

Lease vs. Buy analysis

Best practices
for IT, fleet and
equipment
leasing programs



Benefits of equipment leasing

Many organizations lease (rather than buy) much of the equipment they use to run their business. From forklifts, trucks and planes to computers, printers and medical equipment, leases can be found almost anywhere in an organization. There are a number of financial and strategic benefits to leasing equipment.



Cash flow



Budget expansion



Technology obsolescence



Lower asset management

Cash flow

Without equipment leasing, an organization has 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 move faster to acquire critical equipment.

Benefits of equipment leasing

Lower asset management costs

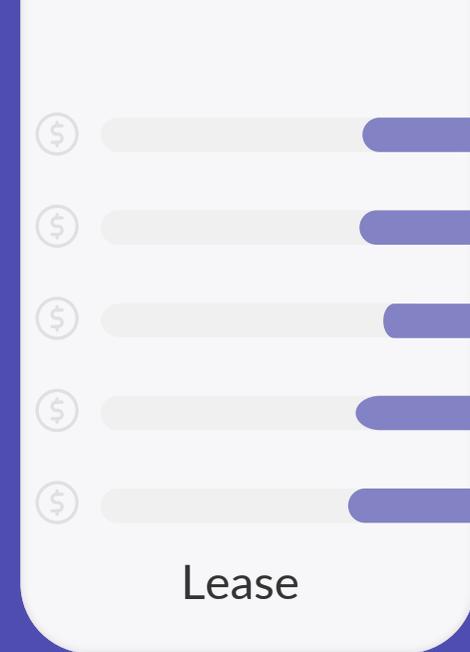
Many organizations recognize that ownership of certain assets, and the various chores associated with maintenance and repair, falls outside their core competencies. The disposal of equipment such as refrigeration or computers may also require strict adherence to regulations that are unfamiliar to an organization. One considerable benefit of leasing is reduced operational costs realized by outsourcing the ownership function to a specialized third party.

Technology obsolescence

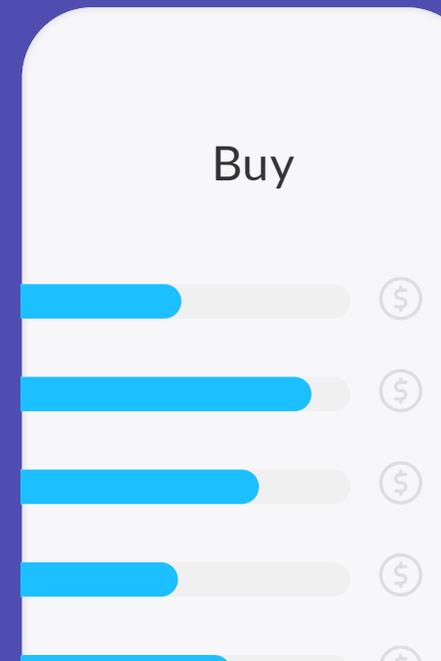
Regular replacement of older technology with the latest and greatest technology increases productivity and profitability. Instead of buying a server to use in your data center for five years, you can lease the machines and get a new replacement every three years. If you can return the equipment on time, you are effectively outsourcing the monetization of the residual value in the equipment to an expert third-party, the leasing company.

Leasing as a strategic tool

Corporate Finance organizations should think about equipment finance and leasing as a strategic tool for the business. In addition to optimizing the use of capital, managing leasing programs proactively can help manage liabilities and improve financial stewardship. 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.



VS



There are many leasing challenges

Although equipment leasing offers numerous competitive and financial benefits, most companies do not fully realize the economic rewards of their programs. Big organizations spend 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 vs. Buy analysis before acquiring equipment.

Cost leakage from equipment leasing



No competitive bidding on leasing rates and terms



Inconsistent Lease vs. Buy analysis



Evergreen fees paid for leases past end of term

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

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

Most use a combination of these sources of liquidity.

What is Lease vs. Buy analysis?

Lease vs. 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 organizations, Lease vs. Buy analysis is an important component of capital planning.

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, these rules require recording leased assets and the underlying liabilities on the balance sheet. The rules effectively eliminate “off balance sheet” leases (previously known as operating leases).

