CIO Office Insights

الجزيرة كابيتال
ALJAZIRA CAPITAL الجزيرة للأسواق المالية

Investing in Leased Real Assets

December 2023

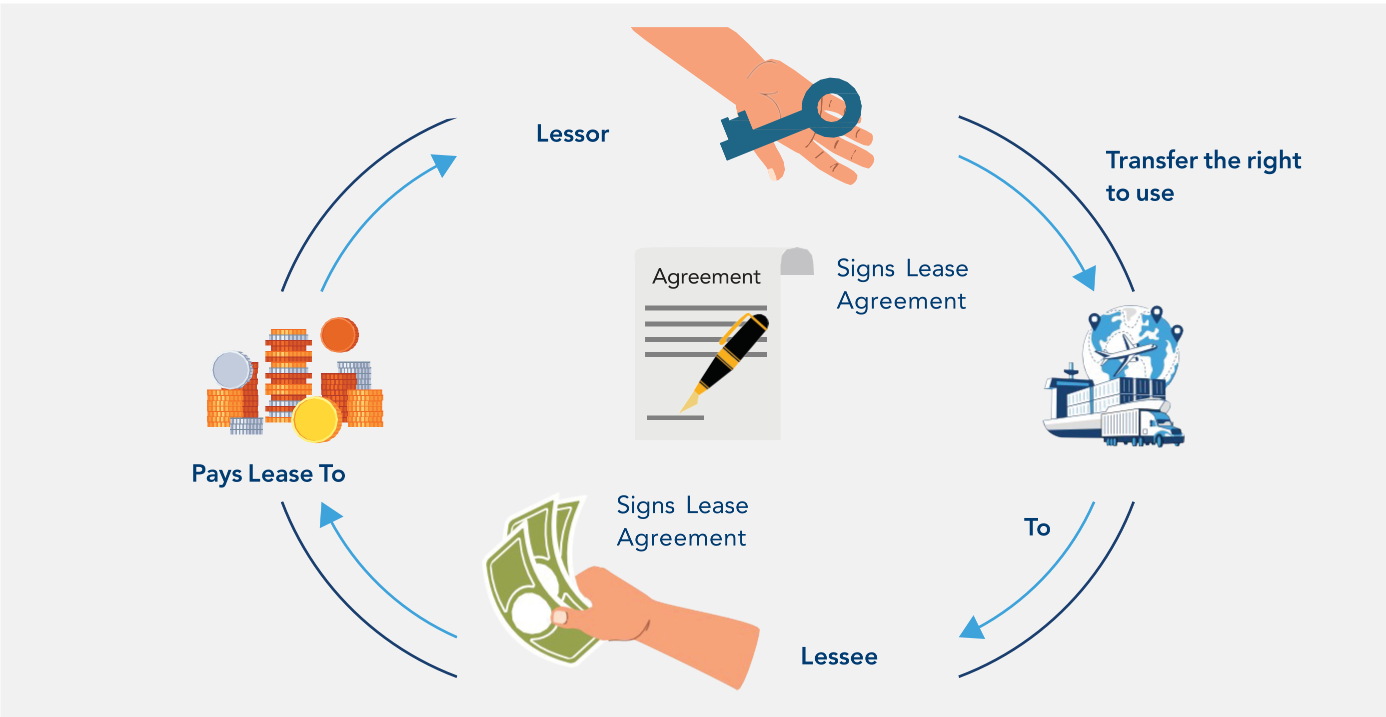
Key Takeaways

- Leases play a pivotal role in the functioning of a healthy economy. In the US, 8 out of 10 companies use equipment financing.
- The transportation industry is the most prominent user of leased assets globally, with an expected CAGR of 5.6% over the next 5 years.[1]
- The sentimental shift towards a sustainable means of transportation is accelerating growth in the railcar industry, which is heavily dependent on leasing for its assets.
- Niche lease operating managers provide an opportunity to invest in this asset class to earn a risk-adjusted return.

Leasing as an Asset Class

Defining and Classifying Leases

A lease is an arrangement wherein the owner of an Asset ("lessor") transfers its usage rights to a tenant ("lessee") while keeping ownership of the asset intact.



There are generally two types of leases, Finance Leases and Operating Leases:

Financing Lease	• Ownership rights are transferred after the completion of the lease period. • Duration is generally equal to the useful life of the asset.
Operating Lease	• More like short-term rentals - Allows the company access to equipment/assets. • The Lessor retains ownership of the equipment.

