

LEASING: COMPETITIVE ADVANTAGE OR COSTLY ALTERNATIVE?

Use Versus Ownership

In the early 1990's 32% of new equipment acquisitions in the United States were provided through leasing. Does American business recognize an inherent competitive advantage in leasing or is this situation simply a matter of U.S. companies being strapped for the cash necessary to make acquisitions?

Generally speaking there are four ways that a company can obtain funds to acquire an asset: borrowing, retaining earnings, selling new equity, or leasing. In many cases rapidly growing companies do not have the cash for down payments on conventional loans. Shareholders may balk at retaining sufficient earnings, or the rate of growth may be outstripping the company's ability to ration adequate earnings either for purchases or conventional financing. Selling new equity may be either difficult or the dilution of equity may be unsatisfactory to existing owners. In many cases leasing is the only attractive alternative to provide the new equipment necessary to sustain growth. Most companies recognize that it is not ownership, but utilization, that determines the value of new equipment.

Advantages

Many of the advantages of leasing apply to special situations, such as equipment that requires technical maintenance unavailable from the lessee, but provided by the lessor; or equipment that is needed for a short time. In the latter case leasing relieves the lessee from finding a market for the used equipment.

Certain advantages, however, apply to most situations. The most common is the Conservation of Cash. Most leases do not require a down payment, whereas most loans require 20% to 30%. Corollaries include the fact that leases are Off Balance Sheet Financing and can provide Longer Payment Terms than loans. Typically bank loans are for terms of three to five years, while leases may be for five to twenty years. It should be noted, however, that most lease terms are limited to 80% of the useful life of the equipment.

Leases can be negotiated to provide Convenient Payment Schedules coinciding with a company's earnings or seasonal activity cycles. Leasing may also Extend Credit Lines by preventing a company from exceeding restrictive loan agreements that prohibit additional debts or obligations. In addition leasing companies tend to impose Less Stringent Financial Conditions than banks, because they continue to own the equipment and are familiar with the market for it. Banks are not in the business of reselling repossessed used equipment and are therefore, less willing to accept risks associated with the equipment as collateral.

There are potential Tax Benefits to leasing. The full cost of the lease can be expensed. A company with a 35% tax bracket would experience an actual after-tax outlay per month of \$162.50 on a \$250 per month lease. The advantages of depreciation over the long run could be greater, but the lessee might enjoy greater short term advantages in the early years. This advantage would be particularly true of a company that had already exhausted the benefits of rapid depreciation.

Perhaps one of the most overlooked advantages to leasing is the fact that many leases provide some Protection Against Obsolescence. Technologically complex equipment often must be replaced frequently. The risk of obsolescence remains with the lessor, not the lessee, if the term of the lease is reasonable. Also many lessors are willing to periodically replace older leased equipment with more technologically advanced equipment.

Disadvantages

The other possible disadvantages are all related to the specific Terms of the Lease. The lessor may place all sorts of restrictions on the lessee, such as Penalties for Termination, Required Maintenance, No Opportunity to Retain Equipment upon Termination of the Lease, and Unfavorable Purchase Terms at the End of the Lease. Some lease agreements are complicated enough that they require legal assistance to evaluate or negotiate, with a corresponding up-front cost.

A Lessee's Market

While there has been a dramatically increasing demand for lease equipment, there has been a corresponding increase in companies that provide leasing options or who will finance leases. The competition is fierce, and provides the lessee with an opportunity for comparative shopping. As with most purchasing situations, comparative shopping will almost always result in improved terms. The odds are highly favorable that there is a leasing source prepared to meet your requirements.