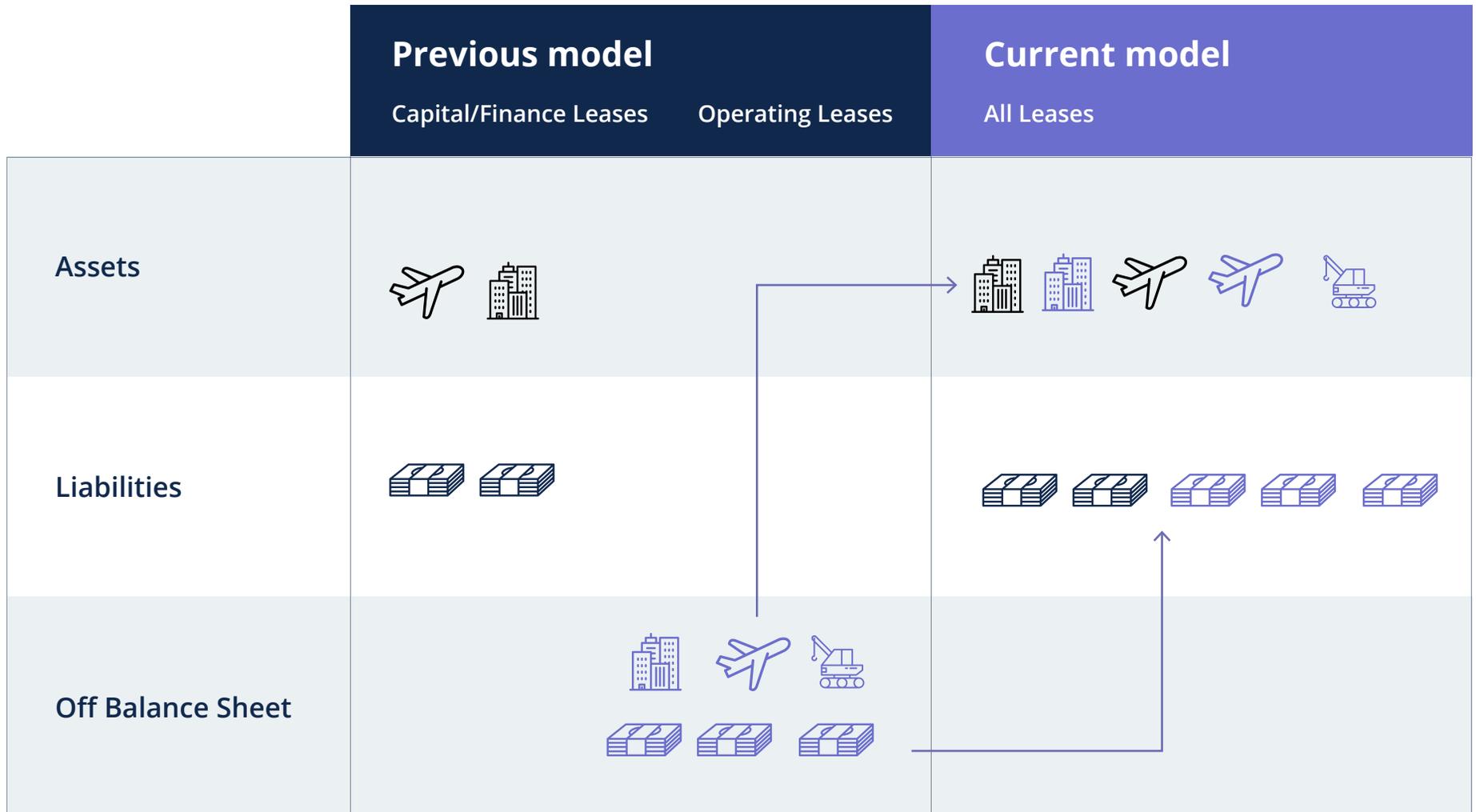
Although there has been a significant change in the accounting rules, such changes do not significantly impact the economics, or cash flow impact, of leasing. As a result, Lease vs. Buy analysis will continue to play a critical role in effective capital planning. In fact, such analysis will become even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

Organizations 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 vs. Buy analysis tools will become essential in making economically correct decisions during the capital planning process.

ASC 842

IFRS 16

Leases move on the balance sheet



Three steps for Lease vs. Buy analysis

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.

