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The 'Gotchas' of Equipment Leasing

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Abstract. Why is it that equipment leases often end up costing more than you expected, sometimes a lot more? Our experience shows that 99% of all leases contain "Gotchas." Purchasing professionals responsible for selecting a leasing company and negotiating for the best lease possible for their company feel as if they don't speak the leasing language.

Ten years ago staying on the cutting edge of technology did not require equipment upgrades every 12 to18 months. Today, as technological innovations advance, all types of manufacturing, production, office and distribution equipment show its age more rapidly than at any time in history. This is why equipment leasing has continued to remain popular.

Leasing enables businesses to conserve cash, often allowing companies the ability to finance 100% of the purchase price of the equipment. The length of the lease often parallels the company's useful life for the assets. Leasing helps companies keep current with technology and sometimes with a lower total cost of ownership. Lease paperwork is often completed with a minimum of red tape while a bank loan process can be cumbersome and time consuming.

However, there can still be many headaches hidden in the fine print of a lease.

In 2004 Global Insight surveyed 150 companies in a Waltham, Massachusetts, economic forecast. They cited the number one reason for leasing was the discipline it placed on the maintenance and replacement of equipment. Protection against obsolescence was recognized by 54%; off-balance sheet accounting by 53%. The convenience of leasing scored 51%.

Leasing is Big Business - Industry Statistics

In 2006 the U.S. equipment leasing industry activity declined from an estimated annualized volume of $260 billion to $234 million. Equipment leasing industry expert Jeffrey Taylor believes this is a direct result of Sarbanes-Oxley. He explains, "Sarbanes-Oxley has had a negative impact on corporate America's attitude towards off-balance sheet financing."

A survey of manufacturing companies was conducted for Bank of America Business Capital between August 21, 2006 and October 10, 2006 by an independent market research firm of 601 top financial decision makers in companies with revenues between $25 million and $2 billion.

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The survey found that for 2007, 34% will use leasing as one of the financing alternatives available for capital expenditures.

The U.S. Department of Commerce states that fully 80% of U.S. companies and professional offices now lease when acquiring or upgrading equipment. The Department listed several reasons for this statistic. Companies want to:

- Manage growth
- Receive tax benefits
- Add, update and upgrade equipment
- Stay a step ahead of obsolescence
- Improve asset management

Large businesses as well as small businesses choose to lease. The seventh annual survey of Small Business Administration (SBA) State Small Business Person of the Year winners, conducted by the Equipment Leasing Association (ELA), found that 84% of respondents believed leasing was a good business strategy for meeting the demands of small business.

Smart Leasing Strategies

After deciding to lease, the next step is working on the details. Often companies accept the lease solution provided by the equipment manufacturer or supplier. Additional options are made available to procurement professionals from independent lessors or bank-owned leasing companies. It is wise to compare all three sources. A manager might think this step is unnecessary and time consuming. Experience will show that significant money may be saved if a lease Request for Proposal (RFP) process is instituted. Benefits include:

- Securing a new source of business capital.
- More competition between the leasing companies often leads to better and more flexible pricing.
- Receiving alternate financing structures that can provide cash flow or tax benefits not offered by the manufacturer's leasing company.
- Some companies prefer to keep their financial statements out of the hands of equipment salespeople and feel more confident dealing directly with financial professionals from the leasing companies.

If the decision is made to consider alternate financing options, a leasing RFP should contain the following.

1. **Type of lease:** Typically, an off-balance sheet lease is desirable. We recommend also requesting pricing with a $1.00 purchase option. Receiving this can be quite helpful in determining the leasing company's expectations about the residual value of the assets at the end of the lease term.

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2. **Term:** Define the lease length. What is the useful life of the equipment within the company? It is often wise to structure the length of the lease for the same length as the useful life of the equipment within the corporation. If the lease term is longer than the useful life, companies have found themselves "upside down" in the lease, owing more than the value of the asset.

3. **Security deposits:** Unless the company is in a difficult financial condition, do not agree to pay any security deposits, executory fees, upfront fees, etc. The primary purpose of these types of charges is to increase the return to the leasing company. Indicate in the RFP that inclusion of these types of fees will exclude the leasing company's proposal from consideration. A small documentation fee is not unusual and may be acceptable.