Source 1: Statista - Size of the global logistics industry

A typical lease agreement has the following key terms:

Terms of a Lease Agreement

3 When, where, and how the leased assets may be used

6 Specifies liabilities and repairs needs

4 The assets' terms and conditions cover both legal and financial penalties

5 Extension Rights, if any, provide rights over assets when the lease expires.

Based on these lease agreement terms, leases can be further classified as gross, net, percentage, or variable leases.

Identifying the Lessor and Lessee

Lessor: Depending on the nature of the lease, the lessor's characteristics can change.

- In the Operating Lease, the owners of these assets are operating companies with the expertise required to own and manage these assets. As these companies are active in the niche industry, they have the inner know-how and relationships required to identify quality users and their evolving needs.
- In the Finance Lease, the transactions are generally backed by financing firms like banks and Financing Companies. In 2021, the majority of US equipment financing came from bank lenders (~53%), followed by independent financing companies and fintech lenders (~28%), while manufacturers, vendors, and others contributed the remaining (~19%)[1].

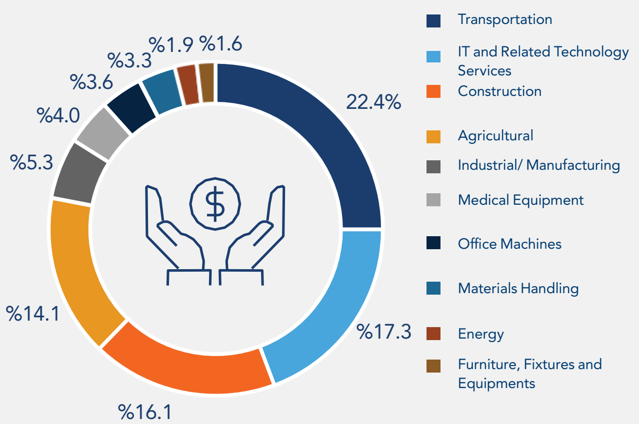
Lessee: Leased equipment are vital assets for businesses, but these come at a high cost and require a substantial cash commitment. Instead of buying them, end users such as businesses, farms, manufacturers, industries, etc. typically lease these essential assets and use the capital that would otherwise be needed to reinvest in their core operations.

8 out of 10 U.S. Companies use Equipment Financing[3]

Leasing was the most common financing method (used by 26%), followed by secured loans (19%) and lines of credit (17%)

Due to its capital-intensive nature, the transportation industry is the most prominent user of leased assets

Survey of Equipment Finance Activity, 2022[2]

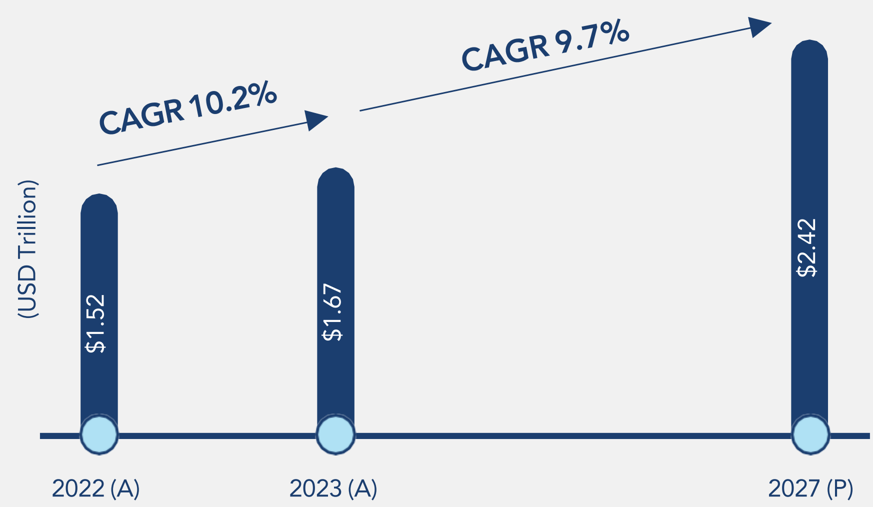


Source 1: Foundation End User Survey 2022
Source 2: 2022 Survey of Equipment Finance Activity
Source 3: Equipment Leasing and Finance Association

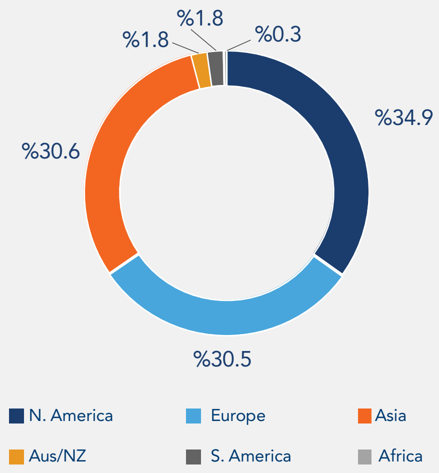
Understanding the Market Size

Leasing offers a unique investment opportunity in the space of Alternative Asset Class.

