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READY TO SELL?

CAN AN EQUIPMENT FINANCE BROKERAGE BE SOLD?

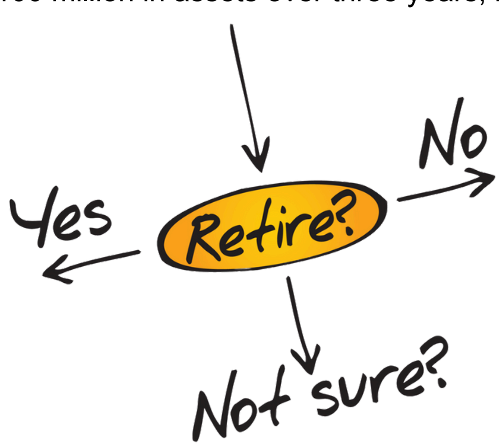
By Bob Rinaldi

Not much is written about the successful exits of equipment leasing and finance Brokerages. Little is known about how many Brokerages exist in the US, let alone any statistics or benchmarks about the Brokerage ecosystem. This article focuses on the viability of a Brokerage to have a successful exit. Brokerages' principals frequently contact Rinaldi Advisory Services ("RAS") about what their company would be worth and to whom. The answer is always the same. It depends. It's not a copout, as you will see. Buyers determine the value and, thereby, the price they are willing to pay a seller, not vice versa. Brokerages must look at themselves objectively, like outsiders, and put themselves in the shoes of potential buyers.

First, let's define the term "Brokerage" I will be using. For this article, a Brokerage is an entity that syndicates/sells more than 90% of its annual new business volume (i.e., funded volume). Also, a Brokerage, as used, does not service (accounting, billing, and collecting) a meaningful amount of their annual new business volume funded. As I see it, a Brokerage falls into one of two camps. Those whose principals are aging out have determined they may have three years left before they call it quits and retire.The other camp's principals have much longer time horizons regarding their career longevity. That said, let's move on to the Brokerage characteristics that determine the value of a Brokerage enterprise. Among a plethora of characteristics, two of the most important are: "scalability" and "quality of earnings," followed by the "management team" and the "platform." Here is another thing for the Brokerage's principals to remember: ultimately, you are telling a story when considering an exit in the future, regardless of how far in the future. It's your story you are writing. What kind of story do you want a buyer to read?

Scalability

A buyer would be interested in buying a Brokerage to drive its scaling, meaning its asset growth. Why? Simple, to help the buyer execute its strategic growth plans. Oh yeah, contrary to all other businesses, banks and other institutions consider equipment loans and leases as assets. Here is an example of what I mean. What is a meaningful add-on if a hypothetical buyer wants to generate $500 million in income-producing equipment leasing and finance assets (over the next three years? Is it a Brokerage doing $15 million a year or one doing $50 million a year, even assuming both can grow 10% per year post-acquisition? Of course, the $15 million-a-year Brokerage does not move this buyer's needle. If the buyer held onto all the assets the Brokerage generates on its balance sheet post-sale for the next three years, the assets on the balance sheet from this purchase would be roughly $40 million. Why just $40 million? Because the customers will be making lease/loan payments from the funding dates to the end of the three years in this example. Those payments made are considered "run-off" of the assets. So, a Brokerage's value depends optimally upon the buyer's or buyers' needs. However, if the buyer only wants to generate, say, $100 million in assets over three years, now that $15 million a year Brokerage can be attractive to this buyer.



Quality of Earnings:

This is something that many Brokerage's principals frequently misunderstand, usually due to simple internal bias in their company. Quality has to do with things like:

- The repeatability of their annual new business funding volume and the income it produces. Are the Brokerage's channels of business generation concentrated from a few customers, vendors, or salespeople?How much of the new business volume is generated by the principals themselves? By the way, every buyer's biggest concern is that the principals take the money from the sale and then bolt. The more diverse the channels of origination and less dependent on the principal, the higher the quality of earnings. The higher the quality of earnings, the higher the purchase price.

- Is the historical year-over-year production and income growth consistent, or does it look more like a saw tooth when graphed?

- What is the credit model for the Brokerage, in terms of the percentage of, say, A, B, C, and D-type credits of what it funds? For example, suppose the Brokerage tends to focus on very high-yield transactions (C and D type credits) because of the higher broker fees it can generate. In that case, the buyer will likely have to be a non-bank (another Brokerage or independent leasing company). If, on the other hand, your average customers have a 680 or above Paynet score, then you are likely in the “A” and “B” markets, which will appeal to the bank buyer. Non-bank buyers consider income as net income adjusted for credit losses more than banks. Brokerages do not look at income this way at all. Herein lies a significant adjustment in the Brokerage's mindset.

