Lease Versus Buy Analysis
BEST PRACTICES FOR IT, FLEET AND EQUIPMENT LEASING PROGRAMS

Updated To Include Consideration Of The New Lease Accounting Standards
BENEFITS OF EQUIPMENT LEASING

Many companies lease (rather than buy) much of the equipment they use to run their business. Many of the forklifts, trucks, computers and data center equipment companies use to run their business are leased. There are a number of financial and strategic benefits to leasing equipment.

Cash Flow

Without equipment leasing, a company would be forced to use its working capital to make up-front capital expenditures to purchase trucks, computers, forklifts and other specialized equipment. In the leasing model, that working capital can be invested in other parts of the business that might have better returns such as expansion, marketing or R&D. Another benefit of leasing is the predictability of payments. Monthly expenses are known in advance allowing treasury organizations to better forecast and plan for cash needs.

Budget Expansion

Leasing equipment uses less of departmental budget since payments are made monthly over a multi-year period instead of all up front. As a result, the approval processes are faster. Furthermore, many companies establish lease-lines with financing companies that can be drawn upon over a period of several years when new equipment is needed. These pre-established lines of credit allow buyers to circumvent the complicated process of seeking budget approval for capital expenditures internally.
Lower Asset Management Costs

Many companies recognize that ownership of certain assets, and the various chores associated with maintenance and repair, fall outside their core competencies. One considerable benefit of leasing is reduced operational costs realized by outsourcing the ownership function to a specialized third party.

Technology Obsolescence

Regular replacement of older technology with the latest and greatest technology increases productivity and profitability. Instead of buying a server to use in your data center for five years, you can lease the machines and get a new replacement every three years. If you can return the equipment on time, you are effectively outsourcing the monetization of the residual value in the equipment to an expert third-party, the leasing company.
Corporate Finance organizations should think about equipment finance and leasing as a strategic tool for the business. Strategic use of equipment finance involves consideration of lease structures from the perspective of proactive management of the liabilities side of a company’s balance sheet. For example, equipment finance transactions can free up other liquidity facilities, such as revolving credit agreements, for opportunistic acquisitions. Alternatively, proceeds of equipment finance transactions can be used to retire existing debt with high interest rates and/or restrictive covenants, or to repurchase outstanding shares. An active program of equipment finance can also broaden and diversify a company’s funding sources, thereby improving market acceptance.
Although equipment leasing offers numerous competitive and financial benefits, most companies do not fully realize the economic rewards of their programs due to poor execution. Big companies waste millions of dollars annually under-negotiating savings at the inception of a lease and over-paying monthly fees well beyond the end of a lease term. And many companies make poor leasing decisions by not conducting a proper Lease versus Buy Analysis before acquiring equipment.

**Cost Leakage from Equipment Leasing**

- No Competitive Bidding on Leasing Rates and Terms
- Inconsistent Lease versus Buy Analysis
- Evergreen Fees paid for Leases past End of Term
WHAT IS LEASE VERSUS BUY ANALYSIS?

Companies fund business expansion and capital expenditures through a variety of mechanisms:

» Operating earnings
» Sale of equity
» Borrowings
» Secured finance vehicles such as leases

In fact, most companies use a combination of these sources of liquidity.

Lease versus Buy analysis refers to the comparison of two financing alternatives: a “lease scenario” in which the asset is financed via a lease, and a “buy scenario” in which the asset is purchased by the company. For most companies, Lease versus Buy Analysis is an important component of capital planning.
NEW LEASE ACCOUNTING STANDARDS

In early 2016 the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued ASC 842 and IFRS 16, respectively, requiring that lessees capitalize all leases with terms over twelve months. Accordingly, the new rules will result in recording leased assets and the underlying liabilities on the balance sheet. The new rules will effectively eliminate “off balance sheet” leases (currently known as operating leases).

Although there has been a significant change in the accounting rules, such changes will not significantly impact the economics, or cash flow impact, of leasing. As a result, Lease versus Buy analysis will continue to play a critical role in effective capital planning. In fact, such analysis will become even more important for those companies who previously bypassed Lease versus Buy analysis due to a bias towards the “off balance sheet” reporting of operating leases.

Companies can now focus on the true economics of leasing versus purchasing an asset. Decision makers can consider all possible lease structures, rather than being distracted by the accounting considerations since the balance sheet impact and leverage will be very similar between a leased or purchased asset. Effective Lease versus Buy analysis tools will become essential in making economically correct decisions during the capital planning process.
## Leases Move on the Balance Sheet

<table>
<thead>
<tr>
<th>Current Model</th>
<th>New Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital/Finance Leases</strong></td>
<td><strong>All Leases</strong></td>
</tr>
<tr>
<td><strong>Operating Leases</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Current Model

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Off Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="airplane.png" alt="Airplane" /> <img src="building.png" alt="Building" /></td>
<td><img src="dollar-signs.png" alt="Dollar signs" /></td>
<td><img src="dollar-signs.png" alt="Dollar signs" /></td>
</tr>
</tbody>
</table>

### New Model

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Off Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="building.png" alt="Building" /> <img src="airplane.png" alt="Airplane" /> <img src="airplane.png" alt="Airplane" /> <img src="truck.png" alt="Truck" /></td>
<td><img src="dollar-signs.png" alt="Dollar signs" /></td>
<td><img src="dollar-signs.png" alt="Dollar signs" /></td>
</tr>
</tbody>
</table>
THREE STEPS FOR LEASE VERSUS BUY ANALYSIS

Correct Lease versus Buy analysis comprises three basic steps:

1. **STRUCTURING**
The first step is selecting the lease structure that best fits the asset characteristics, the expected period of use, and the financial objectives of the lessee. This step requires familiarity with available lease structures and expertise in matching lease structures with specific fact patterns and business objectives.

