

buy or lease?

Here are five things to consider
before your company makes its next
equipment investment.

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Is your company's current overriding goal to make its balance sheet look better, polish its income statement, or improve its tax situation? These issues will influence its next equipment investment: whether to buy outright with cash, buy through debt financing, or lease. To help you with your decision, let's examine some advantages and disadvantages of equipment ownership vs. equipment leasing and look at current trends and recent developments in accounting, taxation, and asset management.

For more than two years, investment in new equipment has been weak in the U.S. because businesses of all sizes have deferred upgrading in favor of "making do"

with existing infrastructure. Similarly, U.S. businesses have curtailed expansion plans, seeking instead to preserve profitability or protect their financial position in the face of weak demand for products and services.

There are signs of change. The National Bureau of Economic Research recently noted that Gross Domestic Product had generally been expanding since the fourth quarter of 2001. *The Wall Street Journal* commented, "The U.S. economy continues to experience growth in income and output, but employment continues to decline....The main reason for the more favorable performance of income and production...is the continuation of rapid productivity

growth.” The *Journal* attributes this to “squeezing more out of their existing workers and equipment.”

This has the obvious effect of additional wear and tear on existing equipment, hastening its ultimate demise. When combined with the effort to postpone new equipment purchases, it makes it highly likely that the U.S. economy is in a condition of pent-up demand for equipment for both replacement and expansion needs.

The renewed increase in equipment investment has favorable ramifications for an economic recovery. But how will American businesses pay for the needed gear? In an outright purchase—using cash on hand or borrowing—the business will have all of the rights and privileges of ownership. But there are advantages and disadvantages to owning equipment compared to leasing it.

CONSIDERATION 1: THE BALANCE SHEET

When a company buys equipment with cash, the asset side of the balance sheet exhibits a reduction in cash and an increase in “property, plant and equipment.” The money disappears from the balance sheet contemporaneously with the purchase. A purchase in which debt is incurred to buy the item of equipment leaves some of that cash on the balance sheet, but the debt balance, of course, is recorded as an increase in liabilities. In either example, there may be adverse consequences resulting from diminished liquidity ratios or increased leveraged ratios.

But if a company leases the same piece of equipment and the lease passes all the required “GAAP” tests, the equipment acquisition isn’t reflected on the balance sheet.

Under generally accepted accounting principles (GAAP), Statement of Financial Accounting Standards (SFAS) No. 13, “Accounting for Leases,” addresses a number of underlying issues covering a wide range of facts and circumstances. Although it was issued in 1976 and later modified, the core concept of SFAS No. 13 survives and can be stated simply: If an equipment lease genuinely leaves “substantially all of the benefits and risks incident to ownership of property” with a third-party leasing company, the equipment lease transaction should qualify to be off balance sheet.

There are several empirical tests that will have to be applied to ensure compliance with the off-balance-sheet rules. The first and foremost test asks: Is the present value of the minimum contractual lease payment less than 90% of the equipment cost? In other words, let’s assume that a business has only committed to pay \$1,000 per year for four years and that the item of equipment being leased costs \$5,000. Because the present value of the pay-

ments is less than 90% of \$5,000, the leasing company still has significant risk—when the lease expires, \$1,000 of investment is unrecovered. Hence, the transaction isn’t an installment sale to the user nor is it a lending scheme. The leasing company hasn’t passed on the “benefits and risks incident to ownership” because it must find a way to recover its “naked” 10% investment (20% in this case—\$1,000) later in the life of the equipment plus whatever additional amounts it can to make it a profitable transaction.

In another example, say a piece of equipment costs \$5 million. In a lease for a term of four years with monthly payments at the end of each month, the lessee is making 48 payments of \$83,333.33 per month. The present value of these payments is calculated using an interest rate that reflects the lessee’s cost of capital. So, using 6% interest for the calculation, the present value of the lease payment obligation is approximately \$3,500,000, which is 70% of the equipment cost of \$5 million. If the rent were higher, perhaps \$105,000 or more per month, the present value of the payment obligation would exceed \$4,500,000 (depending on the interest rate used in the calculation). Once the present value of the lease payment obligation approaches 90% of the cost of the equipment, the lease may be deemed to be a purchase and not qualify for off-balance-sheet treatment.

If a lease transaction successfully passes this 90% rule and other GAAP tests, neither the equipment (asset) nor the payment obligation (liability) appears on the corporate balance sheet. For certain companies, then, acquiring equipment through off-balance-sheet lease financing can help with their broader corporate goals of limiting leverage and maximizing cash (inasmuch as cash was not used to buy the equipment).

In today’s tougher credit environments, many companies are operating under restrictive covenants put forth by their lenders or bondholders, and, in many cases, these covenants are expressed in terms of conventional working capital, debt to worth, and cash flow coverage ratios. In other words, a company with \$150 million of debt and \$100 million of equity may be up against its borrowing limit if its lenders have imposed a 1.5:1 debt-to-equity ratio maximum. This company might be unable to buy a \$10 million item of equipment if it doesn’t have cash on hand. Leasing the \$10 million item with off-balance-sheet treatment leaves its leverage ratio at 1.5:1. Consequently, off-balance-sheet leasing may be a very useful tool for those companies needing the additional “legroom” in managing their financial position.