- How good is the availability and usability of all the Brokerage's data? Having lots of historical data about every aspect of your business activity is imperative to providing a compelling value proposition. I am talking about everything from application to booking data to portfolio performance data you sold to each funding source. This is so vital in telling the story. Without fantastic data and robust reporting on that data, you really cannot support the earnings quality story that needs telling. After all, we are telling and selling a story.The good news on this front is that it is quickly and economically solvable by investing in a data mart and business intelligence system that automatically pulls in data from all systems the Brokerage employs, from CRM to credit adjudication. We will touch on this again in the platform section below.

Management Team:

Specifically, the higher the quality of the management team underneath the principal, the better. Is there significant tenure? Are they a long way from retirement and motivated? Have you been keeping them educated and cross-trained? In other words, does the company continually invest in the talent quality of its team? One selling feature that sells well is that the higher the percentage of the company's employees with their CLFP, the better. Do you have an ongoing educational improvement schedule for the team?

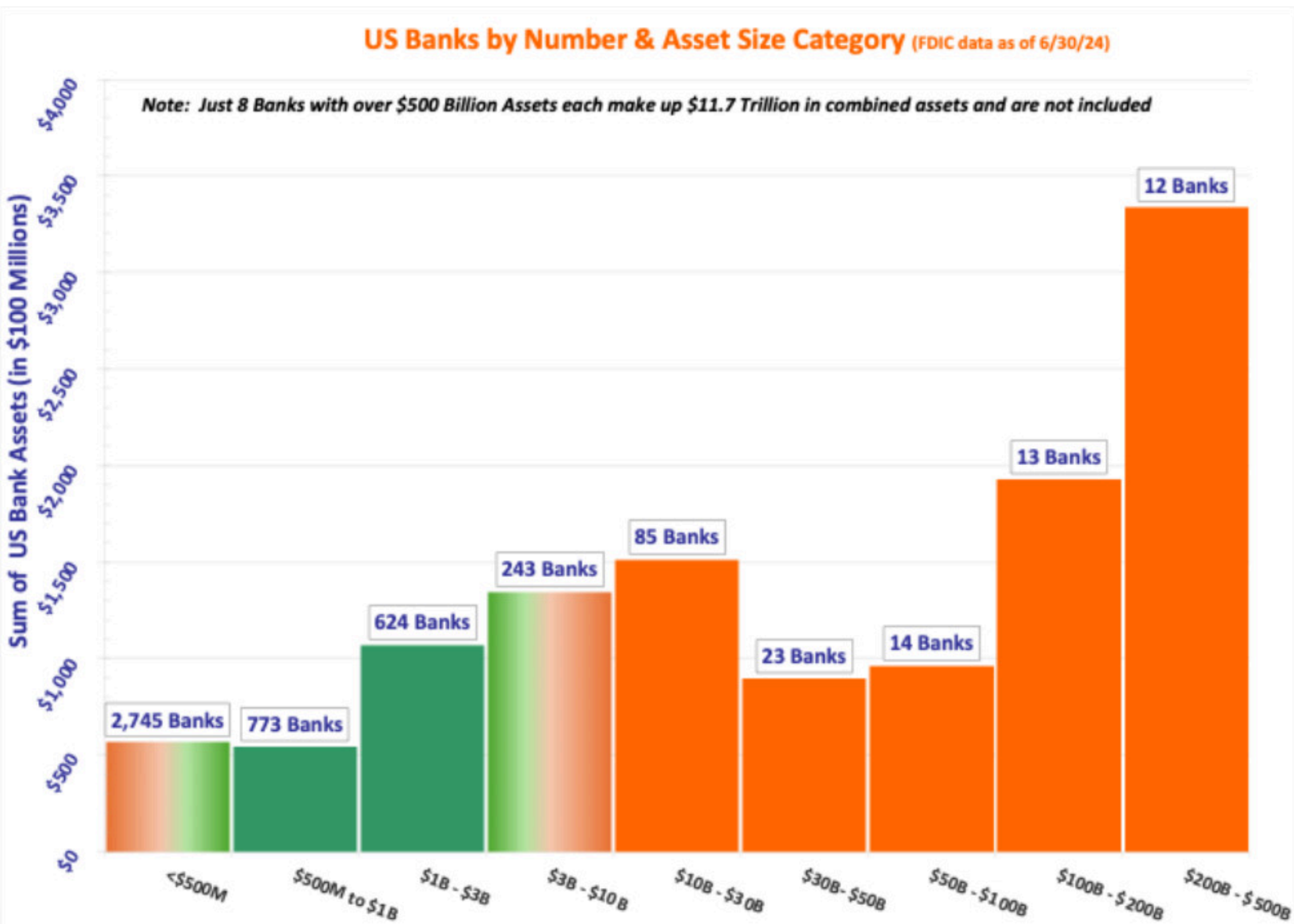
Platform:

Generally, Brokerages only service a portion of the annual new business volume it originates and funds. Sure, some Brokerages may service some transactions they cherry-pick for their accounts. However, to service their portfolio and the portfolio of transactions they sell or discount to funders, the Brokerage must have the capital to hold some transactions on their balance sheet. These are usually funded by a bank line of credit, working capital, or both. If the Brokerage has no servicing experience, then the likely buyer will not be a bank wanting to enter the leasing business. The platform is one of those value adds that encourage a bank to pay a premium for the seller. Without a platform, the ideal buyer is likelier to be a larger Brokerage, a smaller lessor who does service, or a bank that may already have an equipment leasing platform. I mentioned a data mart and business intelligence earlier. Few systems on the market provide reporting capabilities that cross platforms or even within their software. Being able to report on your data regardless of where it comes from is vital if a bank buyer is your preference. For one reason, it demonstrates that the principals and their management team have a tight grip on the pulse of their business. For another reason, it provides a bank buyer with a lot of comfort that the regulatory data requirements the acquiree will be expected to provide will not be an issue.

Now, let's talk about the buyer types.

Banks:

Typically, the bank buyer for a Brokerage is a community bank. There are roughly 4,500 FDIC-insured banks in the US. Below is a breakdown of these banks by asset size. Those banks shown in the green shaded columns are more likely possible fits.As you can see, there is no shortage of them. However, several metrics for these banks narrow the list down significantly. Those metrics are beyond the scope of this article, but it suffices to say that specific metrics like the bank's asset size and its core loan-to-deposit ratio help to narrow the list of possible prospective bank buyers. Remember the example given above about the annual new business volume and total assets those Brokerages can generate three years post-sale? Here is another rule of thumb. Any bank's leasing portfolio of assets should not exceed 10% of its total loan portfolio of all types or, simpler yet, 10% of total bank assets. As you will see from the chart, the quantity of banks in the target range for Brokerages is significant.



Lessors:

I define lessors as those who hold (on their balance sheets) and service some meaningful percentage of their annual new business volume. This may also include those that discount and retain the servicing of the transactions they do not hold on the balance sheet. Most lessors aim to generate at least $50 million in annual new business volume with an upward-sloping trajectory in their forward run rate. This is the point where the lessor starts to become a compelling acquisition candidate. Getting there requires a continual investment in the business. One of the investments that lessors will consider if they have enough equity is inorganic growth or the acquisition of Brokerages and smaller lessors with significant asset-generation talent, vendor programs, niches, etc. Since the lessors likely have a platform, the Brokerage's servicing and back-office capabilities are not usually necessary to the lessors. Unfortunately, I cannot provide a chart like the one for the number and sizes of lessors or Brokerages. There isn't enough publicly available data about the number of lessors in the US, let alone the metrics and benchmarks. The ELFA annually publishes the Survey of Industry Activity, an invaluable benchmarking, and metrics report from 100 lessors of all types (bank-owned, independent, and captives). The other leasing associations would consider doing the same for their membership. Just saying…

Brokerages:

Likewise, Brokerages ideally want to reach a target of $50 million annual new business volume with an excellent forward-looking growth trajectory. At this point, Brokerages also start to explore obtaining their first significant bank line of credit, which is beyond the scope of this article. Again, just like the lessors above, this annual volume target can be obtained through organic growth as well as acquisitions of smaller Brokerages. The acquiree's prerequisites that interest them would be the same as what lessors are looking for but at a smaller scale.

Hopefully, the above provides insight into the question, can a Brokerage be sold? We did not touch on value or valuation. Not to be redundant, but the answer is still, it depends. There are so many things to consider. Sure, all the characteristics discussed above apply generally. But there are two more important things to consider. The most important of the two is understanding the buyer's specific needs and their importance to its strategic plan. The second is the seller's time horizon to when it wants to sell. Keep in mind that in acquisitions of a Brokerage, the buyer will likely structure the price to be paid as a small percentage at close and the remainder of the price over several years to ensure that the Brokerage's principals remain in the game to guarantee the buyer's investment and anticipated return are achieved. So, if the principal's time horizon is to sell three years from today, the principal should plan for six years before lounging at the beach full-time.

In summary, can an Equipment Finance Brokerage Be Sold? It depends, but from what you have read, you should be able to answer the question about your company. You have the requisite knowledge about all the variables based on the characteristics of your company, as explained above.

ABOUT THE AUTHOR

Bob Rinaldi is President of Bob Rinaldi Advisory Services, serving independent lessors, financial institutions, manufacturers and entities entering the USA equipment finance market. Bob has started two independent leasing companies in the USA and has sold successfully both to banking institutions.