THE REAL RATE OF RETURN

A look at what an investor will actually get provides a different view of high-yielding equipment leasing partnerships.

BY EDWARD BROWN

Most financial planners today recommend equipment leasing partnerships on the basis of highly competitive distributions projected by their sponsors—ranging from 10% to 15% or more a year. For clients interested in total returns, slick marketing brochures quite often boast projected internal rates of return in excess of 15%.

Unfortunately, these yields have little to do with the real world and even less bearing on how much cash an equipment leasing investor will actually receive from his investment. A better picture of what an investor can expect comes from simply combining the projected after-tax cash flow with a real-world assumption of what that cash will earn—sometimes called the adjusted or modified rate of return. Even using a sponsor's optimistic projections, the result can often raise serious doubts about whether a partnership's returns adequately compensate for the level of risk involved.

In Table 1, a well-known sponsor of equipment leasing partnerships provided the information for the first three columns labeled *percentage distributed*, *cash distributed* and *taxable portion* for an initial investment of $10,000. These figures represent an assumption that distributions start at 11% and escalate to 15% over a six-year period. In years seven through nine, the general partner sells the equipment on the market, distributes the proceeds and closes the partnership.

The total of the distributed cash in Column B comes to $19,648, representing an internal rate of return of 12.35%. On that basis a planner might recommend this partnership to a client whose portfolio can stand a moderate degree of risk in return for above-average returns. However, after taking a harder look at what an investor will actually receive under this scenario, the planner may come to a different conclusion.

The first thing to consider is taxes—not from the usual sponsors' angle of valuing the tax benefits, but from the investors' perspective of having to pay them. Tax benefits in an equipment leasing partnership come from depreciation of the equipment and the amortization of up-front organization costs as required by the Tax Code. Column C shows the portion of each distribution that is subject to tax. The taxable income over the nine-year life of this program totals $6,760.

In this example, we assume an investor pays income taxes at an effective 30% rate, a figure that can easily be adjusted to each client's circumstances. Column D shows the taxes paid on the unsheltered income totaling $2,028. And finally, Column E shows what an investor actually keeps under the sponsor's project scenario—the after-tax distributions. This $10,000 investment returns a limited partner an after-tax net of $17,620.

A thorough analysis, though, doesn't end here. Next we need to account for the time value of that distribution stream. Cash distributions can be reinvested and earning interest while the partnership continues. Consequently, distributions made in the early years are more valuable than later ones, which don't have as much time to compound.

How much more valuable depends on what that money could be earning elsewhere. High-grade municipal bonds make a good alternative as much for their relatively low risk as the ease of calculating the after-tax returns on their tax-exempt yields. At the time of this writing, tax-free munis were yielding around 8%.

Column F illustrates a simple way to calculate the results of reinvesting each after-tax dividend in a tax-free vehicle each year, called the after-tax adjusted rate of return. To be conservative, we assume all investments are made on Jan. 1 and all distributions are received Dec. 31. Each year's distribution compounds at the reinvestment rate, in this case 8%, for the number of years remaining in the partnership. In other words, the first $1,100 distribution accumulates at 8% interest for eight years; the next distribution ($1,100) accumulates for seven years at 8%, etc. The total of Column F represents an after-tax future value of $22,339.

The final step is to compute the real rate of return on this investment from this projected future value. To do so requires a calculator that computes the time value of money such as an HP 12-C or a computer spreadsheet. The numbers can be taken right off the chart. Simply insert the initial $10,000 investment as the present value (PV), the nine-year life of the partnership as the number of years (N), and the future value (FV) as $22,339, and then ask the calculator to compute the interest rate. The solution is an after-tax annual yield to the investor of 9.34%.

With this real-world rate of return in hand, a planner can then ask whether the equipment leasing partnership fairly compensates an investor for the risks involved. Or put another way, is this yearly 9.34% yield enough higher than the relatively risk-free muni bonds at 8% to compensate for the chance that the sponsor's projections won't come true?

Accurately assessing a sponsor's projections can involve a great deal of time and research and more equipment leasing expertise than most planners possess. Yet although a planner should conduct an in-depth analysis of this kind before committing a client's money, many partnerships can be evaluated using a few basic principles and some common sense.

Some important factors include the length of the leases and the projected re-lease rates. Most leases run for about three years, which means the equipment will have to be re-leased at least once and usually more during the life of a partnership. The first three years of distributions will probably have been accurately projected since most leases

TABLE 1
AN EXAMPLE OF WHAT A TYPICAL EQUIPMENT LEASING PARTNERSHIP MIGHT RETURN ON A $10,000 INVESTMENT.

YEAR	A. PERCENTAGE DISTRIBUTED	B. CASH DISTRIBUTED	C. TAXABLE PORTION	D. TAX*	E. AFTER-TAX DISTRIBUTION	F. DIST. REINV. 8% TAX-FREE
1	11%	$ 1,100	$ 0	$ 0	$ 1,100	$ 2,036
2	11%	1,100	0	0	1,100	1,885
3	12%	1,200	0	0	1,200	1,904
4	13%	1,300	1,300	390	910	1,337
5	14%	1,400	1,400	420	980	1,333
6	15%	1,500	1,500	450	1,050	1,324
7	60%	6,041	1,280	384	5,657	6,598
8	41%	4,123	1,280	384	3,739	4,038
9	19%	1,884	0	0	1,884	1,884
TOTALS		$19,648	$6,760	$2,028	$17,620	$22,339

PV = $10,000 FV = $22,339 (Column F)
N = 9 I = 9.34% tax-free rate of return
*Assuming an effective tax rate of 30%

are written producing fixed rental income. After that, however, the market economics—the demand for the kind of equipment the partnership owns and its availability—as well as prevailing interest rates will dictate rental income.

An investor's need for liquidity also plays an important role. Most programs are long-term—generally eight to 15 years—with substantial penalties for early liquidation. Although some alternative investments, such as the muni bonds used here, are also long-term, an active secondary market makes liquidation much less of a problem.

And of course, the most important factor of all is the estimated value of the equipment when it is sold. Naturally, the lower the estimate, the more conservative the cash flow projection and the greater the chances that an investor will actually receive the projected returns.

How reasonable projected residuals are isn't easy to determine. In Column B of this example, distributions in years seven through nine return 120% of the initial investment, suggesting a residual value so much higher than the original cost of the equipment that even after subtracting sales commissions and the general partner's cut, it not only recoups the front-end load but also provides some appreciation on the gross investment. That doesn't mean these projections won't prove to be accurate. For example, some used jet aircraft in the early 1980s did appreciate in value, returning limited partners extraordinary yields. But in the real world, few assets, particularly machines that work every day, increase in value.

The bottom line? Every partnership must be evaluated on its own merits, using the real return to the investor. But in this example, it's hard to believe an additional 1.34% yield each year, even after tax, makes up for the chance that the equipment won't greatly increase in value, the general partner won't be able to re-release it at favorable rates or the investor won't need his money before the end of nine years. □