

Lease or Buy? Which is better?

So, is it better to lease, or to buy? Every article, book, or web site about leasing addresses this classic question.

The answer usually involves a financial comparison of the two options-typically ignoring the fact that the consumer may have interests other than overall long-term cost that can't be factored into a simple financial analysis

Although the authors of these articles often go into great detail, providing lease- buy calculations and the obligatory side-by side cost analysis, the answers always come out the same- though frequently presented with a biased slant that reflects the author's particular viewpoint about leasing

But before trying to answer this great question, let us revisit some of the important concepts about equipment acquisition decision. For many readers, advantages of outright purchase of equipment using owner's funds or loan from the bank is known and widely practiced. It is because of that background in mind, I will focus more on the other way of financing asset procurement which is financial leasing

Its tough deciding what equipment you need, and even tougher choosing how to acquire, finance and manage it. The decisions you make affect the entire business circles, especially financial and operational viability of the company. There are several questions which surround the decision to acquire assets

- Should you buy or lease
- Whom should you trust to help you navigate the process
- How do you plan for future unknowns
- How do you get the most equipment for your budget while minimizing the total cost of ownership
- How do you protect your company from liability given current security disposal laws

Leasing could be the answer to many of these questions. When you need to purchase the asset, you have three basic choices to finance the acquisition. You can pay cash from owns savings, borrow the money or lease. Lease financing is an attractive alternative to buying as it frees up monetary resources and provides enhanced flexibility for cash/capital that would normally be tied up in equipment is then available to meet the real financial needs that arise. That is why the concept of "leasing" is being rapidly accepted in the world market

Leasing has now become very popular all over the world and especially in the developing world where small and medium sized businesses are predominant, Leasing enables business entrepreneurs to gain more benefits from the leased items rather than buying. It allows you to make the best use of the equipment without having to invest to own them

Generally, there are two ways of leasing worldwide: Financial Leasing and Operating Leasing

Finance Lease

According to the International Accounting Standard 17, Finance lease is defined as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset, title may or may not pass. Finance lease is also defined as an agreement to lease certain equipment with a fixed period of time—mostly medium to long, where the leasing company will not provide any service or maintenance, repair or insurance of the leased item. The lessor will calculate payment, depending on the price of the item, plus interest and benefit. Neither the Lessor nor the lessee can terminate the agreement.

Operating Lease: IAS 17 define operating lease as a lease other than finance lease. Literally this is an agreement to lease certain items, just like a Financial Lease, but within a shorter time (mostly between 12-24 months). The lessor or the lessee can terminate the agreement at any time, on the basis that the lessor will be responsible for any damage occurring to the leased item. This type of Leasing is very close to a normal Rent Agreement.

There is also a hire purchase which is different from leasing, the major difference being, at the end of a lease agreement, the right in the leased items can be sold to the lessee. But at the end of a hire purchase agreement, the right of property belongs to the person who has made the payments. However, there are other factors that consumers should consider between Leasing and Hire Purchase, such as, interest rate, types of interest (fixed or float rates), tax deductions, monthly payment, period of agreement etc, before making any decision.

Advantages of Leasing

i) No- collateral requirements

In leasing, collateral is seldom required because the leased asset serves as security as the lessor retains ownership over the asset. In event of default, the lessor can repossess the asset, a relatively straight forward process in most countries.

ii) **Simple to structure lease deals/low transaction costs.** A lease transaction can be concluded more quickly and simply than a bank loan. The lessor is only interested in determining the ability of leased assets to generate sufficient cash flows to pay monthly rentals throughout the lease term rather than looking into credit history and the balance sheet of the borrower/lessee.

iii) **Tax Incentives:** In many countries the tax system is normally conducive to leasing. Tax incentives differ from one country to another. In Korea, for example, the lessor registers the full lease payment (principal + interest) as income but deducts the accelerated depreciation of the assets. The lessee claims the lease payment (rentals) as deductible. The lease term is usually shorter than the economic life of the equipment, so the lessee in fact depreciates the equipment faster than if the asset was purchased. In Tanzania it is different, the lessee is the

one entitled to claim depreciation and interest portion of the lease rentals is registered as income to the lessors.

