



SECTION - 4

LEASE FINANCING

This Section includes

- **What is Lease Financing?**
- **Why Lease Financing?**
- **Operating Leases**
- **Financial Leases**

4.1 WHAT IS LEASE FINANCING ?

- 4.1.1 Leasing is a form of debt financing which provides for the effective acquisition of the asset. Unlike debt or equity financing, leasing is typically identified with specific assets. The risk to the lessor is minimized when the lessee does not meet the contractual obligations. The lessor, as the legal owner of the asset, has a stronger legal right to reclaim the asset.

4.2 WHY LEASE FINANCING ?

- 4.2.1 A common misconception is that leasing allows the use of an asset without a company having recourse to its own funds. Lease payments are based on the price of the asset plus an interest factor. It is also unlikely that the lessor would advance a loan for the total cost unless the proposed lessee had other assets or equity to offer as collateral to the loan.
- 4.2.2 The commonly used lease terms are:
1. Operating Leases
 2. Financial Leases
 - a. Rental Lease
 - b. Net lease
 - c. Direct lease
 - d. Leveraged lease
- 4.2.3 Lease financing is resorted to for both the right and wrong reasons. The right reasons for leasing are:
- a. Short-term leases are convenient
 - b. Cancellation options are available
 - c. Maintenance is provided
 - d. Standardization leads to low costs
 - e. Tax shields can be used
 - f. Avoiding the alternative minimum tax



4.2.4 The wrong reasons for leasing are:

- Leasing avoids capital expenditure controls
- Leasing preserves capital
- Leases may be off balance sheet financing
- Leasing effects book income

4.3 OPERATING LEASES

4.3.1 An Operating Lease normally includes both financing and maintenance services. Normally the lessor agrees to maintain and service the asset, the costs of which are built into the lease payments. Further, an operating lease is one where an asset is leased or hired for a period of time less than its useful life. The lessor expects to recover costs in subsequent renewal payments or on disposal.

4.3.2 An Illustration:

Acme Limo has a client who will sign a lease for 7 years, with lease payments due at the start of each year. The following table shows the NPV of the limo if acme purchases the new limo for \$75,000 and leases it out for 7 years.

	Years						
	0	1	2	3	4	5	6
Initial Cost	-75						
Maintenance, insurance, selling and administration costs	-12	-12	-12	-12	-12	-12	-12
Tax shield on costs	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Depreciation tax shield	0	5.25	8.4	5.04	3.02	3.02	1.51
Total	-82.8	-2.55	0.6	-2.76	-4.78	-4.78	-6.29
NPV @ 7% = - \$98.15							
Break-even rent (level)	26.18	26.18	26.18	26.18	26.18	26.18	26.18
Tax	-9.16	-9.16	-9.16	-9.16	-9.16	-9.16	-9.16
Break-even rent after-tax	17.02	17.02	17.02	17.02	17.02	17.02	17.02
NPV @ 7% = - \$98.15							

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Tax	-9.16	-9.16	-9.16	-9.16	-9.16	-9.16	-9.16
Break even rent after-tax	17.02	17.02	17.02	17.02	17.02	17.02	17.02
NPV @ 7% = - \$98.15							



4.4 FINANCIAL LEASES

- 4.4.1 A financial lease is one which lasts for the whole of an asset's estimated useful life and where the lessee in effect takes on all the risks and benefits associated with ownership. In effect, a financial lease is the purchase of an asset financed by the lessor as lender. Such leases are now required to be shown on the balance sheet as assets at fair value and as liabilities for future lease payments.

An Illustration from the lender's perspective

Terms and conditions	
Cost of the asset	1000
Depreciation rate	20% WDV
Tax	40%
Lease period	5 Years
IRR of lessor	25%

What will be the lease rental to be recovered assuming that the lessor passes on the entire tax shield benefit to the lessee in the form of lower lease rentals?

Step 1 is to calculate the present value of tax shield on depreciation

Step-1	Present value of depreciation tax shield			
	Year	Depreciation	Balance	Taxshield
	1	200	800	80.00
	2	160	640	64.00
	3	128	512	51.20
	4	102	410	40.96
	5	82	328	32.77
		PV of depreciation tax shield		158.69
Step-2		PV of residual value		107.37
Step-3	Lease rental to be recovered			733.94