LEASE FINANCING
Unit 2
Merchant Banking and Financial Services

Meaning of Leasing

- . From an economic perspective, lease is a contract between two parties where one party (the lessor) provides an asset for usage to another party (the lessee) for a specified period of time, in return for specified payments
- This is also reflected in accounting-related definitions: According to the Accounting Standard IAS 17 “a lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time” (European Commission, 2012).

How leasing works

- Lease finance or lease financing means contract between owner of asset and user of asset. In this contract only rent is paid at periodical intervals for using of asset by user.
- If user of asset has no money to pay initial amount of leasing contract, he can also do contract with third part to pay initial amount or specific period rent of lease. It will be also lease finance. In following words, we can explain its importance

What can be leased?

Almost any type of physical asset can be leased as can certain intangible assets.

Examples of leased assets include: plant and manufacturing equipment, IT equipment and software, printers, photocopiers and telecommunication equipment, construction and logistics equipment, vehicles and other means of transport, medical equipment, renewable energy equipment, infrastructure, utilities and property, to name but a fe

Types of leasing

The most common types of leases are operating leases and finance leases.

Operating Lease

- An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset.

- The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period.

- Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

Financial Lease

It is used as the most popular financing tools in the latest business world, Financial Leasing Service uses finance leases to leverage assets. A Finance Lease is a lease that is mainly a method of getting finance to pay for assets.

- It is a commercial arrangement where:
- The lessee (customer or borrower) will select an asset (equipment, vehicle, software);
- The lessor (finance company) will purchase that asset;
- The lessee will have use of that asset during the lease;
- The lessee will pay a series of rentals or installments for the use of that asset;
- The lessor will recover a large part or all of the cost of the asset plus earn interest from the rentals paid by the lessee;
- The lessee has the option to acquire ownership of the asset (e.g. paying the last rental, or bargain option purchase price);
- The finance company is the legal owner of the asset during duration of the lease.

Sale And Lease Back

- It is a sub-part of finance lease. Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals.

- However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction.

- Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land.

- The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement.

- The sale and lease back transaction can be expressed with the help of the following figure.

Leveraged Leasing

- Under leveraged leasing arrangement, a third party is involved beside lessor and lessee.
- The lessor borrows a part of the purchase cost of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan.

- The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor.
- The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

Direct Leasing

- Under direct leasing, a firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer itself.

- The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc

Advantages of leasing

There are several extolled advantages of acquiring capital assets on lease:

Saving Of Capital: Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes e.g. purchase of inventories.

Flexibility And Convenience: The lease agreement can be tailor- made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

Planning Cash Flows: Leasing enables the lessee to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

Improvement In Liquidity: Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

Disadvantages of leasing

The disadvantages of leasing your equipment and other business assets include the following:

Overall cost. The biggest disadvantage of leasing is that the costs over the life of the asset are generally going to be higher than if you purchased the asset.

No ownership interest. Your lease payments generally do not establish any equity in your leased equipment. In other words, at the end of the lease you won't have a tangible asset to show for your payments.

Lost tax benefits. Assuming that the IRS doesn't recharacterize your lease as a purchase for tax purposes, a potential disadvantage of leasing is losing the tax benefits of depreciation deductions that come with ownership.

Commitment to property. Once you sign a lease agreement, you're generally committed to making payments for the entire lease period even if you stop using the property. Most equipment leases are either non-cancelable or impose a stiff penalty for early termination.

Why firms take leasing into account

1. Lease finance is easy to get than getting loan for buying all fixed assets.

2. Monthly rent payment for lease finance will be operating expenses. It will be allowed to deduct total income. So, company can get tax benefits in lease financing.

3. It can show as invisible debt of company out of its balance sheet. You can show lease finance in the footnote of balance sheet, if you did contract directly with the owner of asset.

4. One of major important point is that it is more flexible way of finance. You can fix your need of asset and get it one lease through lease financing.

Financial Evaluation of Lease

Once a firm has evaluated the economic viability of an asset as an investment and accepted/selected the proposal, it has to consider alternate methods of financing the investment

The firm can either buy the asset or lease it .The evaluation is done for the purpose of deciding which of the two is a better option i.e. whether to buy or lease (Cheaper option).

The after tax cash outflows become the base for making a decision.

Taxation plays a very important part in making such an evaluation

The evaluation of lease financing decisions from the point of view of the lessee involves the following steps:

i) Calculate the present value of net-cash flow of the buying option, called NPV (B).

(ii) Calculate the present value of net cash flow of the leasing option, called NPV (L)

(iii) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following criterion:

(a) If NPV (B) is positive and greater than the NPV (L), purchase the asset.

b) If NPV (L) is positive and greater than the NPV (B), lease the asset.

(c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether.

Since many financial analysts argue that the lease financing decisions arise only after the firm has made an accept-reject decision about the investment; it is only the comparison of cost of leasing and borrowing options.