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Lease Financing Adds Financial Flexibility

Surviving and growing in fast-changing, uncertain markets requires companies to ensure they have a solid strategy as to its optimal capital structure and cash flow strategies to finance operations. Additionally, with the growing demand on technology to improve productivity, there is increased need to upgrade assets subject to rapid obsolescence. Lease financing should be included in a company's strategies to address these needs. In many cases, financing via leasing gives businesses increased flexibility to negotiate terms to (i) better manage cash outflows with expected inflows, (ii) improve the company's capital structure, and (iii) increase overall profitability and return on invested capital. Approximately one-third of all equipment acquisitions are now financed by leases. In addition, nearly 80% of all companies lease to some extent.

There are two basic forms of leasing. An **operating lease** arrangement typically results in established payment terms over the life of the lease with the asset returning back to the lessor-owner after the lease term. An operating lease provides the business owner with tax deductions for the entire lease payment. No asset or debt is recorded on the company's balance sheet for this arrangement. As such, a company can gain more flexibility in maintaining its ability to obtain increased debt financing for working capital or other long-term assets. The expected lease commitment and annual payments are generally required to be disclosed in the footnotes to the audited statements. Banks and other lenders may require these lease payments to be included in ratios of fixed charges to determine a company's further borrowing capabilities.

The other basic form of leasing is a **capital lease**. Capital leases are in its simplest terms another means to finance an acquisition of an asset. Lease terms for capital leases generally included (i) lease payments over the majority of the estimated useful life of the asset, (ii) bargain or fair market value buy-out clauses at the end of the lease term, (iii) the asset ownership transfers to the lessee at the end of the lease term. For financial reporting purposes, capital leases are treated as if the company acquired the asset with debt.

Sources of lease financing include institutional leasing companies, banks, and the financing divisions of equipment manufacturers. Benefits of lease financing include:

- **Low Cost -** The most obvious benefit is **low cost**. A "true" lease can offer low cost financing because the lessor takes advantage of tax benefits that are passed to the lessee in the form of reduced payments. If the lessee cannot currently use tax depreciation to offset taxable income due to current operating losses, loss carry-forwards or alternative minimum tax, depreciation benefits may be lost forever if the lessee purchases rather than leases.

- **On or Off-Balance Sheet -** A lease can be structured to qualify as an **operating lease** under FASB 13 for financial reporting purposes. The choice depends on the accounting objective of the lessee and other cost trade-offs that the lessee is willing to make to achieve such an objective.

Improved Return on Assets - Many companies place a heavy emphasis on **ROA** and **ROE** for evaluating profitability and performance. Operating leases

- often have a positive effect on ROA and ROE. In many cases, this is also true for companies that rate performance on the basis of EVA/SVA.

- **Industrial Revenue Bond Limits -** When the costs of plant and equipment to be financed by **industrial revenue bonds** are expected to exceed statutory limits, equipment can often be financed through a lease to keep the project within the bond's capital expenditure limits.

- **100% Financing -** Leasing provides **100% financing** (which may include reasonable shipping and installation charges), while a typical equipment loan requires an initial down payment. The lease can finance most costs incurred in acquiring equipment. These costs include delivery charges, interest charges on advance payments, sales or use taxes and installation costs. Such costs are not usually financed under alternative methods of equipment financing.

- **Obsolescence -** A lease can be used to obtain equipment while shifting the risk of **obsolescence** to the lessor.

- **Budget Limitations -** Acquisition of equipment not contemplated by a **capital expenditure budget** can sometimes be accomplished through use of an operating lease, with lease payments being classified as operating expenses.

- **Longer Terms -** Leases can offer **longer terms** than conventional loans because lease terms up to 80% of the useful life of the equipment are permitted.

- **Convenience -** Leasing is often more **convenient** than alternate means of financing. With a master lease in place, documentation is usually simpler and more flexible than other sources of capital, such as debt and equity.

- **Fixed Rate Lease Payments -** By leasing major pieces of equipment, a lessee knows the exact amount of future payments and avoids the risk of fluctuations in the cost of funds. A **predetermined rent payment schedule**, which can include seasonal payment terms, permits a lessee to more accurately predict its future expenses and cash needs.

- **Improved Cash Flow -** Lease payments may provide the lessee with improved **cash flow** compared to loan payments. Furthermore, the overall cash flow on a present value basis is often more attractive in a lease.

- **Loan Covenants -** Depending upon the language and intent of **covenants** in existing loan agreements, a lease may provide financing not otherwise permitted. Generally, leases do not contain financial covenants.

If you need assistance analyzing the potential benefits to your company of lease financing, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail dhillier@harvestcfo.com. Also, please visit our website at www.harvestcfo.com.

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