

FINANCING HIGH TECH EQUIPMENT - THE LEASE OR THE BANK?

Excerpted from remarks at the Digital Image Marketing Association Seminars at New Orleans, Louisiana in February, 1997 by Kenneth D. Goodman, CLP

Good morning.

The purpose of this discussion is to help you assess your financial choices in acquiring the wonderful new machines that are available today. We will talk a little bit about how banks operate and a little bit about how leasing companies operate and I will try to point out some of the pitfalls in working with each.

To begin with I'd like to share one of the main things I've learned in over a quarter of a century of financing all kinds of capital equipment, and that is that banks don't really want to finance equipment. Here's why:

Let's say you're a banker and you have the following two choices, which one do you take?:

- (A) Finance a bunch of high tech equipment that you know nothing about for individual small and medium size companies in high risk industries, document each transaction separately and be totally at risk; or
- (B) Go to a company that specializes in this type of thing, such as a leasing company, and buy the same paper \$5 million at a time, letting them do the documentation and billing, and keeping them on the hook on a recourse basis until you are paid off.

Anybody pick (A)?

This is why when you go to your bank to finance the latest new toy that you would like to have, they will try to do everything other than make an equipment loan.

"We'll just add it to your line of credit," they say.

Or "Why not just take it out of operating funds?"

"We'll give you an inventory loan to cover it, or an accounts receivable loan."

And if perchance they do agree to do an equipment loan, it is usually under onerous conditions (more about this later).

In short, they just don't want to be in the equipment finance business.

Now, I want you to know that I appreciate banks' reticence about equipment finance because we in the leasing business wouldn't be as successful as we are if the banks were more aggressive in the way they go about financing equipment.

Ownership Versus Use

The second point that I would like to make is that there is a difference between **ownership** of equipment and **use** of equipment from the standpoint of what makes profit.

The only time that **ownership** of an asset makes profit is when that asset is going to appreciate in value: real estate, for instance, (except in Southern California recently) or patent rights; precious metals or collectibles. If it is an appreciating asset, it makes sense to consider owning it. If it is not an appreciating asset, then the only real question should be, "What is the most effective way for me to gain **use** of that asset and pay for that use for the time that I am going to need it?"

As anyone who will walk out on the floor of a trade show in the days to come will readily attest, everything they saw three years ago is a "boat anchor" today. New technology has obsoleted everything that was "new technology" the last time we had this conversation. And that is going to continue to happen.

So the critical consideration becomes to figure out the best way to get the use of this new technology for as long as it is viable. Ownership is a purely secondary consideration. Making this possible is exactly what leasing companies do.

What Is A Lease?

Now, the term "lease" is one of the most misused terms that I know of, largely because there are at least five or six different definitions of a "lease" and most people use them incorrectly.

There is one set of rules that makes a lease a lease for accounting purposes; another set of rules that makes a lease a lease for tax purposes; and still another set that the courts go by.

Furthermore, the words "lease" and "rental" are often interchanged so that "rental" is used on long term finance agreements where "lease" is appropriate and vice versa.

A good example of a "rental" is getting a car from Hertz or Avis for the weekend. You have no equity. You have no ownership. You don't expect any. You're using the equipment for a finite period of time and paying for it. You will return it at the end of the rental period.

Conversely, there is the "finance lease" or "lease to own" or "long term lease/finance" contract. Whatever you want to call it, that is basically a vehicle for you to "buy" or acquire the use of the equipment for an extended period of time and be able to own it at the end of that time if you choose to do so.

Generally speaking, most of the lease contracts that you will have offered to you for high tech, high volatility equipment will be of the finance lease variety.

Accounting Treatment

In order for a lease to be a lease for accounting purposes, the leasing company cannot finance more than 90% of the cost in the initial contract. Now I can give you the wording of Financial Accounting Standards Board Regulation 13, which talks about things like the lower of the implicit rate or the lessee's incremental borrowing rate and all that kind of stuff, but the bottom line is that if the leasing company finances 100% of the cost, they are not going to be able to get all of the benefits that they would ordinarily get, and you would not be able to get all of the benefits that you would ordinarily get.....from an accounting perspective.

Most leasing companies do not want the risk of a 20% or 30% residual position (needing to get that amount for the equipment on resale to break even) in equipment that is going to obsolete rapidly, which is what they would have to do to qualify under these conditions. Therefore, the chances of getting a

lease that is a lease for accounting purposes on high obsolescence, high volatility equipment is relatively small, unless it is for a very short term such as one or two years.

Tax Purposes

It is, however, possible to get a lease that is a lease for tax purposes and that is far more important to most of us.

A tax lease is one where you can expense the payments directly as an operating expense on your tax returns, rather than having to capitalize and depreciate that equipment over a longer period of time. There are basically four tests of whether a lease so qualifies:

- 1) Title cannot pass as a result of the transaction;
- 2) There cannot be a bargain purchase option;
- 3) There cannot be a bargain renewal option; and
- 4) The length of the lease cannot exceed 75% of the equipment's useful life.

Now, if any leasing salesperson, or equipment salesperson, tells you that they can give you a five year lease and then sell you the equipment for one dollar, or 1% of its original cost, at the end of that lease and that that will be treated as a lease by the IRS, do not believe them. That is **not** a lease. They **will** find you and audit you and hit you with penalties. However, if the four tests listed above are met then you will be able to expense the entire lease payment for tax purposes, and that gives you the opportunity to write off your investment in your high volatility equipment much faster than you could if you owned it.