- iv) **100% Finance provision:** Banks usually require part finance of the project cost/investment from clients. Down payments often range from 50 percent to 75 percent. In lease, 100 percent of equipment cost is financed and up-front security payments seldom exceed 20 percent.
- v) **Leasing offers a way to modernize production** and develop small businesses, allow technological refresh and sometimes provide an off balance sheet financing (for the countries where finance lease is classified as a “lease” and not as a “loan”)
- vi) **No risk of Fund diversion:** Funding provided to for leasing goes directly to the supplier of the equipment without passing through the hands or account of the lessee. This eliminates the risk that the lessee might be tempted to use the funds for unintended purposes, also averts the possibilities of lessee to use the credit to settle down a loan from another lender.

Lease vs Buy

It's a common dilemma: lease versus buy-(lease or buy equipment) - which is better? Everyone who has ever considered leasing has had this question cross their minds. So what is the answer?

The answer: It depends

Leases and loans are simply two different methods of asset financing. One finances the use of equipment, the other finances the purchase of the equipment. Each has its own benefits and drawbacks. It's not possible to simply say that one is always better than the other because the answer depends on each specific situation.

When making a “lease or buy” decision you must look not only at financial comparisons but also at your own personal priorities- what's important to you. Things like, is having a new equipment every two or three years with no major repair risks more important than long-term cost, or are long term cost savings more important than lower monthly payments. Are having some ownership of equipment more important than low up-front costs and no down payment? Is it important to you to pay off your equipment and be debts-free for a while, even if it means higher monthly payments for the first few years? So, making the lease or buy decision is not quite cut and dry. There are things you need to consider first. Let's take a look at some of these things. First, is to understand that buying and leasing are fundamentally different, not just two versions of the same thing.

Buying and leasing are different

When you buy, you pay for the entire cost of equipment; regardless of how much usage of the equipment. You typically make a down payment, pay applicable taxes in cash or

roll them into your loan, and pay an interest rate determined by your loan company, based on your credit history. You make your first payment a month after you sign your loan agreement. When you lease, you pay for only a portion of the asset's cost

Leasing may be a best alternative to acquire the equipment you need today, (see below chart which provide comparison of leasing to outright purchase of asset). You have the option of not making a down payment; you pay only relevant taxes and lease rentals which include financial charges similar to interest rate on loan. You may be required to pay special-related fees and possibly a security deposit that you don't pay when you buy. You make your first payment when you sign your lease contract for the month ahead.

Lease payments are made up of two parts, a depreciation charges (capital repayment) and a finance charge. The depreciation part of each monthly payment compensates the leasing company/bank for the portion of the equipment's value that is lost during your lease. The finance part is interest on the money the lease company has tied up in the equipment while you are using it. Loan payments also have two parts, a principal charge and a finance charge similar to lease payments. Principal pays off the full purchase cost price while finance charge is loan interest.

However, since similar type of equipment depreciate in value by the same amount regardless of whether they are leased or purchased, part of the principal charge of each loan payment can be considered as a depreciation charge, just like with leasing—it's money you never get back, even if you sell the equipment in the future.

So buying equipment with a loan is essentially like putting money into a declining value "savings account"- you never get out as much as you put in. A portion of every payment you make is lost to depreciation and finance charges. What you have to show for your investment when your loan is paid off is only the part that is left over after depreciation and interest. A terrible investment by any measure.

Leasing, then, is similar to buying, but without the equity "savings account". You only pay for what you use and you don't put anything into "savings" It's true that you will own nothing at the end of a lease, you will have nothing to show for the money you have put into it, But what you don't own is the same part of the equipment's original value-depreciated part- that a buyer too doesn't own at the end of his loan.

With leasing, you may have the option of putting your monthly payment savings into more productive investments, such as stocks, treasury bonds mutual funds etc

To summarize, the leasing typically does not build equity, while buying does. The reason that a buyer has equity at the end of his loan is that he purchases that equity by making higher monthly payments.