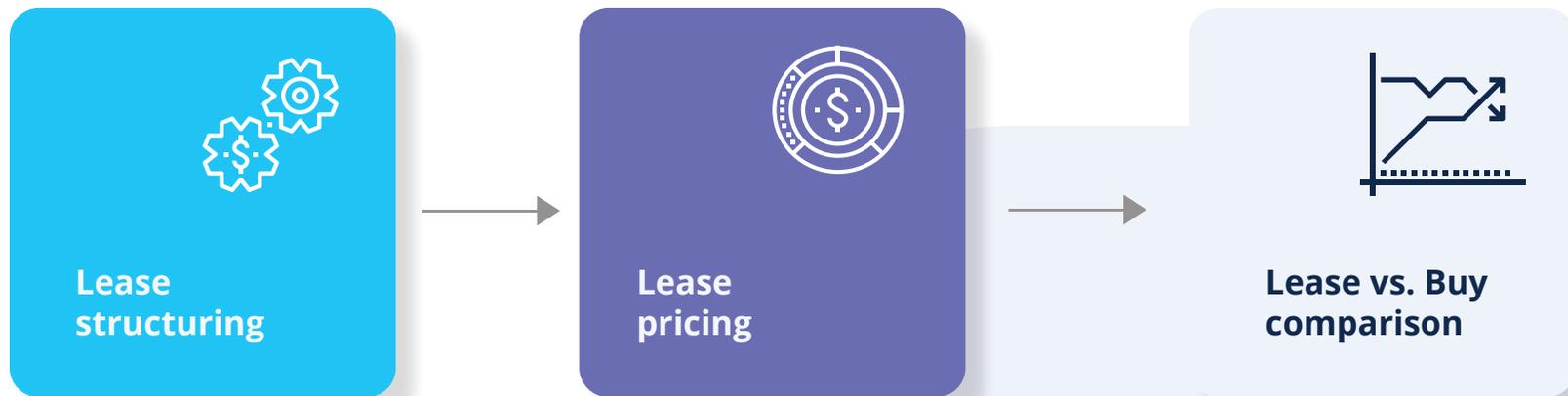
Pricing

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.

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.



Step 1: Structuring

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 the match the specific organization's circumstances and business objectives for each financing.

