OPERATING LEASES

What is an Operating Lease?

An operating lease involves a party (“the lessor”) who owns assets and allows a third party (“the lessee”) to use the asset under a contract (“a lease”) for a defined period (“the lease term”). The lessee is typically responsible for the operational risks of the asset, including insurance, operations taxes, day to day maintenance and whether the lessee is able to use the asset in its business profitably.

The best known operating lease in the Singapore market is over property. The owner of the property (such as a real estate investment trust or REIT) leases the property to a tenant (“lessee”) for, say, two years. The property owner earns the lease rentals and has the risk on the rental he may earn when he comes to release the property and the long term value of the property.

Babcock & Brown Structured Finance Fund Limited (“BBSFF”) owns assets, other than property, with long useful lives and leases these assets to third parties. For example, BBSFF owns commercial aircraft on lease to international commercial airlines. BBSFF does not take passenger traffic or oil price risks – these are operational risks undertaken by the owner of the airline business, that is, the lessee. BBSFF merely provides the business owner assets to use for a price. BBSFF will typically incur debt to purchase the asset.

Operating leases are generally short-term (from six months to 12 years in duration), making them attractive when aircraft are needed for a start-up venture, or for the tentative expansion of an established carrier.

What happens when the lease ends?

At the end of the lease term, the lessee gives the asset back to BBSFF. At that point of time, BBSFF has a number of options:

- Lease the asset to the existing lessee or a new lessee, and again, earn regular income;
- Sell the asset, repay the debt and therefore release the value in the asset which has been created during the lease term.

What assets does BBSFF own and lease?

Commercial aircraft used by international airlines and rollingstock used to carry freight in North America. It is considering an investment in passenger and locomotive rollingstock in mainland Europe.

How does BBSFF make money from Operating Leasing?

BBSFF funds its purchase of the assets with equity from BBSFF shareholders and debt from banks.

BBSFF receives rental income from the user/lessee.

BBSFF repays its debt from its rent, but typically also has sufficient additional cash which it can use to pay a dividend to its shareholders. BBSFF aims to repay its debt at a rate that is faster than the rate of depreciation of the asset – and therefore BBSFF builds up value in the asset which can be released to BBSFF and its shareholders at a later date.

An illustrative example of Operating Lease Economics*

	Start	End
Asset Value	$100	$80
Equity Investment	$30	
Debt Balance	$70	$45
Interest Rate	6.5%	
Rent	$12.50 p.a.	
Operating Expenses	$0.15 p.a.	

Year	0	1	2	3	4	5
Asset	- 100.00					80.00
Debt	70.00					
Rental		12.50	12.50	12.50	12.50	12.50
Finance Cost		-$8.94	-$8.94	-$8.94	-$8.94	-53.94 ie.– 8.94 – 45
Oper Expenses		-0.15	-0.15	-0.15	-0.15	-0.15
Equity CF	-30.00	3.41	3.41	3.41	3.41	38.41
Internal Rate of Return	**14%**					

The internal rate of return (“IRR”) in this example is 14%.

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