EVOLUTION OF LEVERAGED LEASING IN AUSTRALIA

by

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Recent Government pronouncements concerning leveraged leasing for statutory bodies have thrown a spotlight on this relatively new but fast growing method of off-balance sheet financing for major capital projects. Among other innovations, leveraged leasing has pioneered the concept of non-recourse cash flow lending for Australian institutions as compared with traditional “bricks and mortar” secured lending. The author, who took part in the founding of leveraged leasing in Australia, traces the various stages in its acceptance over the past nine years, and concludes that the market for this type of financing will continue to expand as it becomes better understood in the business community.

Leveraged leasing was introduced to Australia in 1973 by a small group of people who understood its success in the U.S.A. over the previous 15 years and believed it would form a useful addition to Australian markets.

A small handful of big public companies were prepared to listen to the explanations and arguments about leasing but few took it as anything more than an interesting alternative that would be filed away and considered at some time. In fact, some of the sentiment at that time was negative, bordering on the hostile. “Leasing is expensive”. “Leasing is one of the most common forms of ‘last-resort’ finance”. “Leasing is often used to overcome cash flow problems”. These three comments were widespread in the early to mid-1970’s among large companies that rarely leased at all, and certainly would not do so in respect of high-cost assets.

Outlandish though it may appear today, the view prevailed in many Board rooms that ownership of assets was one of the factors in generation of profits (that is, for an airline, for example, to be profitable it is just as important to own aircraft as to use them properly). This belief perhaps stemmed from the Depression days when ownership of assets was all important.

Peko-Wallsend was one of the exceptions to this philosophy. The newspaper reports at the time suggested that Peko saw leveraged leasing as long term fixed rate financing that was very competitive with the alternatives. It enabled the company to re-finance from a short term, U.S. dollar facility and to match financing costs with projected cash flows.

When Peko’s leveraged lease was announced in July 1974 the general reaction was one of surprise. The company had sold its biggest asset. The share price responded by falling the day after the announcement.

However the Peko transaction proved to be the start of a period of strong growth for leveraged leasing — growth that has exponentially risen to an estimated $1,000 to $1,500 million in assets financed in the latest year.

The initial impetus to leveraged leasing really came from the very tight economic conditions that prevailed in Australia from late 1974. The leasing industry was able to thrive on adversity. Traditional means of finance dried up and companies were put into the position of very carefully assessing new and alternative methods of finance. Happily, as a result of increased education in the market place, more companies now had some knowledge of leveraged leasing and were able to appraise it seriously.

This time was also one in which the packagers and managers of leveraged leases, the role filled by companies such as Lease Underwriting, could re-assess their product and their market. It seemed clear that their expectations of the Australian market, based on experience in the U.S.A., were aimed too high — at least in the economic conditions then prevailing. It was clearly inappropriate to regard leveraged leasing, as it was regarded in the U.S.A., as highly sophisticated financing to be used sparingly on major projects. In Australia, there were no major projects.

The response of packagers was to lower their sights. A number of leases for relatively small amounts —
between $1 million and $3 million — were concluded, for both fixed and movable assets. Some of these leases involved the aggregation of assets worth even lesser amounts as individual units, for example dump trucks and related pieces of heavy duty earthmoving machinery for a firm of civil engineers and coal miners. The leases were being written for top-name companies, and this in itself acted as a drawcard to more and more financiers.

Leveraged leasing, as is now widely known, introduces a third party, the lender, into the conventional relationship between lessor and lessee. The lessor normally provides only about 25 percent of the total cost of the equipment, but he claims the whole of the ownership benefits, in depreciation, and, where applicable, the investment allowance, for tax purposes. These are passed on to the lessee in the form of rentals lower than they otherwise would have been. The lender (generally a group of lenders) provides the balance of about 75 percent as a long term loan and receives regular payments of principal and interest. He gives the transaction its “leverage” or gearing.

(See following diagram)

The hands-on involvement of a small but growing group of financiers in a number of these smaller deals provided a valuable form of education for these institutions, as well as giving much needed real experience to the packagers themselves. Nevertheless, the process of educating the financial community was by no means easy.

The lessor market was basically no problem, because it was essentially limited to banks and merchant banks, with some participation by finance companies. When the investment allowance applies to a lease financing transaction, only a “leasing company” as described in the Income Tax Assessment Act may take advantage of its taxation benefits. Further, the potential lessor needs to be earning fairly substantial pre-tax profits, perhaps more than $1.5 million a year throughout the term of the lease, in order to gain the offsetting benefits.

This limitation has never applied to the lender market which, however, had to undergo a considerable revolution in its own thinking in order to accept leveraged leasing. A charge over an asset — a normal physical and fundamental requirement for a lender — is rarely offered in a leveraged lease financing. Instead, the lender is likely to be offered a mortgage of the cash.
flows generated under the terms of the lease. Leveraged lease financing has in effect pioneered the notion of cash flow lending.

Although today there is no shortage of lenders, with life insurance companies, superannuation funds, overseas banks, merchant banks, equipment suppliers, and specialist government agencies all willing, this situation has only been reached as a result of substantial and generally favourable exposure to leveraged lease financing over nearly a decade.

During these formative years, which were the final two years of Labor Government, a number of interesting things happened. Many capital-using projects were abandoned. Awards to build oil drilling vessels were cancelled due to government policy, tariffs were cut, and interest rates rose. Many companies chose not to do anything new while they struggled with high inventories, rising costs, static or declining markets, and all manner of Commissions and enquiries.

