How to Optimize an Equipment Leasing Program

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In the aftermath of the credit crisis vacuum, more and more healthcare executives are turning to the $521 billion leasing market to finance replacement equipment and fulfill new facility equipment needs.

At a Glance

To enable their organizations to get the most value from an equipment leasing contract, healthcare finance executives should:

- **Be aware of "yield enhancers" that could result in unnecessary expenses for the organization (including advance fee requests, restocking fees, and conditions related to contract renewals)**
- **Know how to incorporate value-added services as part of contracts (such as asset tracking, memory scrubbing, and equipment disposal)**
- **Thoroughly understand the master lease agreements and schedules and be prepared to negotiate, if possible, cross-default language that links to other indebtedness or material contracts**

Ask any CFO assistant and you'll find they all agree that one of the top 10 worst parts of their job is to screen calls from equipment leasing vendors. An informal survey conducted last year found that the typical CFO assistant receives as many as five phone inquiries per day from equipment leasing company representatives. Why are the more than 3,300 equipment leasing companies that represent the $521 billion equipment leasing market focused on your healthcare organization?

The answer is relatively simple. Due to healthcare reform and the aging of baby boomers, big dollars are being invested in healthcare infrastructure at a time when traditional sources of capital and funding have temporarily dried up or are relatively expensive. In many cases, lessors can achieve rates of return that exceed 15 percent.

Although the market for bond offerings has improved since early 2008, offerings are still under increasingly tight scrutiny. Even if an organization is able to access the bond market, purchasing short-term assets with long-term funds is an inherently flawed strategy when the useful life of the assets expires but bond payments continue.

Banks' covenant requirements now tend to favor off-balance-sheet structures such as operating leases, which explains why equipment leasing companies are highly motivated to engage healthcare entities: Operating leases are one of their most profitable products. However, depending on a healthcare organization's institutional credit status, the size of the transaction being considered, and the equipment being financed, it is possible to structure lease financing that is competitive with a healthcare organization's short-term revolver—in the range of 3 to 4 percent.

Given the financial stress that all firms face these days, the equipment leasing community naturally is in the business of improving its yields for the benefit of its shareholders. Every healthcare finance executive should be aware of the evolving methods with which leasing contracts are structured—and learn how to avoid unnecessary expenses.

Identifying the Yield Enhancers

According to the Equipment Leasing & Finance Association, overall, new business volume for January 2011 was $4.2 billion, up 24 percent in comparison with the same period in 2010. Further, compared with 2010, credit standards relaxed as approvals increased to 74 percent in January 2011. The pricing margin for general leasing equipment has risen 50 to 150 basis points, and lessors of equipment are scrutinizing collateral more carefully. In addition, more emphasis is being placed on the documentation of all deals, not just the multimillion dollar transactions, such as the leasing of MRIs and CTs. Healthcare finance executives would be wise to consider the effect of the following "yield enhancers" that are being employed by lessors in the marketplace.

Advance fee requests. Many leasing firms will request advance fees to set up equipment lease lines of credit. These fees are not required by many top-tier lessors and are a negotiating point for healthcare organizations.

Restocking fees. Within the master lease documents, be aware of miscellaneous charges such as boilerplate restocking fees when equipment is returned. These fees also can be the basis for negotiation, as lessees are already generally responsible for hard costs associated with equipment return. These types of fees are very profitable for the lessor. With respect to accounting, fees of this type must be included in the guaranteed minimum lease payment calculation, which hurts the "90 percent test" that is part of Statement of Financial Accounting 13 issued by the Financial Accounting Standards Board (FASB). According to this statement, the present value of the minimum lease payments should be less than 90 percent of the fair value of the asset.

Quarterly Consolidation of Lease Commencement. Much has been written about how interim rent is bad for lessees. Another way to phrase "interim rent" is quarterly consolidation of lease commencement, whereby schedules officially "commence" and the base period of the lease begins on the first day of the following calendar quarter. Why is this bad? Typically, interim rent is charged for the period or partial period (such as a fixed period equal to 45 days) leading up to the first day of the following quarter commencement, and many boilerplate lease documents do not specifically spell out the interest rate at which the interim rent will be charged. It may surprise even the most experienced healthcare finance professional to know that pro-rata interim rent can have effective interest rates that range from 20 to 40 percent. On small schedules, the cost could be a few hundred dollars; on multimillion dollar schedules, interim rent could cost an organization tens of thousands of dollars while providing no relative value. So whether it is called interim rent, quarterly commencement, or something else, the expense incurred prior to lease commencement should be carefully negotiated.

