for in a distressed sale—usually a public auction). The anticipated value of the asset at the end of the lease, assuming a disposition in the ordinary course of business (i.e. not a distressed sale) is also important to the lessor.

4. *Fair market value* is the price for which a lessee usually can purchase the equipment at lease expiration. Lease agreements typically provide that the fair-market value of the equipment may be agreed upon between the lessee and lessor, or be decided by a third party by appraisal of the asset if the parties cannot agree.

5. *Floating rates* are rental/installment payments that fluctuate throughout the term of the transaction depending upon movements in the prime rate of interest.



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