2. **PRICING**
The second step is determining market pricing for the optimal lease structure. This step requires up-to-date market knowledge. Because published price indexes are generally unavailable, market pricing is typically informed by comparable transactions or price indications obtained from lessors.

3. **COMPARISON**
The final step is comparing the lease scenario versus the buy scenario, typically through after-tax Net Present Value (NPV) analysis. This step requires specification of the use period, the lessee’s tax position and the end-of-term disposition. It also requires an understanding of the “buy scenario” financing method. Once determined, these variables should be processed through a computational tool or calculator.
The following sections review the principal considerations involved in each of these steps.
Leasing is a flexible tool that can provide cost-effective financing for capital equipment and property. Lease structures differ with regard to several different factors. One is the end-of-term options and the transfer of residual risk. Another is the control of tax ownership. A third is the party responsible for maintenance and operations during the term of the lease.

By manipulating key variables, the lease structure can be tailored to match the specific company circumstances and business objectives for each financing.

**End of Term Options**

Assets may become surplus to the business needs of the lessee for a variety of reasons including technical obsolescence, changing business requirements, and ordinary wear and tear. To protect against the risk of financial loss arising from the resale of a given asset, many companies elect to transfer residual risk to a third-party lessor that specializes in the asset type in question.
10% Option
Skip Lease
Step Up Lease
60 Day Deferred

TRAC

Dollar Out
Fair Market Value
Renewal Option
Guaranteed Residuals
Variable Rent
Purchase Option
TAX
Ownership

Structuring of Equipment Leases

White = Types of Leases
Dark Blue – Structuring Variables
The typical lease structure facilitating such residual transfer is a Fair-Market-Value (FMV) lease in which the lessee has the right either to purchase the asset at its fair market value at end-of-term, or to redeliver the asset to the lessor. This structure transfers “downside risk” of a significant decline in resale value to the lessor.

However, the lessee may alternatively anticipate circumstances in which it will not return the asset end-of-term, but instead will purchase the asset. In order to limit the lessee’s “upside risk” that high secondhand values may drive up its FMV purchase option price, the lease may include a fixed-price early buyout option during the lease term. Additionally, renewal options at the discretion of the lessee may further enhance asset use flexibility while protecting against the downside risk inherent in ownership.

**Controlling Tax Ownership**

Tax ownership can also be controlled through choice of lease structure, often independently of accounting ownership. Placing tax ownership with a full taxpayer paying local, state and federal taxes may create a fundamental arbitrage opportunity for lessees with lower tax burdens or with net operating loss carry-forwards.

For the vast majority of countries that have taxes that are different from accounting, the changes to the lease accounting standard should have no impact on the quantitative aspects of the Lease versus Buy analysis, except perhaps some ratio analysis.

The outcome of Step 1 should be selecting a lease structure that best fits the asset characteristics, expected period of use and financial objectives of the lessee.

**Impact on Financial Measures**

Companies should evaluate the impact of purchasing and leasing on their financial ratios and incorporate this analysis into their decision making process. It should be noted that the new lease accounting standard will reduce the significance of any ratio differences as all leases will be on balance sheet. Ratio differences will vary depending on whether leases are booked as on balance sheet operating leases, or on balance sheet finance leases.
Once the lease structure has been selected, the next step is determining how lessors will price the transaction. In fact, pricing and structuring are highly interrelated in that particularly aggressive pricing of a particular structure may tilt the structuring decision in its favor.

Current Market Conditions

Pricing of secured finance structures has improved significantly relative to both unsecured debt and equity. Investors have become saturated and have indicated preference for the additional security inherent in asset-backed financings. Increased investor appetite for secured transactions and leases has combined with historically low interest rates to make secured finance available at extremely aggressive rates.
Asset Considerations

Asset characteristics are centrally important to lease pricing, especially to lease structures involving significant residual risk transfer from lessee to lessor. The willingness of lessors to take aggressive residual risk positions changes from year-to-year, reflecting industry conditions, sector considerations and changing investor preferences.

