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PRACTITIONERS' TOOL KIT

Equipment Lessors Present Unique Challenges for Crisis Managers

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Which industry in the U.S. owns more equipment than any other? According to the Equipment Leasing Association (ELA), it's the equipment leasing industry, which acquires, finances, and leases all manner of equipment to its customers.

However, when an individual leasing company threatens to go belly-up, the company's physical assets can quickly turn into a liability. The equipment and the names of creditors holding liens on it are no more than a series of accounting entries in a leasing company's books. Turnaround professionals brought in to salvage such a situation are frequently hard-pressed even to locate the equipment, much less successfully liquidate it and apply proceeds to the proper creditor.

This is one of many challenges that crisis managers and equipment remarketing specialists encounter in working with troubled leasing companies. Each situation differs, but most share at least two similarities:

- Crisis management of leasing companies and other finance-related businesses requires insight into the complexities of the industry. Armed with this, crisis managers know the right questions to ask and the right people to interview, both inside and outside the organization.
- Optimal strategies for valuing and liquidating the assets of a leasing company are equally critical to a successful turnaround.

Strong Industry, Weak Links

The U.S. equipment leasing and finance industry has profound reach. Worth an estimated $208 billion, the industry funds nearly one-third of all equipment used by American businesses, according to the ELA.

Most equipment leasing and finance companies are performing solidly. However, there are weak links in every industry, and leasing companies have had their share of problems. *The Monitor*, a leasing trade journal, attributed many recent problems to a sense of "unbridled optimism" that resulted in flawed business practices, such as:

- Unwarranted expansion beyond a company's market niche.
- A focus on volume, not quality, when originating leasing deals.
- Appraisals that inflated the estimated value of leased equipment.

While the U.S. economy has picked up considerably in the past year, it's clear that a certain percentage of leasing and finance companies will continue to experience significant problems requiring the expertise of crisis managers and their consultants.

Crisis managers with industry-specific experience have an advantage in dealing with distressed financial services companies. Their understanding helps them ask the right questions of the right people when evaluating the viability of such a firm.

The first question to ask when evaluating a troubled leasing firm is, does the company still have access to capital markets? Leasing companies depend on the capital markets to provide the financing they need to acquire new equipment and then lease it to their customers. If the markets have lost faith in a company and are no longer willing to provide new financing, it's likely in the best interests of all concerned to begin the company's liquidation as soon as possible. If the company can still borrow, crisis managers can start developing plans to turn it around through managerial changes, financial engineering, or both.

Among the most valuable leasing company employees to interview in a crisis management situation are the collectors of problem accounts. Informal off-site conversations with these people may uncover flawed equipment funding patterns and poorly implemented default policies, which are known in the industry as "extensions" and "rewrites."

In one case, workout specialists uncovered through such conversations repeated examples of overfunding and questionable business practices. They found that equipment worth $50,000 had been financed for $300,000, in addition to an asset concentration risk involving extensive lending against knitting machines to individual borrowers in a single community.

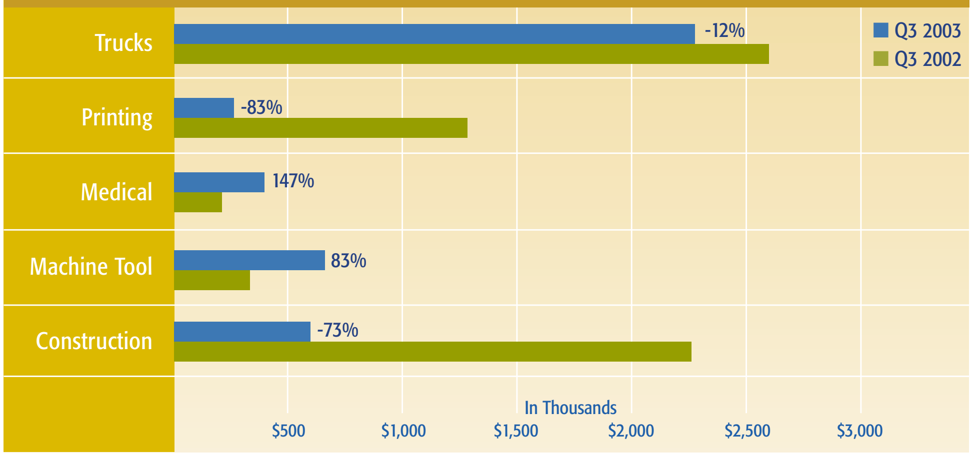
Interestingly enough, venture capitalists had invested a significant amount of money in this leasing company just months before its collapse. The investors' due diligence process, conducted by a very bright analyst who nonetheless had limited experience in the leasing industry, failed to pick up on these and other telltale signs of bad lending policies and, ultimately, of accounting fraud.