Table 1

Let's assume an item of large industrial equipment has an expected life of 25 years and will be scrapped at the end of its life for 10% of its original cost. It cost \$100 and will be used by a company with \$50 in annual revenue. Under the Tax Code, the corporation is allowed to reduce its income at an accelerated rate for tax purposes (assumed 7-year MACRs in this example), which might put it in the following tax position:

Year	1	2	3	4	5	6	7
Sales	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Various Expenses	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00
Accelerated Depreciation	-14.30	-24.50	-17.50	-12.50	-8.90	-8.90	-4.40
Pretax Income	10.70	0.50	7.50	12.50	16.10	16.10	20.60
Taxes (34% assumed)	3.64	0.17	2.55	4.25	5.47	5.47	7.00
Taxes Paid: First Seven Years	28.55						
PV at 6% of Taxes Paid	21.69						

Furthermore, there would be deductions for interest expense paid if the company acquired the equipment with a 100% loan at a 6% interest rate. We assume five-year debt amortization and show the interest expense that results:

Year	1	2	3	4	5	6	7
Sales	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Various Expenses	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00
Accelerated Depreciation	-14.30	-24.50	-17.50	-12.50	-8.90	-8.90	-4.40
Interest Expense	-5.52	-4.43	-3.27	-2.04	-0.74		
Pretax Income	5.18	-3.93	4.23	10.46	15.36	16.10	20.60
Taxes (34% assumed)	1.76	-1.33	1.44	3.55	5.22	5.47	7.00
Taxes Paid: First Seven Years	23.11						
PV at 6% of Taxes Paid	16.91						

CONSIDERATION 2: THE INCOME STATEMENT

A company's income statement is also affected as a result of leasing vs. outright purchase. Cash-rich buyers will, in all likelihood, want to buy equipment in order to avoid rental expense and/or interest expense. In a cash purchase, the income statement will reflect depreciation expense but won't have any rental expense item (attributable to a lease) or any interest expense item (attributable to borrowing to purchase).

In comparison, borrowing money to buy equipment will result in higher total expenses because the company will incur depreciation expense and interest expense associated with the debt-financed purchase. This will likely reduce pre-tax income. In general, a lease transaction will result in a new expense item—rental expense—that will be less than the combined interest and depreciation expense resulting from a leveraged purchase. As a consequence, it's quite likely that in the early years of equip-

ment use/ownership, the income statement will benefit from leasing as opposed to borrowing.

CONSIDERATION 3: TAX ISSUES

Under many circumstances, accelerated depreciation can significantly benefit companies that want to reduce taxes. But for some companies the impact can be of little value. Understanding the variables will help ensure that your business assesses the true economic opportunity and costs of leasing.

For many years, domestic fiscal policy has generously rewarded investments in equipment slated to be located within the U.S. because of the potential to improve domestic economic output resulting from high levels of domestic capital investment. This view, shared by most economists, recognizes the "multiplier effect" from an equipment purchase, which puts dollars in the pockets of equipment manufacturers, suppliers, and their employ-

Table 2

Using the economics from the example in Table 1, assuming the scenario of leveraged ownership of the equipment, the company has paid \$23 in taxes over seven years. Had it leased the equipment at a rental rate of, say, \$12 per year, or \$84 over all seven years, it would have instead deducted the \$84 as rental expense and paid approximately \$31 in taxes as follows:

LEASE IN SCENARIO

Year	1	2	3	4	5	6	7
Sales	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Various Expenses	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00	-25.00
Rental Expense	-12.00	-12.00	-12.00	-12.00	-12.00	-12.00	-12.00
Pretax Income	13.00	13.00	13.00	13.00	13.00	13.00	13.00
Taxes (34% assumed)	4.42	4.42	4.42	4.42	4.42	4.42	4.42
Taxes Paid: First Seven Years	30.94						
PV at 6% of Taxes Paid	24.67						

Therefore, the tax savings from ownership slightly favor buying over leasing, all the more so if the savings are viewed on a present value basis and leverage is used to buy the equipment. Whether this example holds up in the real world will depend on the precise economics of the lease and the company's tax position. A more sophisticated analysis considers the other variables as well as the opportunity cost (how the company might have benefited from keeping the \$10 of equipment investment and using the cash to grow the business).

ees, and the dollars are then employed again at (for example) the local grocery store, etc. Hence, “accelerated depreciation” policy incentivizes capital spending by allowing equipment investors to enjoy considerable cost savings from the actual expenditure. Taxes, which would have been paid in the years of and after the purchase, are postponed with Uncle Sam’s blessing. See Table 1 for an example.

At least two types of companies, however, don’t benefit from accelerated depreciation: companies in capital-intensive industries that may be subject to the Alternative Minimum Tax (which limits depreciation benefits) and companies in the red that don’t need the tax reduction. In the latter case, companies that have zero taxable income have no economic reason to further reduce their taxes because they were already \$0. In either case, these “valuable” accelerated depreciation benefits can’t be applied to effectively reduce the cost of equipment to these companies. See Table 2 for an example.