Evergreen renewals. Similar to interim rent, evergreen renewals can erode the original economics of a lease. Evergreen renewals occur when the lessee fails to provide irrevocable notice to the lessor regarding the end-of-lease term option that is being selected by the lessee. Failure to give the contractual notice results in the lease automatically renewing for a period of time. In many cases, the renewal term is six months or a year, typically at the same monthly payment amount as the base term. It doesn't take a financial guru to realize that adding the equivalent of six or 12 monthly payments to the expense of a lease will hurt the original economics of the contract, such that the lessee could make excess payments totaling more than 40 percent of the original equipment cost and still not own the equipment. In our 20-year history, we have actually seen situations where companies, unbeknownst to their CFOs, allowed equipment to auto-renew for more than seven years at the original monthly payment. In some of these instances, equipment could not even be located.

What should an organization do if there is no capital budget to replace existing technology? From the example above, we know that many lessors would gladly allow organizations to continue making the same payment on an asset that is worth significantly less. It is therefore best to plan ahead for the eventual end-of-lease scenarios, but if you find yourself in this position with only one option–which is to extend the lease–consider recreating the economics of the original deal and negotiating with the lessor. Most top-tier lessors will value the current and future business relationship and work out a fair agreement.

All or nothing versus any or all. Let's say that three years ago, a hospital's IT department purchased a combination of PCs, servers, software, monitors, and storage. The end of the lease for this equipment is approaching, and the IT department wants to keep the servers but return the rest of the equipment. Depending on how the lease agreement is written, the organization may only have the option of returning all of the equipment specified on a schedule or none of it. Given these limited options, the organization is at the mercy of the lessor to provide options that fit both the organization's needs and its budget. Planning ahead with regard to future use of the equipment is critical to eliminating unnecessary fees.

Mutually agreeable versus fair market value purchase option. One of the most challenging clauses to deal with is a mutually agreed upon end-of-term purchase option. This is where both parties must come to an agreement regarding the value of an asset, and if one of the parties does not agree, there is typically no other option available to the lessee but to extend the lease (revisit the previous section on evergreen renewals for rationale about why this situation would be unfavorable). Ideally, leases should incorporate a fair market value fixed-purchase option at the end of the lease and early buyout options mid-term that give the organization the flexibility it needs to operate in an uncertain environment.

How to Get Added Value from a Lessor

In addition to providing much-needed capital, equipment leasing companies can provide many value-added services for clients, including the following.

Asset tracking. Many lessors have developed or purchased sophisticated asset tracking systems for their internal use and provide access to these systems to their customers. A good asset tracking system can provide financial and asset management professionals with the necessary tools to manage a variety of assets across a physically distributed environment.

Memory scrubbing. No longer just a feature of PCs and servers, memory/storage is now found in high-end printers, copiers, and advanced medical diagnostic equipment. From a legal perspective, to remain compliant with the Health Insurance Portability and Accountability Act, healthcare organizations must be concerned with how to properly destroy information contained in equipment that would be returned to a lessor. The burden is on the healthcare organization to destroy or eliminate the data. However, many lessors have access to resources that can scrub hard drives and memory to Department of Defense standards. The cost of performing this service is typically a negotiable item and can include on- or off-site services.

Equipment disposal. Whether the returned equipment is recyclable or bound for the scrap heap, lessors can typically arrange for the de-installation and disposal of leased equipment that has no remaining useful life for a fee.

Equipment remarketing. In instances where an organization chooses to return equipment that has valuable remaining useful life, many lessors are capable of re-marketing the equipment on the organization's behalf. Setting up win-win scenarios in which a lessor has an incentive to obtain the maximum value for the used equipment generally serves both parties well. Some lessors have programs in which lessees can economically benefit from the net proceeds the lessor receives from its remarketing efforts; this is a strategy that lessors employ to maintain long-term relationships with customers.