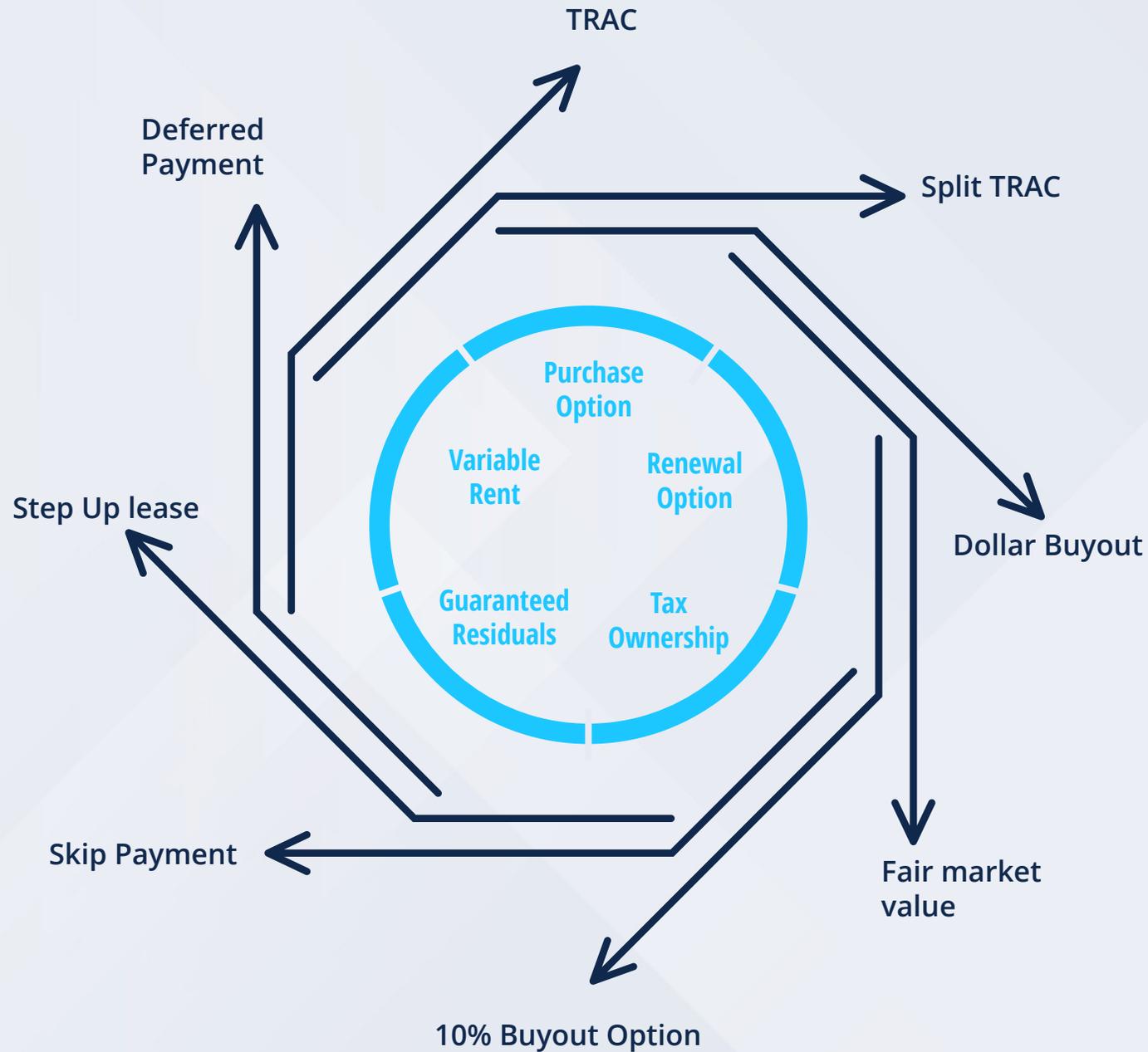


End of term options

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 organizations elect to transfer residual risk to a third-party lessor that specializes in the asset type in question.

Lease structuring options

Navy = Types of leases
Blue - Structuring variables



The typical lease structure facilitating a 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 return 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 vs. Buy analysis, except perhaps some ratio analysis.



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 lease accounting standards reduce the significance of any ratio differences as all leases are on balance sheet. Ratio differences may vary depending on whether leases are booked as on balance sheet operating leases, or on balance sheet finance leases.

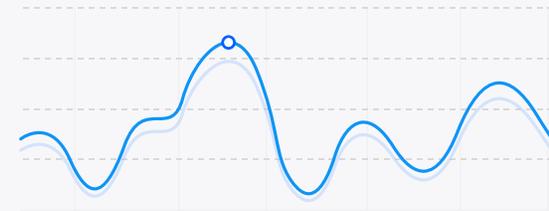
The outcome of Step 1 should be selecting a lease structure that best fits the asset characteristics, expected period of use and financial objectives of the lessee.

Step 2: Pricing

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.



32%

45%



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

An 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 step-payment rent pattern may have a very favorable cash flow 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.

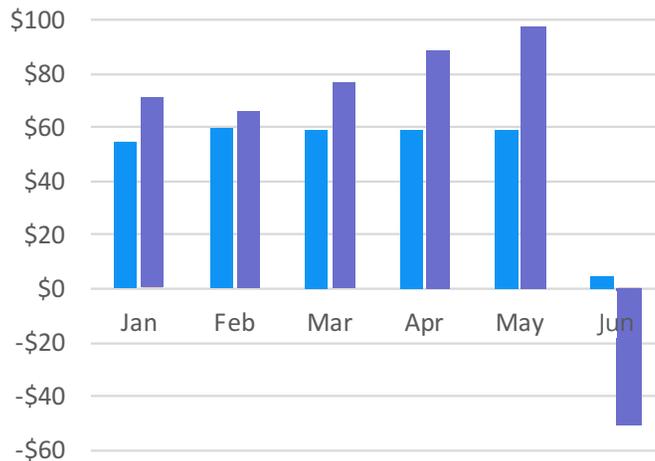
Step 3: Comparison

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 vs. Buy cash and flow and Net Present Value analyses.

Most companies have a Lease vs. 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 vs. 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 vs. 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

Net Cash Flows After Tax



Specification of “Buy Scenario”

Of central importance in the Lease vs. 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 vs. Buy analysis.

