THE DEFINITIVE GUIDE TO ASSET FINANCE

Asset finance (also known as equipment finance) broadly covers a number of finance products and as its name suggests is used to fund specific pieces of property, plant & equipment. Finance packages are provided by banks, specialist providers and finance brokers.

While asset finance is best used for major capital costs, the decision must be undertaken in the context of helping your business grow and having a clear strategic plan is vital. We need to ask ourselves the following questions:

1. How much do we need to borrow and for how long?
2. What level of risk are we prepared to take?
3. What are the funds for?

While almost any type of asset can be leased, from motor vehicles, IT (hardware & software), industrial machinery to aircraft; the nature of an asset will dictate which type of lease is most appropriate or whether the lease should be short-term or long-term. Broadly speaking, the lease period should match the useful life & the period of revenue generation of the asset.

In this article, we will discuss the different types of leases, the relative strengths & limitations of each type and the varying accounting and tax treatments. We hope that by understanding these fundamental principles, you are able to make the right commercial and financial decision for your business.

Asset finance can support businesses to refinance or grow their production capacity by allowing them to spread the cost of new equipment, as well as outsource the responsibilities of insurance, maintenance and disposal of the assets at the end of their useful life or when new technology makes them uneconomic.

The Finance and Leasing Association (FLA) has estimated that 91% of SMEs who apply for asset finance are successful[1] with £30bn of new asset finance written in 2016[2]. While this was the 6th consecutive year of growth and represented a 5% uplift on the prior year, it remains below the 2008 pre-financial crisis peak and is consistent with a stable outlook which reflects the broader economy.

Terminology

A lease is a **contractual agreement** and the equivalent of an extended rental agreement. The owner of the equipment (**lessor**) allows the user (**lessee**) to operate the equipment in exchange for regular lease payments.

The payments are usually constant, but their timing may be tailored to the user's needs, such as a "shakedown" period before volume production starts for a manufacturer. When a lease is terminated, the leased equipment reverts to the lessor. However, the lease agreement often gives the user the option to purchase the equipment or take out a new lease.

[1] FLA - 2014 Parliamentary Reception Asset Finance Key Facts
[2] FLA - Finance & Leasing Association, Press Release Feb 2017

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Operating leases are short-term, cancellable leases where the lessor bears the risks of ownership. **Financial (capital) leases** are long-term, non-cancellable leases where the lessee bears the risks & rewards. Financial leases are sources of financing for assets that the firm wishes to acquire and use for an extended period.

Full-service leases may be either and include insurance and/or maintenance. If the lessee is responsible for these costs the lease is termed a **net lease**.

The lessor may be either the asset's manufacturer (**sales or vendor lease**) or an independent leasing company or finance provider (**direct lease**). The lessee is often indifferent as to who owns the asset.

If the asset is very costly, it may be convenient to arrange a **leveraged lease**, in which the cost of the leased asset is financed by issuing debt and equity claims against the asset and the future lease payments.

As we will see, the distinction between different types of leases depends upon a number of key factors. This is primarily guided by both the Financial Accounting Standards Board (FASB) & HMRC.

Hire purchase "HP" (lease purchase)

A **hire purchase** is a lease agreement with an option to buy the asset at the end of the agreement. There may be a degree of customisation so payments reflect projected cash flows. Lower regular payments may be offset by paying a larger lump sum up front or at the end of the agreement (balloon payment). This should reflect the expected future value of the asset. From the lessee's perspective if the balloon payment is greater than the value of the asset, the payment is not made.

Agreements are also usually at a fixed rate and accounting and taxation treatment classifies the business as the owner of the asset. So, if a business buys an asset on HP, they can claim the capital allowances - therefore offsetting the expenditure against taxable income.

Operating leases

Operating lease (rental agreements) have a much shorter term, are more likely to be cancellable and do not cover all of the asset's working life. Consequently, payments are not sufficient to recover the full cost of the asset so the lessor retains the risks and rewards of ownership. The asset will not be shown on the lessee's balance sheet.

The value of a cancellation clause also depends on future technology and/or economic conditions, therefore operating leases are often best suited to equipment that becomes obsolete relatively quickly.