Equipment sourcing. Conversely, should an organization require new or used equipment, lessor representatives should be able to provide a wealth of information regarding which equipment might best meet the organization's needs, where to find it, and what prices and discounts are available.

When Lease Deals Go Bad

Given the financial stresses that many organizations currently face, there are times when a lessee is in technical or outright default. If you find your organization in a default situation, be aware that severe consequences and penalties can pile up fairly quickly. Know that there will be similar financial remedies for both a casualty and a default; that is, there may be an opportunity to cure any breach before legal proceedings take place. However, it behooves your organization to contact the lessor as soon as possible to proactively resolve any outstanding issues. Finally, if your organization's leases are in default, tough return and maintenance conditions may also exist.

Should your organization find itself on its way to court, the organization's complete understanding of the master lease agreements and schedules will be tested. Lessors will generally be focused on non-court enforcement procedures and repossession/remarketing values in comparison with the booked and anticipated residuals. Be aware that many boilerplate master lease agreements contain cross-default language that links to other indebtedness or material contracts. Depending on the organization's credit strength and relationship with the lessor, these issues can also be negotiated.

The Future of Leasing in a Changing Regulatory Environment

Since 2006, FASB and the International Accounting Standards Board (IASB) have been working on a joint project to establish one global leasing standard. The net effect of the proposed changes would mandate that lessees capitalize operating leases by recording an asset and an obligation to pay rent. This would apply to equipment as well as real estate (representing $1.3 trillion in debt) obligations. As of publication, the proposed FASB-IASB changes have not been finalized, and implementation is anticipated to take place between 2012 and 2014.

Many of the challenges that face the healthcare industry with respect to this change in accounting standards include how to properly calculate the present value of payments when leasing contracts contain early buyout options, fixed purchase options, or predetermined extension options, including the potential responsibility of quarterly reassessment of the obligations. Healthcare finance executives can plan for these changes by first ensuring that their organizations have copies of all relevant active contracts. Historically, we've experienced situations where, due to a distributed environment, lease contracts are spread across the enterprise with no centralized contracts database and very little (if any) visibility into the entire lease portfolio. Taking a holistic approach to understanding both the small-ticket obligations and the multimillion-dollar schedules will help organizations identify opportunities for cost savings through economies of scale as well as eliminate unnecessary expenses in the future.

Several industry groups, including the Equipment Leasing and Financing Association (ELFA), continue to lobby the accounting standards boards to minimize the compliance impact on lessees. Some of the main concerns cited by ELFA center on the following:

- Ensuring that the lessee's profit and loss statement does not reflect artificial accounting charges that exceed or are less than the amount of rent a lessee would have recorded
- Preventing the capitalization of estimated contingent rents and non-bargain renewal options for lessees
- Preventing constant adjustments to estimates for lessees
- Expanding the types of leases that qualify for sales-type lease accounting
- Grandfathering existing leveraged leases, direct finance leases, and sales-type leases (www.elfaonline.org)

The net effect of these standards changes is to bring all indebtedness onto the balance sheet. But because the standards have yet to go into effect, your organization may still be able to benefit from off-balance-sheet transactions today.

Consider the case of a healthcare organization that successfully completed a $50 million transaction earlier this year and, with the approval of its Big Four accounting firm, qualified for off-balance-sheet treatment. The transaction was not a factor in calculating the current covenant ratios. As it relates to future bank covenant ratios, a discussion with your bank relationship manager as to whether the new standards will require prestandards obligations to be included is worth having.

Careful Planning Can Reduce Costs and Add Value

The healthcare equipment finance industry is as strong as ever. If contracts with lessors are negotiated properly, top-tier lessors have the capacity to provide their clients with cost-effective solutions that meet not only today's needs, but tomorrow's needs as well. Healthcare organizations should focus on minimizing the number and impact of lessor yield enhancers and seek to build fair and reasonable partnerships with funding sources. Long-term contingency planning can eliminate unnecessary equipment financing costs.

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