Key parameters

Used to determine cash flows and respective net present values

Lease parameters	Tax considerations
<ul style="list-style-type: none">» Commencement date» Lease term» Payment frequency» Payment timing (in advance or arrears)» Payment schedule (level or step)» Deposit» Up-front fees» Buyout price» End of term buyout or return	<ul style="list-style-type: none">» Asset Depreciation life, class and convention» Marginal federal and state tax rates» Federal and state deductions and benefits» Net operating loss position» Alternative minimum tax position and rate

Buy parameters

- » Asset Cost
- » Up-Front Fees
- » Equity Amount and Rate¹
- » Debt Amount, Rate and Payment Terms²

Rates used in discounting cash flows

- » Weighted Average Cost of Capital³
- » Debt Rate

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.*



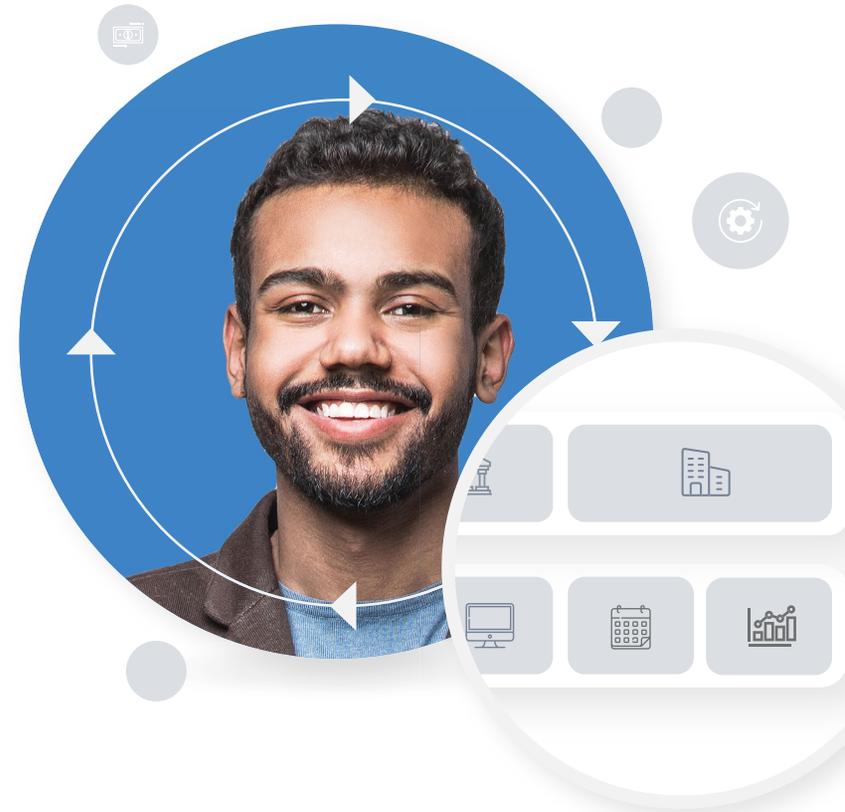
Breakeven analysis

In order to facilitate management's ultimate financing decision, an effective Lease vs. 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 vs. 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 a wide range of asset types, industry segments and funding sources gives us a level of expertise that typically exceeds most organization's in-house treasury resources. We typically base our analysis of market levels on a combination of recent comparables, our ongoing dialogue with lessors and specific pricing indications we solicit.





LeaseAccelerator provides a global Lease Lifecycle Automation platform that improves free cash flow and ensures long-term compliance across equipment and real estate assets. Thousands of users rely on our Software-as-a-Service (SaaS) platform to manage and automate 700,000 leases valued at \$200 billion across 5 million assets in 172 countries.

The LeaseAccelerator platform includes integrated asset-level accounting, reporting, governance and stakeholder performance management, along with a competitive leasing marketplace fueled by a unique global network of more than 500 lessors. Using our strategic financial platform, customers gain business insights about decentralized assets and stakeholders from centrally managed, rich lease data. On average, customers save 7% on lease financing in our lease marketplace and 10% on lease costs through better end-of-term management. Customers can leverage expert training or choose to outsource the leasing process using one of our trusted managed service providers.

www.leaseaccelerator.com