The global leasing market is expected to reach $2.42 trillion by 2027, with a CAGR of 9.7%[1]



Volume by region (2021)[2]



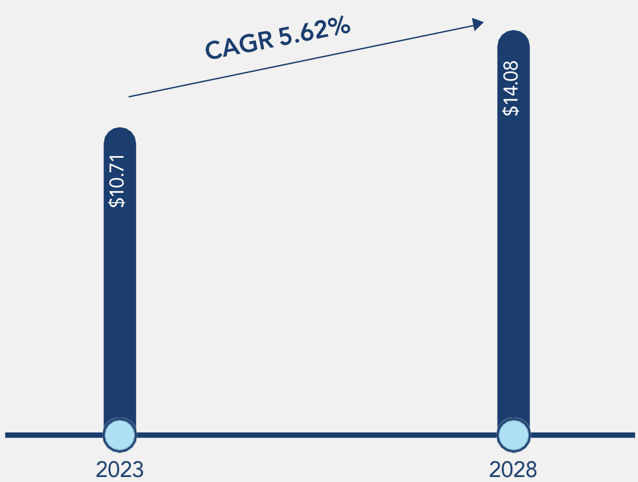
Growth can be attributed to the rising demand for heavy machinery, equipment, and other critical assets.

Scope of Leasing Within the Transportation Industry

The Transportation industry can mainly be distributed into Rail, Road, Aviation, and Marine transportation; each plays a pivotal role in the functioning of the global economy. The escalating demand for intermodal freight transportation (conveyance of freight by more than one mode of transportation), advancements in transport infrastructure, and the advent of digital freight brokerage services represent some of the key factors driving the market.[3]

> Several factors are driving the industry's growth, including the structural shift driven by e-commerce demands. In the US, the Federal Highway Administration forecasts a 30% increase in freight movements from 19.3 billion tons in 2020 to 25.1 billion tons in 2040.

Global Transportation & Logistics Industry[4]

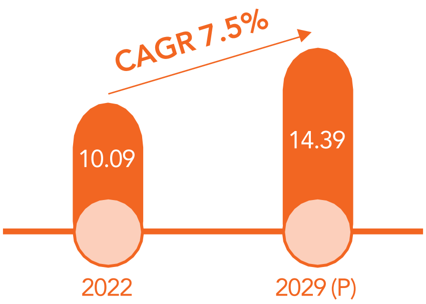


Source 1: Research and Markets - Leasing Global Market Report 2023
Source 2: Solifi Global Leasing Report 2023
Source 3: Yahoo Finance - Global Intermodal Freight Transportation Industry
Source 4: Statista - Size of the global logistics industry

Transportation Sub - Sectors

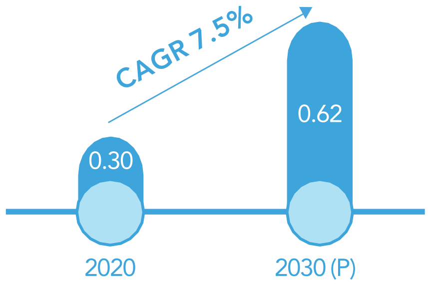
More than any other mode of transportation, freight rail accounts for around 40% of long-distance freight in the U.S. Typically, 80% of assets in the industry are leased.

Railcar Leasing Industry[1] ($ Tr)

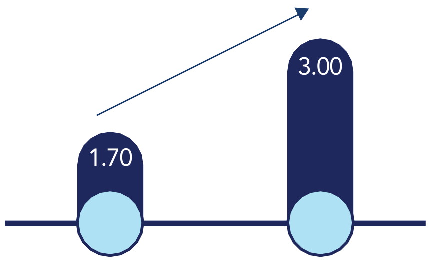


The global aviation industry, valued at approximately $841.5 billion, has seen growth due to increasing travel and tourism, rising disposable incomes, and growing international tourist travel.

Aircraft Leasing Industry[2] ($ Tr)



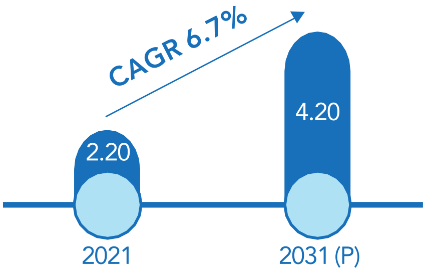
Freight Trucking Industry[4] ($ Tr)



The freight trucking market has experienced steady growth due to increasing international trade, and e-commerce.

