

## LEASING DECISIONS

**Leasing:** A Financial arrangement under which the owner of the asset (Lessor) allows the user of the asset (Lessee) to use the asset for a defined period of time (Lease Period) for a consideration (Lease Rental) payable over a given period of time.

|              | <b>Lessor</b> | <b>Lessee</b>  |
|--------------|---------------|----------------|
| Asset        | Legal Owner   | User           |
| Rental       | Income        | Expense        |
| Taxation     | Taxable       | Tax deductible |
| Depreciation | Yes           | No             |

Three parties are involved in a lease transaction:

1. Lessor
  2. Lessee
  3. Supplier
- In determining NPV, from the angle of Lessor, three elements to be considered are
1. Cost of Asset,
  2. PV of tax Shield on Depreciation and
  3. PV of post tax lease rentals.

### Principle 1:

- How to identify whether a lease is good for the lessor –
- For the lessor, leasing is a capital budgeting decision.
- He would give the asset on lease if the cash flow associated with the lease either gives a positive NPV or if its IRR is greater than the cost of capital.

### Evaluation of Leases – Lessor's Perspective

**Principle 2:** What happens when lease rentals are received in advance.

- ✓ Rentals can be received either in arrears or in advance.
- ✓ When received in advance it means at the beginning of the relevant payment period.
- ✓ This can also be taken as received at the end of the previous period

### Evaluation of Leases – Lessor's Perspective

#### Principle 3: Fixing the Lease Rental

- ✓ In fixing the lease rental, the lessor tries to ensure that the cash flow structure associated with the lease gives him a rate of return, which is equal to or higher than the cost of capital.

#### Principle 4:

- a. For a desired rate of return, the lease rental if payable in advance will be less than the lease rental payable in arrear
- b. For a desired rate of return, the longer the time interval between two payments, the larger is the payment.

#### Principle 5: The Implicit rate of a lease transaction is driven by four factors:

- a. Length of the lease period
- b. The amount of lease rental
- c. The mode of payment, namely in advance or in arrears
- d. Residual value of the asset at the end of the lease period.

#### Principle 6: An Operating Lease is one where a significant part of risk-bearing burden is on the lessor. However, this does not alter the mechanism for evaluating the lease or for ascertaining the lease rental.

### Evaluation of Leases – Lessee's Perspective

#### Principle 1: Selecting an appropriate discount rate

- ✓ To the lessee, leasing is a Financing decision.
- ✓ A lessee has two options regarding the discount rate to be used.
  1. Cost of Capital - Marginal Cost
  2. Opportunity Cost – Cost of Borrowing

If leasing is taken as an alternative to borrowing, the relevant opportunity cost is the cost of borrowing.

#### Principle 2: Borrow and Buy, or Lease

##### a. Leasing as a source of finance:

In evaluating the leasing option three elements are relevant

- i. Lease rental after tax
  - ii. Timing of cash flow
  - iii. Discount rate
- ✓ The lease rental after tax should be discounted at the appropriate after tax discount rate to arrive at the present value of lease outflow
- ✓ In evaluating the borrow and buy option, following elements are relevant:
- i. Purchase price
  - ii. Tax saving on depreciation
  - iii. Net cash flow on terminal value of the asset

**b. Implications of Target Debt Ratio:**

A leasing decision leaves the equity of a firm unaffected.

- ✓ If a firm decides to modify its target debt ratio, leasing should be compared with borrowing.
- ✓ If the target debt ratio has to be increased, the decision will depend on whether such an increase would be brought about by leasing or borrowing.
- ✓ If the target debt ratio is to be brought down, the decision will be to fund the asset by equity rather than by leasing or borrowing.

**Present Value Approach:**

The three steps involved in evaluating a buy/borrow or lease option are:

1. Compute Present Value of lease option
2. Compute Present Value of loan option
  - a. Purchase price
  - b. **Less:** PV of tax saved on depreciation
  - c. **Less:** PV of net terminal value of the asset
  - d. Result being PV of Borrowing option
3. Apply decision rule, namely, option that leads to lower cost of PV gets selected.