Rates

One of the first questions that I get when someone comes up to my booth at a trade show is invariably "What are your rates?" Frankly, I'm never sure how to answer that question because there are probably thirty answers to it, thirty different ways to compute "rates" or "interest."

However, the most important thing that I try to stress, and I know that this sounds downright blasphemous to many of you, is that rate, the cost per thousand dollars of equipment per month or the implicit "interest rate" that is being factored into the transaction, is **the least** important consideration in the transaction, and I want to prove that point to you now. To do that, we will compare two different approaches.

Terms and Conditions

On the one hand, let us say that I offer you a lease contract at the "ridiculously high" interest rate of 12% or so. It finances 100% of the equipment cost. In fact, it finances 110% of the equipment cost because it picks up delivery, installation, training and maybe some initial supplies. The leasing company requires you to pay the first month's rental payment in advance. They file only against that specific equipment with the Secretary of State and don't bother you for the next five years as long as you make your payments. At the end of that five year period, they sell you the equipment for its then

current fair market value (which is minimal); and you will have expensed your lease payments completely for tax purposes.

On the other hand, you are offered a bank loan. It is at “only” 8 1/2% interest. You are required to keep a 30% compensating balance in a non-interest bearing account (so the bank is really lending you 70% of their money and 30% of your money). By the way, if you compute the real yield on that, it is over 21% (because you’re paying interest on \$100 but only getting \$70).

So you have this “low” rate. But you keep part of it in compensating balances, you have covenants that require you to maintain certain financial ratios, and you are cross-collateralized for your kids’ trust account, your personal account, and everything else that bank can ever lay their hands on if you hiccup and they don’t like it.

There is also probably a clause in the agreement that says that if at any time they feel uncomfortable with the industry that you are in, they can call the loan even if you have made every single payment on time.

There is even probably a clause that says if their cost of money goes up next year that they can change the rate to compensate. In short, if you want to read one of the most one-sided, totally abusive documents in existence, read a bank lending agreement.

My point is, of course, that the pure “rate” or the pure “interest” quoted is **not** the only factor in making a decision of how to finance a particular piece of equipment. You have to look a lot deeper.

Flexibility

As an example of some of the deeper factors, let’s consider seasonality. Most leasing companies will vary lease payments to match your cash flow curves. If you are located in a ski lodge community, you don’t want high payments in the summer. Good lessors will make the majority of the payments due in the winter under these circumstances. Or vice versa, if you’re in a summer resort area, we will make the majority of the payments due in the summer and require no payments in the winter. In other words, leasing companies will match the payments to the specific need that you have. They will also match the payments to the logical period that you will be using that equipment before it is necessary to upgrade; and will usually allow you to upgrade without penalty as well.

In fact, there are a number of these features available in a lease, loan or finance contract that dramatically affect your net cost. So I urge you when considering any type of financing, be it a lease, or a bank loan or a loan disguised as a lease from either, to listen carefully to what they are telling you; to make sure those commitments make it to the final documentation; and to not be afraid to consult your professional advisors and make sure they understand what is being agreed as well.

Now let’s review some of the elements that differentiate bank lending agreements from leasing agreements.

Bank Lending Agreements

What to look for in a bank lending agreement:

- 1) Compensating balance requirements;
- 2) Blanket liens and/or cross collateralization;

- 3) "Call any time" provisions;
- 4) Hidden fees (documentation fees, points on the loan);
- 5) Restrictive covenants (are they going to tell you how to run your business?); and
- 6) Length of the term and the size of the down payment (generally speaking, they tend to want shorter terms and larger down payments).

Lease Agreements

Leasing companies do not require most of the items listed above. However, leasing companies have other requirements that can affect your costs. Among these::

- 1) The implicit interest rate as such is usually slightly higher than it is on a bank loan. Part of that is offset by the tax treatment of the two different instruments and part of it is offset by the value of the flexibility considerations you are getting.
- 2) The lease requires advance rental payments such as the first month's rent or the first and last month's rent in advance. I have seen first and last five months' rentals in advance. Every one of those additional payments is tantamount to a down payment. And so the effect is the same as what the banks do with compensating balances and points: they are getting more money up front, reducing their risk and lending you back some of your own money.
Thus, there is a difference between two leases at the same rate where one requires the first month's rent only and the other one requires the first and the last five, or the first and a 10% security deposit or a 10% prepaid purchase option. Each one of these requirements reduces the amount of exposure that the leasing company has and increases their yield. Each of these structures is a tool to create different scenarios to fit the needs of different customers and there are advantages to each of them, but you must be aware of their effect on the actual cost.
- 3) Since a lease is a contract for the use of equipment over a period time without transferring ownership, it does require you to return the equipment to the leasing company at the end of the lease. Also, if you have an option to purchase at lease end, there is a provision that says that you will notify the leasing company a number of days or months in advance that you intend to either exercise it or return the equipment. If you do not do that, the lease usually extends automatically beyond the initial term, sometimes for an entire year, sometimes on a month to month basis. There is a logical reason for this notification requirement and that is if the lessor is getting back a piece of equipment, they need to know that in advance so that they can arrange to re-lease or re-market it. But you should be aware of these notification requirements and meet them.

One Final Word

Be careful about documentation in general. Whether it is a lease, a loan agreement, or any other business document, read and understand it. Be sure it contains everything you agreed on. Whether an omission is due to an accidental clerical error or to someone intentionally trying to defraud you, it can hurt just as much. Be aware of what you are signing.