4. **Payment frequency**: Usually payments are due monthly in advance. Be aware of a 'gotcha' if the lessor's proposal contains the term "monthly equivalent payment." This means the leasing company plans for you to make the payments quarterly in advance. This results in costing you more and can ruin budget and cash flow projections. Some leasing companies will also offer flexible low payments for the first three to six months of the lease term. Beware; this method can also be a way for lessors to disguise the true cost and rate of a lease.

5. **Interim rent**: This is one of the biggest 'gotchas' in the leasing industry. This is a type of lessor return enhancement. It is frequently found in technology leases. Interim rent is an amount of money that is charged for the period between equipment acceptance and lease commencement. It is facilitated by the use of quarterly lease schedule commencements. The lessor will offer to assist the company by commencing each lease schedule at the beginning of the calendar quarter, thereby decreasing the number of lease schedules. Where is the 'gotcha' in this? The 'gotcha' is the rate at which this cost is assessed. Lessors use the daily lease rate which is the monthly lease rate divided by 30 days. An example of this is:

    One hundred computers (with a total cost of $100,000) arrive on the 15th of January. The lease schedule is due to commence on the first of April. The 36-month term lease payment is $3,000. The lessor invoices interim rent charges for 75 days at the daily lease rate. The company receives an initial interim rent invoice for $7,500. How can this be avoided? The RFP must define the interim rate to be paid by the company. A more fair way is to assess interim rent at an interest only rate. In this example, 75 days of interim interest at the current prime loan rate of 8.25% would be $1,695. This represents a savings of $5,804.

6. **Prompt vendor payment**: The equipment purchase price and payment terms have been negotiated. The leasing company must follow the payment terms. Some lessors have been known to delay payment to vendors due to "missing paperwork" or by using other delaying

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tactics or excuses. The RFP should contain language requiring the lessor to follow all negotiated vendor payment terms. The RFP should state that vendor late payment penalties due to unnecessary lessor delays are the responsibility of the leasing company. Do not allow the leasing company to jeopardize future vendor relationships.

7. **End of lease options:** Traditional end of lease terms are to a) buy, b) renew or c) return. Variables that make this process much more complicated include fair market value definitions, bargain purchase options, renewal terms and payments, and notification requirements. It must be remembered not to be too taken by the low upfront payments and forget the end of the lease. Michael Keeler, CEO of Ecologic Leasing Solutions, a lease management outsourcing company in Great Falls, Virginia, said "Most lessors make money through some obfuscation in the lease." He goes on to say, "If the rates are pushed down at the beginning of the lease, the rates at the back end go up."

   Let's examine the specific end of lease options individually.

   a) **Buy:** Establish a process for defining the purchase price in the RFP. Make sure your process is included in the final Lease Agreement. The process should address any disagreement between the lessee and the lessors regarding the Fair Market Value purchase price. If the two parties cannot agree, the contract guides the parties to hire a qualified appraiser who is mutually satisfactory to both parties. The cost for the appraisal is equally shared by both parties. The definition of the Fair Market Value should *not* contain language referring to the "in place, in use" equipment value. "In place, in use" values can add uncontrolled variables to the cost of the used equipment in order to increase the leasing company return on the lease.

   b) **Renew:** Leasing company standard contract language can allow for renewals to be as long as the original term of the lease or as short as month-to-month. Automatic renewals explain how a 36-month lease can last four years, or even six years. The renewal payments are often unchanged during the renewal portion of the lease. We recommend that if the manager thinks they may want to renew the lease, the RFP should contain a decrease in the monthly payment during the renewal period. Companies that do not anticipate the renewal option may find themselves paying for the equipment many times over. Eaton Corporation, a $11.1 billion Cleveland-based industrial equipment maker, entered into a lease and made the decision to lease based upon "month-to-month" instead of "total costs." When the lease came to the end, they continued to renew the lease,according to Bob Parmenter, vice president and treasurer. He explained, "We could have acquired the equipment for as little as two months' payments, and we found some leases going on for eight, 10, 12 months."

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c) **Return:** Return provisions in the RFP should be very specific because lessors expect to increase their return in this phase of the relationship. In the article "The Imperfect Fit: Making Form Leases Work for High-Tech Equipment," leasing industry consultants Barry S. Marks and James M. Johnson, Ph.D., state "Some lessors may assume that, by creating impossible return standards, they will be able to goad the lessee into paying an above-market purchase price for the equipment."

