Warren & Selbert

Simple as ABC.

Early Buyout Options

Although a lessee may only purchase an asset for then fair market value (FMV) at the end of a true lease, a lessor may allow an Early Buyout Option (EBO) if it satisfies at least the following three requirements on the date of the EBO:

1. The EBO must be sufficient to give the lessor his required yield to date.
2. The EBO may not be a bargain purchase.
3. There must be no economic compulsion for the lessee to exercise the EBO.

The requirement that the EBO provides the lessor with his **yield to date** can be satisfied by requiring that the EBO be greater than or equal to the termination value on the EBO date. Since the lessor is giving up all future earnings after the EBO date, he may require a higher rate of return if the EBO is exercised. For example, if the required full term yield were 6.00%, the required EBO term yield might be 6.50%

In addition to the EBO amount the lessor may require additional compensation from the lessee if the EBO is exercised. This additional compensation may consist of a fixed amount, an amount to represent additional days of return on the outstanding investment balance, and an amount to represent the present value of an expected residual value gain at lease end that the lessor will no longer be able to realize.

The requirement that the EBO **not be a bargain purchase** can be satisfied by requiring that the EBO be greater than or equal to the expected fair market value on the EBO date. This may require an evaluation from a certified appraiser.

The requirement that there must be **no economic compulsion** for the lessee to exercise the EBO means it must cost the lessee at least as much to exit the lease by paying the EBO amount as does to remain in the lease. The cost to remain in the lease can be calculated as the present value of the rental payments after the EBO date and an expected fair market purchase at lease end. Lessees often use their weighted average cost of capital as the discount rate for this calculation.

Some lessors allow the EBO payments to be spread evenly across the remaining tax payment dates after the date of the first EBO payment. The sum of these spread EBO payments are equal to the lesser of equity free cash on the first EBO date and the taxes due after the first EBO date if the EBO is exercised. Since the lessor's outstanding investment has been paid in full by the first EBO payment and assuming a 0% sinking fund rate, there is no cost to the lessor of delaying the subsequent payments, which allows for a lower present value of the lessee's rent and EBO payments.