LEASE FINANCING

Types of Leases

- Operating Leases
- Financial Leases or Capital Leases
- Sale-and-Leaseback Arrangements
- Combination Leases
- Synthetic Leases
Operating Leases

- Payments include maintenance and service
- Not fully amortized
- Often contain cancellation clause

Financial Leases or Capital Leases

- Does not include maintenance or service (or insurance)
- Fully amortized
- Not cancellable
Sale-and-Leaseback Arrangements

- Lessee sells asset to lessor and simultaneously executes lease agreement.
- Lessee gets sale price today and continues to use asset.
- Similar to a mortgage (and financial lease); lease payments calculated like mortgage payments.

Combination Leases

- Contain provisions of more than one of the other types.
Synthetic Leases

- Firm wants to acquire long-term asset with debt sets up a Special Purpose Entity (SPE)
- SPE obtains financing: 97% debt and 3% equity from party other than the company
- SPE purchases asset and leases to company on short-term basis with expectation to renew

- When lease eventually expires, firm (not SPE) required to:
  1. Pay off loan
  2. Refinance loan
  3. Sell asset and pay off loan
- Company guarantees loan, but debt not on balance sheet
Tax Effects

- Lease payments are tax-deductible expenses IF *guideline* or *tax-oriented* lease contract:
  - Term less than 80% of *useful life*
  - Residual value > 20% of value at start of lease
  - Cannot agree to buy asset at fixed value
  - Lessee cannot make any investment in equipment
  - Leased asset must be for general use

Financial Statement Effects

- Off-balance sheet financing
- Leases must be capitalized if they do one or more of the following:
  - Effectively transfer ownership to lessee
  - Allow lessee to purchase property at less than true market value at end of lease
  - Lease is ≥ 75% of asset’s life
  - Present value of lease payments ≥ 90% of initial value of asset
Lease vs. Buy Decisions

- First, decide whether to purchase asset
  - Follow capital budgeting criteria
  - Not a lease vs. buy decision

- Leasing is a substitute for debt
  - Lease vs. buy = lease vs. borrow
  - Discount rate = after-tax cost of debt

Lease vs. Buy Decisions

- Net Advantage to Leasing (NAL)
Example (pages 775-777)

Anderson Company is conducting a lease analysis on some assembly line equipment that it will procure during the coming year. Anderson plans to acquire automated assembly line equipment with a 10-year life at a cost of $10 million, delivered and installed. However, Anderson plans to use the equipment for only 5 years, and then discontinue the product line. Anderson can borrow the required $10 million at a before-tax cost of 10 percent.

The equipment's estimated scrap value is $50,000 after 10 years of use, but its estimated salvage value after only 5 years of use is $2,000,000. Thus, if Anderson buys the equipment, it would expect to receive $2,000,000 before taxes when the equipment is sold in 5 years.

Anderson can lease the equipment for 5 years for an annual rental charge of $2,600,000, payable at the beginning of each year, but the lessor will own the equipment upon the expiration of the lease. The lease contract stipulates that the lessor will maintain the equipment at no additional charge to Anderson. However, if Anderson borrows and buys, it will have to bear the cost of maintenance, which will be done by the equipment manufacturer at a fixed contract rate of $500,000 per year, payable at the beginning of each year.

The equipment falls in the MACRS 5-year class life, Anderson’s marginal tax rate is 35 percent, and the lease qualifies as a guideline lease. Should the firm lease or buy?
When is Leasing Beneficial?

- Tax differentials between lessor and lessee
- Differences in estimated residual value between lessor and lessee
- May increase availability of credit for some firms
- Potentially easier to outsource maintenance and salvage
- May provide operating flexibility
- May reduce risk of obsolescence
Chapter 19
Suggested Problems

- Questions:
  - 19-2, 19-3, 19-6, and 19-8

- Problems:
  - 19-1, 19-2, and 19-4