The key principle when assessing an operating lease is the **equivalent annual cost**. If you plan to use the asset for an extended period, the cost of owning the asset will usually be less than the lease rate. The lessor has to mark up the lease rate to cover the costs of negotiating and administering the lease and the foregone revenue when the asset is off lease and idle.

Operating leases may also make sense if the lessor is able to buy, manage, service & insure the asset at less expense than the lessee, e.g. aviation, IT or logistics, where equipment may need to be refreshed every year.

Contract hire

Contract hire is a form of operating lease & provides sourcing, finance, management & final disposal of an asset. The most common asset type is a car or commercial vehicle, with the lease also including maintenance and other fleet management services.

Sale and lease-back

Sale and lease-back transactions are most common in real estate and are an effective way of monetising an ownership interest in an asset you already hold. A business can retain use of a key asset & immediately access the funds.

The disadvantage is however significant. As a one-off event, funding from capital sources should not be used to fund operations or be withdrawn from the business unless careful consideration is given. Legal ownership of the factory passes to the lessor, often a financial buyer, but the right to use it remains with the original owner for a limited period.

Leveraged leases

Leveraged leases are financial leases where the lessor borrows a portion of the purchase price of the leased asset, using the lease contract as security for the loan. While this does not change the lessee's obligations, it can complicate the lessor's analysis considerably. Such a structure is not common for SME's.

FINANCIAL LEASES

Financial (capital) leases are defined by the FASB under IFRS 16 as any lease which meets at least one of the following requirements:

1. Title is transferred at the end of the lease
2. The lessee can purchase the asset for significantly less than Fair Value (bargain purchase) at expiry
3. The lease lasts for at least 75% of the asset's estimated economic life
4. The present value of the lease payments is at least 90% of the asset's current fair value
5. The asset is so specialised that only the lessee can use it without significant modifications

All other leases are considered to be operating leases.

From the lessee's standpoint, the cash-flow consequences of leasing and borrowing are similar to purchasing capital equipment with a secured loan (and the impact on liquidity this has). Under a finance lease the lessor will be likely to take a charge on the specific asset whereas a lender may take a charge on the fixed and floating assets of your business.

There is an immediate benefit to doing this, because although the lessee does not have to pay for the asset, they do acquire its use and in return assume a binding obligation to make the payments over the period of the contract. The finance lease payments are said to be amortising as they include both interest and principal payments to the lender.

The lease is carried on balance sheet and cannot be cancelled by the lessee. Tax-ownership of the asset often remains with the lessor if the term of lease is less than 7 years.

Because the choice is often not "lease versus buy" but "lease versus borrow", the opportunity cost of lease financing is the after-tax interest rate on the firm's debt. To value a financial lease, one must use the incremental cash flows from leasing at this rate.

An equivalent loan to the lease is one that commits the firm to exactly the same future cash flows. Consequently, to calculate the net present value of the lease, we must compare the amount of financing provided by the lease and the financing provided by the equivalent loan.

Legal ownership however also differs when a financial lease expires, because the lessor gets the salvage value of the asset. Once a secured loan is paid off, the user owns the asset.

Benefits

Many companies have sound reasons for financing via leases. For example, it may be less costly and time-consuming to sign a standardised lease contract than to negotiate a long-term secured loan or even purchase and manage a **non-core asset** for a short period of time.

Short-term leases are often more **convenient & reduce ownership risk**. While the cost may initially seem high, particularly if equipment is easily damaged or has a very short life, the lease may include **service, maintenance & insurance** with guaranteed SLAs.

Cancellation & disposal options are valuable and mitigate obsolescence risk. Leases that initially appear expensive may be fairly priced once this optionality is recognised.

Updating capital equipment can be expensive and often the more urgent the need, the more challenging the cash flow position. Asset finance gives businesses access to the most efficient equipment that may be "rolled over" every 3-4 years when there is a significant improvement in technology or when maintenance becomes an ongoing issue.

Standardisation also allows lower administrative and transaction costs. If the lessor specialises in certain equipment and the underlying asset is used as collateral, the lessor is safely able to "lend" without conducting a detailed credit analysis of each lessee and by using a standard lease contract. Consequently, leasing may be a relatively cheap source of cash for small companies as it offers financing on a flexible, ad-hoc basis rather than undertaking a new loan or utilising cash on hand or overdraft headroom.