A fragmented industry and lower entry barriers lead to limited leasing.

Cargo Shipping Industry[3] ($ Tr)



Within the marine sub-sector, containers play a critical role. The global container market is over $200 billion, and 60% of the global container supply is leased.

In the transportation sector, railways are critical means of transporting freight across the globe. The most dominant global market is North America, with the largest rail network of 225,000 km. The progress in US rail infrastructure has helped find a cost-effective and energy-efficient way to move goods around. Railroads contribute 25% of the 6.2-ton U.S. freight, thereby making it one of the most prevalent and vital modes of transportation. Approximately 50 rail operating lessors own and service the North American railcar fleet.

Source 1: MMR - Railcar Leasing Market
Source 2: Bloomberg - Aircraft Leasing Market
Source 3: Allied Market Research - Cargo Shipping
Source 4: SkyQuest – Global Freight Trucking

Leasing in the Transportation Industry:

Five major shifts are going on globally requiring the increased use of transportation and infrastructure assets:

1	2	3	4	5
Structural	**Geopolitical**	**Market Based**	**Energy**	**Banking**
COVID-19 has exposed structural problems in supply chains that are vulnerable to individual risks of failure and these problems are scalable. This is particularly true in the US, and it has pushed for further reforms.	To expand supply chains and production outside China to over 100 nations, there is a need for more transportation and infrastructure resources, particularly intermodal resources. There is still a demand-supply gap, due to which the utilization rates are expected to increase	Companies are shifting their supply chains closer to customers and end users, particularly in North America and Asia, which necessitates more transportation and infrastructure assets.	The global scenario is experiencing a shift towards cheaper, safer energy sources, with transportation assets playing a significant role in this transition.	Banks in North America and Western Europe are losing deposits to money market accounts, forcing them to sell non-core assets like transportation and real assets. This is opening up markets for more institutional operators.

The shifts in market trends indicate a surge in demand for transportation and supply chain assets, along with a need for more capital to acquire and operate these assets. We expect a higher reliance on leased assets due to increasing lease rates and longer renewal terms, to quickly fulfill the expanding demand.

Merits of Investment in Leasing

Leasing is considered an attractive alternative investment for its capability to generate risk-adjusted return.

Stable Cash Flow

- Economically critical to end-user operations.
- Predictable lease rates on long-term contracts with high utilization.
- Example: The container industry utilization rates are stable and predictable for long-term contracts, typically ranging from 95-100%, and recover faster during economic contraction.

Downside Protection

- Essential assets, with long productive lives and values, experience low instances of credit defaults and write-downs.
- Example: The railcar industry offers predictable downside protection, with asset values only declining by 2-6% during contractions. However, historical data rarely shows year-on-year declines exceeding 10% during extreme stress events like in 2007-08 and 2020.[1]

Uncorrelated Return Profile

- Low to negative correlation to public equity, credit markets, and most alternative asset classes.
- Example: Transportation real assets have a negative correlation of 0.2 and 0.1 with global bonds and public equities, respectively. Meanwhile, they show no direct correlation with global core infra and private equity. On the other hand, direct lending displays a positive correlation of 0.1 with transportation real assets.

Inflation Correlated

- Lease rates and residual values positively correlate to inflation, creating long-term yield stability.
- Example: From 1995 to the first quarter of 2022, the correlation coefficient of quarterly yields between container yields with the five-year Treasury exceeded 0.7.

ESG Friendly

- US Rail accounts for ~40% of the long-distance freight with just 2% of the transportation-related greenhouse gas emissions.
- Also, maritime container shipping has 80% lower greenhouse emissions than trucks and 95% lower than airplanes.[2]

Sharia Compliant

- "Ijara" or leasing is a perfectly permissible asset class under the Sharia law, as there is an underlying asset at the heart of the transaction.

Investing in leasing requires consideration of factors like capital management, effective operations and cost management, assessing the lessee's creditworthiness, understanding the supply and demand structure of the niche industry along with the regulatory requirements, and a good understanding of the terms and conditions of the lease agreement. The niche nature of this industry requires an investor to rely on an experienced manager, with a deep understanding of the market demand and supply forces, along with the operational capability to lease the assets effectively to generate returns.

Source 1: Harrison Consulting Container Data Excel Report
Source 2: World Shipping Council (WSC)

CIO Office

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