So lease versus buy? Let's simplify the answers and summarize them here

1. The short-term monthly cost of leasing is ALWAYS SIGNIFICANTLY LESS than the cost of buying. For the same equipment, same price, same term and same down payment, monthly lease payments will always be 30- 60 percent lower than loan payments. This will still be true even when compared to zero percent or low-interest loans.
2. The medium-term cost of leasing is about the same as the cost of buying; assuming the buyer sells/trades his asset at loan-end and the lessee returns her asset at lease end. The overall cost of leasing compared to buying, over the same lease/loan term is approximately the same , more or less, assuming the buyer sells the asset at the end of the loan
3. The long-term cost of leasing is always more than the cost of buying, assuming the buyer keeps the asset for years after loan-end. If a buyer keeps his asset after the loan has been paid off and uses the asset for many years, the cost is spread over a long term. Therefore short-term leasing is always more expensive than long-term buying. If long-term financial cost savings were the most important objective in acquiring a new asset, it would always be best to buy the asset and use it for as long as it survives-or until the cost of repairs and maintenance begins to exceed the replacement cost

Below chart provide basic criteria that can be used as a guidance principal in the decision of lease versus buy.

Issue/consideration	Lease	Buy
Down payment	Minimal depending on the type of the company and risk level	Small to Large, can go up to 50 percent
Effect on bank lines	Usually considered an additional credit line	Decrease by total cost of equipment
Effect on operating capital	Minimal, due to small down payment, and low monthly cost of true lease	Could be substantial if high down payment and short term loan
Payments	Low fixed monthly cost	Generally less than rental but usually higher than a lease
Insurance	Can be incorporated in lease-paid by lessee	Must be included in existing policy
Tax issue	Possible accelerated depreciation over lease term	Depreciated over useful life of the asset
Hidden costs	Nominal application fee-can generally be reduced or eliminated	Storage, disposal cost
Flexibility	Can add-on-upgrade	Very little-difficult and often expensive to upgrade
Obsolescence	Simply trade up to latest technology	Generally obsolete before it is paid for—upgrades can be expensive
Hedge against inflation	Payments don't change	Payment may change
Approval process	Generally easy due to the low	Must get approval for entire

	monthly cost. Often can be paid for out of operating budget	amount
Application difficulty	Fast and simple	Lengthy approval process and substantial paperwork

Limitations to leasing

i) Tax advantages

Tax advantages have played a large role in the growth of the leasing sector in developed countries. In Tanzania for example, many small and medium enterprises do not benefit from tax advantages, either because they operate outside the formal economy or because they are in presumptive tax brackets where tax is assessed on revenue.

ii) Extending leasing to remote areas

Leasing companies especially in developing countries usually concentrate their operations to urban area. Dealings between town-based leasing companies and rural small enterprises are relatively uncommon. Other factors which tend to execute rural clients are:

- The cost of monitoring the status of the leased equipment and the financial performance of the enterprise is high when it involves traveling to the countryside
- Clients with leased equipment in rural areas are far from supplier's shops and maintenance workshops
- The cost of asset management and repossession is higher when the equipment is far from the lessor's premises.

iii) Working capital constraints

Leasing can only finance the purchase of equipment. It cannot directly fulfill a client's needs for working capital, although it can be argued that the lower down payment of leasing indirectly free up resources for working for the client. Lessors need to be aware, however, the lack of working capital could jeopardize their clients' capacity to generate extra cash flows through the leased equipment, and therefore their ability to keep up with lease payments.

Conclusion

So, which is better, "lease or buy"?

It depends on what's most important to you. All of us have different lifestyles and needs with priorities. Asset lease –versus –buy decisions must be made with your own needs and priority attributes in mind. For example, if one enjoy driving a new car every two in

three years, want lower monthly payments, like having a car that has the latest safety features and is always under warranty, don't like trading and selling used cars, don't care about ownership equity, properly maintain your cars, and are willing to pay more over the long haul to get these benefits, **then you should lease, otherwise you should buy.**

References- to follow

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