Specialised lessors in a competitive market are also able to pass on economies of scale benefits to lessees as they hold equipment in quantity, service it efficiently and if necessary resell it at a foreseeable price.

Depreciation tax shields can be used. If the operating lessor is able to make better use of the depreciation tax shields (deduct depreciation from taxable income) than the asset's user, it may make sense for the leasing company to own the equipment and pass on some of the tax benefits by way of lower lease payments. From the lessee's perspective, operating lease rental payments and the interest portion of finance lease payment are deductible on the income statement. The annual investment allowance may also be applicable.

Financial benefits - leasing allows businesses to reduce financial uncertainty making budgeting easier (particularly under a full-service lease) & may preclude the need for a deposit. It may also reduce wasted expenditure.

Common misconceptions about leasing

Leasing avoids capital expenditure controls. Many firms who already have existing bank debt, particularly club or syndicated facilities, may have covenants which prohibit them from spending substantial amounts on capex or additional indebtedness. While leasing may enable a borrower to circumvent loan documentation it will certainly be looked on unfavourably and a simple waiver or amendment will be more beneficial in the long run. We would always recommend that any action that may be viewed as subordinating a bank's position should be addressed proactively.

Leasing does not preserve capital. While it is often commented that leasing preserves capital by way of saving liquidity, leasing avoids an up-front payment by requiring the lessor to commit to future payments in the same way as a loan. A saving may only be available if the comparable leasing rate is lower than the firm's cost of capital, which may be the case if the firm is a weak credit.

Leases are not off-balance-sheet ("OBS"). Because operating leases are technically excluded from the balance sheet, conventional unadjusted measures of financial leverage are understated.

OBS obligations are still, however disclosed in the Notes and adjustments are made by analysts accordingly. In an efficient capital market (semi-strong form), lenders & investors will look through the firm's accounting results to the true value of the asset and the liability incurred to finance it.

Leasing **does not provide a new access to funding,** simply an alternative form of debt. While a business does not need to draw on their overdraft or enter into a new loan, a lease will still increase indebtedness. Furthermore, under a finance lease, while you do not own the asset, you are obliged to maintain and insure it. There may also be **restrictive covenants** on how that asset is used.

Leases can provide **funds more quickly & cheaply** than traditional lenders. This is true and essentially reflects the leased asset as collateral. If a business fails to make a lease payment and were the asset to be removed, this is likely to have a far more immediate and direct impact on the business to generate cashflow than having ongoing negotiations with traditional lenders.

Financial impact financial & operating leases

Under IFRS, **Company A** with a finance lessee must record an asset, a liability, interest expense & amortisation in their accounts. **Company B** with an operating lessee need only record rental/lease payments in their Income Statement. Assuming both companies lease exactly the same asset, with the same value for the same period of time, **Company A will report**:

- **Higher interest** (non-operating) expense
- **Higher EBIT** because amortisation is less than lease payments
- **Net income is lower** in the early years because depreciation + interest greater than lease payments
- **Net income is higher** in the later years because this reverses
- **Net income will be the same** over the life of the lease (total depreciation + total interest = total lease payments)
- **Assets and debt** will be higher therefore turnover ratios will be lower
- Cash flow from **operations** will be higher
- Cash flow from **financing** will be lower
- **Overall cash flow** is unaffected
- **Leverage** will be higher
- **Lower working capital ratios** - next year's payments are reported as a current liability

Overview[3]

	Finance Lease	**Hire/Lease Purchase**	**Operating Lease**
Who owns the asset?	Lessor	Lessee	Lessor
Which payments are tax deductible?	Interest only	Interest only	Rental payments
Can you claim the Annual Investment Allowance?	No	Yes	No
Accounting treatment	On balance sheet	On balance sheet	Off balance sheet
Can VAT be reclaimed on payments?	Yes	No	Yes
Can VAT be reclaimed on the cost of the asset?	No	Yes	No

[3] Lombard - Your Guide to Asset Finance