Signs of Trouble

Crisis managers should approach a distressed leasing company assignment as if they were performing due diligence on it before an acquisition. The audit examines the company's internal functions, including its senior management, business logic, marketing, credit, operations, systems, legal, human resources, and treasury. It also covers the company's external relationships, including those with banks and sources of business.

Crisis managers should pay particular attention to how a company sources its business. Some leasing companies have their own sales forces; some are vendor leasing businesses that support a particular manufacturer; some rely on brokers; and still others use a combination of the three. Each has its own strengths and weakness.

Figure 1: Top Repossessed Capital Assets



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Additionally, a leasing company's compensation program can offer clues for crisis managers. If it greatly rewards new business people for putting on volume, wise crisis managers take a look at the quality of the volume and its supporting documentation.

Distressed companies usually have appalling accounting records. Either by fraud or incompetence, assets frequently are pledged to multiple creditors. Assets that are owned by third parties and are simply being serviced by the leasing company are sometimes indistinguishable from secured assets. Puts to the company, fixed-price purchase options, and all manner of agreements deleterious to creditor interests may pop up.

Crisis managers must understand lease securitizations and wrapped residuals, borrowing base formulas, security agreements, and UCC filings — all of which are common to the leasing industry — to sort out who has liens.

In addition, securitization once allowed leasing companies to accelerate all but enough income needed to meet their future servicing operations. In other words, leasing companies were reporting income today that actually would come in over a period of time. Several leasing empires that later met their demise were built upon this shaky foundation.

Tighter accounting rules now forbid such acceleration, but they still allow leasing firms to distort their leverage. For example, a leasing company can report a GAAP leverage of 5:1, but have obligations on securitized portfolios they have sold off that would indicate their real leverage is more like 20:1.

Some types of fraud are more likely to occur in leasing companies than in other businesses. Unlike a manufacturing business, whose physical assets are easy to inspect, most of a leasing company's assets are on paper. Some classic leasing frauds that crisis managers should watch out for include:

- Securing funding from lenders on equipment that doesn't exist.
- Overfunding the equipment, which involves applying for loans worth far more than the equipment's value.
- Failing to tell the lender when an equipment lease has had an early termination payment
- Seeking multiple financing on the same asset by different lenders.

Liquidation Strategies

Restructurings or liquidations involving equipment leasing companies will likely include the repossession and sale of some assets. Despite the unique nature of the leasing business, it shares similarities with other industries in terms of best practices for liquidating physical assets.

Before determining an optimum liquidation strategy, crisis managers should consider the types of assets being sold, where they are located, and the interests of parties who will most benefit from their sale, such as secured creditors. Crisis managers who have questions about the best liquidation strategy to use in their individual situation can consult experienced asset management companies.

Asset management companies that have a broad base of leasing customers can also assist crisis managers earlier in the turnaround process. They can research equipment values, identify problem segments, and help spot fraudulent transactions. In one case, for example, an asset management firm involved in liquidating several failed knitting mills located in the same area discovered that their equipment vendor was routinely selling $50,000 machinery for nearly $150,000.

Public auctions are a common form of liquidating equipment. Another, orderly liquidation, offers an alternative. In an orderly liquidation, equipment is marketed and sold over a flexible period of time at a flexible price. Crisis management firms can hire an outside remarketing company to determine the equipment's market value using a variety of sources, recover the equipment if necessary, store it, and orderly liquidate it, or remarketers can liquidate the equipment.

Today, many orderly liquidations are conducted through Web sites. Such a site acts as a point of contact that enables remarketers to post details about equipment and gather bids without revealing the identity of the seller. This feature may be particularly appealing when crisis managers believe that public disclosures of a company's problems may further compromise its financial stability.

Because of the Internet's broad reach, Web-based orderly liquidations may also increase the number of bidders for specialized equipment or assets housed in remote locations that might discourage potential bidders from attending live auctions. A Web-based orderly liquidation also allows a company to begin selling off items individually as they become available rather than waiting until all grouped assets are ready for a public auction.

Orderly liquidations provide a flexible time frame for gathering competitive bids. Sellers, for example, can adjust the time frame if necessary to attract a larger base of bidders, including international buyers who may ask to inspect the equipment first. This may be an especially important consideration if equipment being liquidated might command low prices or scant interest in U.S. markets.

The process may also allow potential bidders more time to perform due diligence, including reviewing maintenance and operational records of the equipment and having qualified personnel test the equipment's reliability and performance. CR

Peter Otto (top photo) and Larry Smircich (middle photo) are Managing Directors of Malvern Hill Associates, a crisis management firm. Both are former commercial and investment bankers who have spent the last decade working as turnaround and crisis managers. For further details on Malvern Hill Associates, please refer to its web site, www.malvernhill.com.

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