Recommendations to decrease return costs are:
1) Limit return shipping distances.
2) Allow return conditions to include "like kind substitutions."
3) Eliminate language requiring equipment to be returned in the original packaging.
4) Define return conditions and responsibilities in the RFP.
5) Require a Stipulated Loss Value table as part of the standard documentation.
6) If equipment can be self-maintained or has a warranty that extends throughout the life of the lease, request that no additional maintenance agreement be maintained.

d) **Notification:** Each lease has specific notification periods that, if not adhered to, can cost the lessee additional money.
1) A 30-day written advance notice period to the lessor for permission to relocate equipment.
2) Do not allow for excessive documentation and filing fees by the leasing company to track such changes.
3) RFP should contain notification language that provides for sufficient time for the company to notify the leasing company of their end-of-lease decision.
4) Upgrades: consider addressing the need for upgrades for certain technological equipment and the costs and process to accomplish this.
5) Establish tracking methods in order to avoid missing end-of-lease notices.

Ask an Expert
Look for resources and materials that discuss equipment leasing. Books and articles abound. However, even with the best resources, the process of leasing needed equipment, furnishings or other goods is not simple. Leasing is serious business. When equipment leases are negotiated carefully, savings can be significant.

Standard contracts are fraught with hidden fees and penalties that are often difficult to uncover and contradictory to bottom line interests. They are written by the attorney for the leasing company. Legal scrutiny is fundamental to implementing any contract; however, a formal legal review alone will not guarantee the best financial package.

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A procurement professional is on the front line of the lease negotiation process. They are facing leasing company representatives well versed in the nuances of lease contract language. Because of the lessor's expertise, a manager may consider working with an independent lease review specialist to help structure a workable financial package and shape a payment stream that fits the company's financial plans.

Independent Lease Review Expert

Some companies hire an independent lease review expert at the start of the leasing process while others wait until the RFP responses have been returned. While still uncommon, the strategy reflects future trends. Whether the intended acquisition is large or small — hundreds, thousands or millions of dollars — any percentage saved means money saved.

Dale Chaffin, the former chief operating officer of Shook Hardy & Bacon, which is ranked as the 84th largest law firm in the U.S. in 2006, stated, "I would not give a proposed lease document to the attorney to review until after it has been reviewed by a lease specialist." When Chaffin equipped his firm's new headquarters in Kansas City, Missouri, good management and a mountain of paperwork prompted him to call for help. Chaffin's finance RFP resulted in more than 70 documents from 13 leasing companies. After the responses were received, Chaffin commissioned a qualified independent lease review specialist to review the proposals. He believed the specialist saved the firm more than a million dollars and conserved valuable time.

Rob Burton, CPA and a senior manager at Beers & Cutler, the leading accounting and consulting firm focused on the Washington, D.C. area, also sees merit in the independent lease review tactic. Burton explained that an independent review of lease contracts is important from not only a legal contractual perspective, but also from a financial and market availability perspective. A lease review expert who is familiar with lease contracts and their terms, and has experience with many different types of clients, is invaluable. Burton believes that the independent lease review expert brings experience into the leasing process and is able to advise on lease terms, financial terms and competitiveness. The expert knows the marketplace. In addition, if a company has existing leases that have not had a formal review, Burton recommends the company engage a lease review expert prior to signing any new leases with an existing provider. He also suggests a contract attorney review the leases.

Conclusion

Leasing equipment can offer a significant and positive impact on the financial condition of corporate finances. However, change is in the wind. The Federal Accounting Standards Board will be looking at leasing and the accounting treatment for all leases during 2007 with changes projected to go into effect by 2009. Issues of each lease must be researched closely, negotiated carefully and monitored throughout the lease life cycle. If all of this is done, leasing will continue to be a wise financial alternative for growing companies.

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Mary A. Redmond, The FearLess Negotiator, works with business professionals who want to become stronger negotiators. After attending one of her workshops or coaching sessions, clients feel more confident in stressful business situation whether they need to close bigger and more complex sales, secure the perfect new job, ask for that well-deserved raise or improve communication with their colleagues, bosses or families.

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