President Bush’s tax bill provides additional tax incentives for equipment acquisition, which may increase the tax benefits for a company buying equipment. Through the end of 2004 and primarily for property to be delivered before the end of 2005, equipment buyers can claim a 30%-50% bonus during the first year of depreciation, deferring the applicable taxes. At this writing, it’s unclear to what extent these fiscal initiatives will encourage capital expenditures. It is clear, though, that the generous tax

deferral available for the upcoming year should be considered in a lease vs. purchase decision.

CONSIDERATION 4: FLEET FLEXIBILITY

Under most circumstances, a business seeking to acquire *mission critical* equipment with *certainty* about its permanent usefulness to the business will be better off owning rather than leasing equipment. Examples of such mission critical equipment include critical components of an assembly line or production facility, equipment necessary for power generation, oil rigs for petroleum companies, aircraft for airline companies, and other items generally inseparable from business operations. If the company is acquiring equipment that is vital to its operations, it might leave itself vulnerable if the “costs and *benefits* incident to ownership” were in the hands of a third party, outside of its control, as follows:

When a lease expires, the user/lessee usually has several stated options under the lease. Typically, equipment can be returned (which may not be practical for mission critical equipment) or purchased for its fair market value. “Fair market value” is a defined term in leases that utilize this concept and varies widely as to its precise definition. For critically important equipment, which has a high replacement cost, some leases define “fair market value” in a way that makes it very dear for the company to acquire the equipment. If an item of machinery cost \$10 million when new—and the replacement machinery

is being sold for, say, \$13 million brand new—an argument could be made that fair market value is \$10-\$12 million for the old equipment.

Normally, a user could elect to return the equipment if the fair market value seemed too high...but in a scenario where the company has no real option other than to buy the in-place asset because it's difficult or time consuming to replace it...the result can often be expensive. Leasing of business-critical components may have seemed like a good idea several years ago, and undoubtedly achieved numerous objectives at the time, but proved to be expensive in hindsight.

But the majority of business equipment leasing deals don't involve business-critical equipment. Most nonessential gear, such as office equipment, can be an appropriate candidate for leasing. Other asset categories like trucks and forklifts are easily replaced by other units. We use the term "fleet flexibility" to describe the general benefit to a business of leasing equipment of "temporary utility" that can be returned easily. "Temporary" utility may mean two to 10 years in capital-intensive industries where equipment might have 12-50 years of useful life.

By not committing to pay for the equipment in full, a business retains the ability to more easily shed surplus equipment that it may not need because the business grew, shrank, or changed its plans. New technologies encourage businesses to shed obsolete equipment, and this can be achieved more easily on leased equipment because the "risk" of obsolescence is borne by the leasing company. For those companies unable or unwilling to make long-term plans for equipment in the face of rapid change, the lease alternative may be particularly suitable.

CONSIDERATION 5: THE "TRUE CASH COST" OF LEASING VS. OWNING

What makes economic sense? All other things being equal, in a perfect world the most cost-effective option for many businesses is to buy equipment with cash unless they have compelling investment opportunities for that cash. But since many businesses are operating in a world where cash is a constraint on their growth, the more frequently faced decision is often between borrowing and leasing.

In their well-regarded reference book, *Equipment Leasing*, Peter Nevitt and Frank Fabozzi stated, "Financial economists have demonstrated that if it were not for the different tax treatment for owning and leasing an asset, the costs would be identical in an efficient capital market."

Though this makes sense when applied at a macro lev-

el, the specific terms and conditions of a lease, as well as the future market for the equipment, must be quantified to the greatest extent possible and compared to the company's borrowing costs. Common sense dictates that, if a business is paying for less than 90% of the equipment value, the periodic cash payments will often be lower than if the equipment were paid for in full by means of a loan. But the lower periodic payments are only part of the economic cost comparison.

In a typical lease, the user will have the option when the lease expires to return the equipment or purchase it, and they frequently can opt to renew. If the equipment has retained value, a company may have lost a resale profit opportunity on resale because it leased (and doesn't own) an item of equipment. Conversely, equipment may prove to have disappointing value, which is a risk borne by the leasing company. After all, it's the leasing company that will take the loss on such a sale, not your company. As an example, airlines leasing commercial aircraft prior to September 11, 2001, benefited by avoiding the brunt of a sharp decline in equipment values since that date, and many leasing companies suffered severe losses.

IT'S YOUR CHOICE

For decades, the lease vs. purchase decision has been among the most complex analyses in modern finance. The net effect of balance sheet and income statement management, tax results, "fleet flexibility," and cash cost considerations is difficult to assess. Yet recent accounting and tax law interpretations highlight some near-term opportunities for companies deciding how to acquire equipment.

Companies today consider all of the above factors and methods when assessing equipment expenditures. For large companies, most often the decision to lease or buy is driven by balance sheet considerations, not only by cash on hand. Those that are also public companies are sensitive to heavy emphasis on reported profitability, which affects stock prices and perceptions. For private companies, tax considerations, fleet flexibility, and the true "cash cost" often carry stronger weight than earnings management. ■

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