

Caveat Emptor:

The Essentials of a Successful Portfolio Purchase

Caveat emptor — let the buyer beware! Although buying leases is the engine that drives many companies, numerous owners and executives do not understand the fundamentals of evaluating a portfolio for purchase or the magnitude of risk that each acquisition presents. Without investing the time to evaluate fundamentals such as the seller, the leases, the equipment and your own business, you are literally flying blind.

By Nancy A. Geary

You may be relatively new to the leasing industry, but you have ambitious plans for success. So you're understandably excited to learn about an opportunity to buy a large portfolio of leases that would grow your business tremendously.

Your first meeting with the seller is promising: The asking price seems reasonable, and the seller is as eager as you are to move ahead quickly. After brief negotiations, you conclude the deal at even better terms than expected.

Three to six months later, your great deal is a disaster. Invoices are late, payments are bottlenecked and taxes are going unpaid. Even worse, an unexpected delinquency rate has consumed your profit margin and much, much more. What happened?

Unfortunately, this scenario becomes reality countless times each year. Although buying leases is the engine that drives many companies, numerous owners and executives do not understand the fundamentals of evaluating a portfolio for purchase or the magnitude of risk that each acquisition presents.

The Cost of Ignorance

There are many situations in which guessing can pay dividends, but buying a lease portfolio is not one of them. In fact, nothing can doom a purchase more effectively than ignorance. To start, many buyers accept the seller's stated delinquency history at face value. The payment history may be accurate — or you may be paying a premium for a portfolio of problem leases.

Similarly, many buyers are drawn to rate spreads that seem to leave a comfortable margin for error. But that margin can evaporate overnight if the seller's representations are exaggerated. Indeed, even a seller's eagerness to move quickly, or his overly optimistic characterization of the portfolio, may indicate that he is trying to close the deal before you can thoroughly examine the portfolio.

The bottom line? Knowing what you're buying and from whom is the difference between a successful portfolio purchase and a disaster. Following the process outlined below should help you become an informed buyer.

Know Your Seller

The value of a portfolio depends largely on the seller's integrity, financial stability, expertise and even reasons for selling. So learning more about the seller is essential. Tactfully explore his reputation. Ask for references, but even more important, call other industry contacts to learn more about the seller's integrity and business acumen.

Running business and personal credit reports, and conducting a thorough background check on the seller, can also prove illuminating. For example, a seller with a questionable past or one who is experiencing significant financial distress may have more incentive to "dress up" a portfolio. Finding lawsuits, liens and judgments against the seller might also raise concerns about the advisability of buying his portfolio.

Determining why the portfolio is for sale can also help you understand the value of any post-purchase commitments you might negotiate. A seller who is recapitalizing his credit line or a financial institution that is exiting the industry is more likely to stand behind their representations and warranties if problems occur later. However, the post-purchase assurances of a financially troubled seller or one who is retiring may prove less dependable.

Lastly, evaluate how well the seller has managed the portfolio. Has he collected sales, use and personal property taxes from the lessees and paid them to proper authorities? Not only is the owner of a lease — potentially, you — responsible for collecting and remitting all applicable current taxes, he may also be held liable for past unpaid taxes. Look at lease payment records to verify that taxes were collected and examine the seller's tax returns and other documents to ensure that they were actually paid.

Know Your Business

Purchasing a portfolio without knowing enough about your own business can be as dangerous as buying from an unscrupulous seller. Many buyers get caught up in an appealingly priced portfolio without first determining if they have the financial and operational capacity to handle it. Take time to review your credit availability, operating costs and back office capabilities before getting too involved in a purchase opportunity.

Once you are sure you can afford a portfolio, consider how you will service it and what servicing will cost. I have seen numerous instances

in which a company acquired leases but had such difficulty servicing the increased volume that invoices were not timely and payments went uncollected for months.

Buying lease management systems and hiring experienced leasing, tax and accounting staff to handle a new portfolio can easily cost hundreds of thousands of dollars. As a result, many companies decide to outsource servicing, which is often much less expensive, and avoids bottlenecks and the need to hire new staff.

Know the Leases

A surprising number of buyers make decisions based on little more than the initial portfolio analysis provided by the seller. Even if your research reveals that the seller is of the highest integrity, financial stability and management skills, this is a potentially grave error. Further investigation is always warranted.