The result of these stringent financial conditions was a high turnover rate among financial people, and a far stronger financial expertise among companies. The treasury function became prominent amongst companies. A growing number of people became prepared to consider leveraged leasing on its merits.

By the time industry and commerce began to come to grips with the Labor approach, leveraged leasing had become well established and had developed in three important areas:
- Variable interest rate loans had been incorporated into transactions as one solution to the lack of long-term fixed rate loans. In fact, the variable rate debt-based lease written for the Rothmans groups in Australia is believed to have been the first of its kind anywhere.
- Offshore funds became another solution to the Australian lending problems, but with particular care to avoid the lodging of any Variable Deposits.
- Non-taxpaying statutory bodies showed interest in using leveraged leasing as an alternative source of funds that could be obtained at an interest rate competitive with semi-government rates and outside the restraints of the Loan Council.

The involvement of non-taxpaying statutory bodies in leveraged leasing began in 1976 when the Urban Transit Authority of N.S.W. (then the Public Transport Commission) financed its new fleet of Mercedes buses. Almost all N.S.W. Government buses and a considerable quantity of railway rolling stock have been financed by leveraged lease.

Almost every State has now used this form of financing for transport equipment and Electricity Commission assets, and, although no official statistics are available, it is thought that statutory authorities comprise around one-third of the total leveraged lease market. Even though the investment allowance is not available in a lease where the user of equipment is not himself a taxpayer, the resulting lease rate from depreciation alone has been sufficiently competitive with alternative sources of funding to ensure that this market is an important one. It is obviously important to packagers because of the volume of business but it is also important to many lenders by giving them the opportunity to lend to creditors of almost sovereign risk category at commercial rates instead of uncommercial official semi-government rates.

The heady days of leveraged leasing occurred during the early part of 1976 when the new coalition Government continued to offer doubled depreciation allowances together with a brand-new 40 per cent investment allowance. The tax benefits were so great that in almost every case the sum of all lease payments was less than the cost of the equipment. Effectively a “negative lease rate” was achieved. Equipment with very low depreciation rates could be leased under attractive terms. A peak in leasing activity was achieved — possibly at the expense of other forms of finance. The extent of the tax benefits was such that finance companies could rarely claim the investment allowance themselves, thus limiting its economic effectiveness. Because of subsequent reductions in the investment allowance, and the abolition of doubled depreciation rates, the lease rate became “positive”, and from the Tax Commissioner’s point of view the sum of the lease payments exceeds the cost of the equipment.

By 1979 leveraged leasing had gone through its first stage of growth and acceptance. There were some five or six recognised and experienced packagers in the market. All major financial institutions in Australia had been involved in at least one of these consortium financings. The market was ready to enter its second and mature stage, in which it is still developing.

The viewpoint of the user or lessee has changed dramatically, and leveraged leasing is now accepted as one of the established components of the financing mix for many of Australia’s leading companies. There is a long way to go in having it fully understood and properly appreciated, but the number of corporate Treasurers equipped to assess and recommend this form of financing is greater than it ever has been.
The lessor market is approaching full utilisation. The capacity of banks and other financial organisations to utilise the tax benefits of leveraged leasing is approaching its limit. This may slow the annual rate of their participation but it sets the scene for a broadening of the lessor base. More organisations are finding ways to participating as lessors by overcoming existing constraints.

The availability of lenders is now virtually unlimited. Because the Australian market for long term fixed rate funds is today so shallow, life insurance companies in particular have little encouragement to invest in that market and so are supplemented as leveraged lease lenders by many other types of domestic and institutional lenders. Every international lender with a positive view on the development of Australia and safety of loans to this part of the world is willing to participate.

Although small transactions (say $2 million — $5 million) are still being written, previous concepts of the size limits of individual transactions have been demolished. A single lease of $245 million was transacted last year for plant and equipment for a leading Australian vehicle manufacturer. (The Eraring plant financing, huge by world standards at $1,650 million, is excluded from this comparison because it is not, strictly speaking, a leveraged lease).

The packagers see to it that leveraged leasing is one of the most competitive forms of finance yet devised. They remain strongly independent of one another, and each achieves some success in gaining a share of the market. How is that success achieved? Basically, in three ways:

- Whenever the market is tight, by expanding that market and carving a niche in the expanded market. The relatively new concept of using the Australian tax base to support offshore lessees is one example of expanding the market, though a controversial one. More local clients, including major co-operatives, have been brought into the market. The new entrants to the market may not always have the necessary credit status, and that has to be supplemented by an insurance policy, letter of credit or some other means of establishing the lease.

- By continually lifting standards of performance for all parties in transactions. By ensuring that their clients are satisfied with their leveraged leases, which are all long term but quite different from one another, the packagers form a basis for repeat business which is fundamental to the success of any ongoing operation.

- By educating clients in the technology of leveraged leases, so that lessees are in a better position to understand how their leases are assembled. The technology is not complex but does involve many changeable financial parameters and just as many views on taxation and its impact on the financial variables. There is thus scope for some misrepresentation to potential clients, particularly in highly competitive situations, just as there is scope for highly ethical behaviour. Fortunately, the latter seems to be in the ascendancy.

Leveraged leasing has come a long way in just eight years or so. Yet it is just as important — maybe more so — to understand the basis of the financing now as it was several years ago.

Leveraged leasing is well established as one of the components in the funding mix of many organisations. It is very well known — not always as well understood. But the market for arranging transactions is developed and highly competitive. Companies can be assured of real benefits by participating in this very useful contribution to the Australian financial scene.