Structure Preferences

A third example of the variability of lease pricing is that certain transaction structures may become prohibitively expensive – or unavailable – for certain lessees, asset types and business sectors. For example, a low-high rent pattern may have a very favorable earnings impact in certain circumstances. However, it may be commercially unavailable for certain transactions, due to lessor credit and asset requirements. In other circumstances, the provision of additional security enhancements by the lessee may be cost-effective in improving the pricing and availability of funds.
Once a lease is optimally structured and priced, the final step is to compare the lease scenario against the buy scenario. To make the best decision, the discounted cash flows for each scenario should be compared, usually adjusted for the effect of income taxes. Discounted cash flow analysis produces an all-in cost-of-funds comparison of leasing versus buying. In order to make accurate and informed comparisons, it is critical that all key parameters and calculations are correct for both the Lease versus Buy cash and flow and Net Present Value analyses.

Most companies have a Lease versus Buy process in place, but many companies have manual processes (prone to human error) that are not being consistently applied company-wide. Common problems include using outdated financial variables or incorrect formulas in the analysis. These both result in incorrect comparisons that lead to costly financing decisions. To avoid incorrect decisions, it is essential that companies adopt an automated and standardized Lease versus Buy application. The automated tool should store all financial variables centrally with regular update by an authorized user. An automated tool will provide assurance that all Lease versus Buy calculations for cash flows and NPVs are accurate. It will ensure that all analyses are consistently prepared in accordance with company policy. Furthermore, a tool will reduce the amount of time a company spends on this process.

* More details in the Accounting requirements section
Of central importance in the Lease versus Buy comparison is correctly portraying the buy scenario. The most accurate and flexible approach to constructing the buy scenario is to consider the purchase to be financed through a combination of debt and equity, each with its separate cost-of-funds or earnings rate. The proportion of debt and equity in a given acquisition might represent the overall debt/equity ratio of the lessee or transaction-specific criteria. By using a blended cost of funds reflective of a combination of debt and equity, the lessee most precisely captures the 100% advance rate typical in lease financing into the Lease versus Buy Analysis.

### SPECIFICATION OF “BUY SCENARIO”

#### KEY PARAMETERS

Used to Determine Cash Flows and Respective Net Present Value

<table>
<thead>
<tr>
<th>Lease Parameters</th>
<th>Tax Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>» Commencement date</td>
<td>» Asset Depreciation life, class and convention</td>
</tr>
<tr>
<td>» Lease term</td>
<td>» Marginal federal and state tax rates</td>
</tr>
<tr>
<td>» Payment frequency</td>
<td>» Federal and state deductions and benefits</td>
</tr>
<tr>
<td>» Payment timing (in advance or arrears)</td>
<td>» Net operating loss position</td>
</tr>
<tr>
<td>» Payment schedule (level or step)</td>
<td>» Alternative minimum tax position and rate</td>
</tr>
<tr>
<td>» Deposit</td>
<td></td>
</tr>
<tr>
<td>» Up-front fees</td>
<td></td>
</tr>
<tr>
<td>» Purchase price</td>
<td></td>
</tr>
<tr>
<td>» End of term purchase or return</td>
<td></td>
</tr>
</tbody>
</table>
Notes on Key Parameters

1. **Equity amount and rate**: This is the upfront cash payment for the asset. In the buy scenario, based on the capital structure of the company, the asset purchase includes an equity component. The amount of equity could be anywhere from 0-100%. The sum of debt and equity is always 100% and makes up the composition of the asset cost.

2. **Debt amount, rate and payment terms**: The amount of the loan, if any, to finance the asset purchase.

3. **Companies may use different discount rates to present value different payment streams**. Typically, the weighted average cost of capital (WACC) is used to discount buy cash flows. However, the debt rate may be used to discount those cash flows that are more certain and/or have similar characteristics to the debt service payments.

**Breakeven Analysis**

In order to facilitate management’s ultimate financing decision, an effective Lease versus Buy tool should include the dollar amount by which the analysis favors a lease or buy decision. Additionally, a breakeven analysis should be provided that calculates the lease payment amount at which the Net Present Value for both the lease and buy scenario are equal. Such analysis can be effective in the negotiation of the final pricing or, if there is no significant difference in the economics, it can aid in management’s consideration of qualitative or other business factors in the final decision.
LEASE VERSUS BUY ANALYSIS CONSULTATION

LeaseAccelerator can help you analyze both the quantitative and qualitative benefits of leasing versus buying. We can also help you determine the optimal lease structure and pricing given a particular asset type; its expected use and your financial objectives.

LeaseAccelerator’s high transaction volume and diversity across such as wide range of asset types, industry segments and funding sources gives us a level of expertise that typically exceeds most company’s in-house treasury resources. We typically base our analysis of market levels on a combination of recent comparables, our ongoing dialogue with lessor and specific pricing indications we solicit.
LeaseAccelerator offers the market-leading SaaS solution for Enterprise Lease Accounting, enabling compliance with current and new FASB and IFRS standards. Using LeaseAccelerator’s proprietary asset-based Global Lease Accounting Engine, customers can account for all categories of leases including real estate, fleet, IT, material handling and other equipment at an asset-level.

On average, LeaseAccelerator’s lease Sourcing and Management applications generate savings of 17% on equipment leasing costs with smarter procurement and end-of-term management.

www.leaseaccelerator.com 
sales@leaseaccelerator.com