First, verify delinquency rates by examining the lease files and checking payment histories in the seller's computer systems. You may decide not to purchase delinquent leases or change your pricing strategy, but you cannot make an informed decision without confirming the actual delinquency rate.

Also examine each lease file to ensure that the documentation is complete, legal for the lessee's location and includes the correct UCC filings.

Run a new credit report on every lessee. Although this may sound laborious and expensive, understanding each lessee's current credit helps clarify the desirability and value of that lease. Moreover, reports may reveal that a certain sector is faltering. Even if lease payments are presently being made on time, the underlying weakness could become an issue. You may want to avoid leases in that sector or price your offer accordingly.

If verifying delinquency rates, checking documentation and running credit reports for every lease in a large portfolio seems daunting, sampling may be in order. I recommend thoroughly reviewing at least 10% of randomly selected lease files, as well as files in discrete categories such as the largest deals and the most recent deals. Any discrepancies should lead you to examine additional files.

Before you decide to sample, consider how long it will take to review every file. Keep in mind that a few more days — or even another week or two — could mean the difference between a successful portfolio purchase and a catastrophe.

Know the Equipment

Many buyers evaluate a portfolio entirely on its financial merits. However, the assets underlying each lease warrant equal consideration — because you may end up owning them.

Review the portfolio's residual value, which has both financial and practical implications. On the financial side, residual value represents the seller's initial estimate of what the underlying asset will be worth when the lease ends. It also drives the book value of an asset brought back into inventory if the lessee defaults during the lease term.

The main question is whether the original estimate was accurate. If not, the lease termination payment or remarketing proceeds could be much lower than projected, especially if the asset is leading edge technology whose value can depreciate quickly, or an intangible asset whose value is questionable.

On the practical side, too high a residual value makes it less likely that a lessee will actually purchase the equipment at termination. If this occurs, do you know enough about that equipment to accurately assess its value and resell it, including shipping, warehousing, refurbishing, advertising, etc.? The larger and more diverse the portfolio, the larger the "remarketing" risk.

Know What to Ask For

In addition to carefully scrutinizing the seller and portfolio, there are also strategies for reducing risk — specifically, "representations and warranties" and recourse.

Representations and warranties are legal commitments attesting to the accuracy of all portfolio specifics (including delinquencies, credit quality, tax collections, payments, documentation and so on) and confirming that the seller has not withheld any meaningful information. Reps and warranties are not automatic; few sellers will volunteer them, but a buyer should demand representations and warranties — and get them in writing.

Understanding your seller's financial situation is an important factor in representations and warranties. For example, how valuable will they be if the seller is likely to declare bankruptcy shortly after the transaction closes?

Recourse is another risk management strategy, and can be negotiated on specific leases or an entire portfolio. It dictates that the seller will compensate you for any problems that appear in the portfolio after purchase. As with reps and warranties, its value depends on the stability and integrity of the seller.

There are two basic types of recourse: partial and full. In partial recourse, the seller is only responsible for losses up to an agreed-upon amount or percentage. In full recourse transactions, the seller agrees to compensate you for any defaults or other problems with the portfolio.

Recourse can be very desirable, but these portfolios are also more expensive. Whether a purchase merits the additional cost depends on everything you have learned so far: how comfortable are you with the seller's integrity? How confident are you that you fully understand the portfolio? How much do you know about the underlying assets?

Know When to Seek Help

Professional support can be very valuable in evaluating a portfolio, especially in areas that require specialized knowledge. For example, attorneys can help review documentation and recommend appropriate representations and warranties. An accounting firm with leasing experience can confirm essentials such as delinquency rates, lessees' credit and tax compliance, any or all of which can easily devour your anticipated profits.

Regardless of whether you do it yourself or hire professionals, exploring the factors outlined above are essential to being an informed buyer. Think about it: you may find significant misrepresentations and decide not to proceed. You may learn that the portfolio is worth more or less than you originally thought. You may decide to purchase only the leases that meet your objectives.

But without investing the time to evaluate fundamentals such as the seller, the leases, the equipment and your own business, you are literally flying blind. Only time will tell if you have made a good purchase that will fuel your company's success — or a bad one that will hasten its demise. **m**

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