

## Lease vs. Buy Analysis: Real-Life Lessons You Don't Want to Forget

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**Abstract.** Cash is king! This mantra is acutely relevant for companies faced with competitive pressures and customer demands for higher productivity and lower prices. Companies that have grown through acquisition are particularly challenged as the additional debt must be serviced. Cash generation and conservation become a focal point throughout the organization. Like it or not, supply management professionals find themselves in a new role working with suppliers of leasing services to evaluate the costs and benefits of leasing.

Quantifying the economic impact of a lease vs. buy decision can be challenging for some of the better financial minds. Though a background in finance is helpful, it is not necessary if you are willing to invest the time to understand the basic concepts of this type of transaction. In addition, leasing decisions may require you to gain a better understanding of an asset's economic life and usage costs than you ever imagined.

Leasing options can range from a simple asset financing arrangement to an all-inclusive, full-service program with lease charges based upon actual usage. And, if you don't find the leasing options particularly complex, the "people" factor will surely challenge you as leasing advocates and opponents take to the battlefield over this on-going debate. This leads us to a number of questions that will be addressed during this workshop:

- Is leasing simply a financing decision? Or, must the leasing opportunity be evaluated in its entirety?
- Should decisions regarding lease renewal or asset purchase options impact the initial leasing decision? Or, are these independent analyses?
- Can an analysis be boiled down to 5 – 10 standard considerations? Or, must considerations unique to each asset be evaluated?
- Can lease compliance be ensured? Or, is complete mitigation of lease penalties impossible?

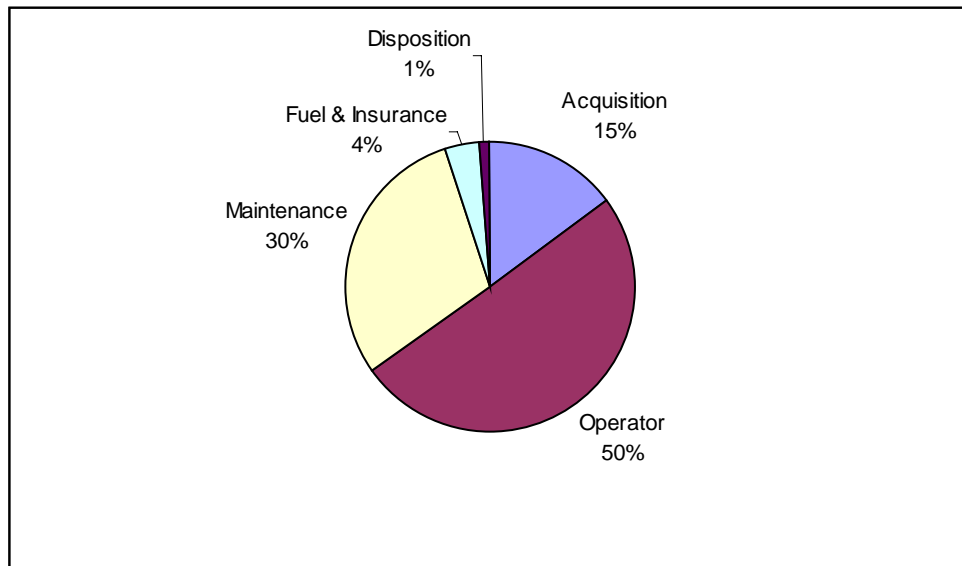
**Key Considerations.** An analysis of a leasing opportunity should at a minimum encompass the following:

- asset total cost of ownership
- asset usage restrictions
- lease management requirements

**Asset Total Cost of Ownership.** An evaluation of an asset's total cost of ownership (TCO) must include not only a net present value analysis of the initial cash outlay to obtain the asset,

but also the costs to maintain and dispose of the asset. Figure 1 depicts the TCO for lift trucks, which are frequently leased:

**Figure 1. Lift Truck Total Cost of Ownership**



Leasing often provides 100% financing of the cost to obtain an asset by avoiding down payments and incorporating shipping and other miscellaneous charges. By diversifying financing sources, leasing can also lower financing costs. By avoiding typical loan covenants, leasing can even provide a less restrictive form of financing. Bear in mind, however, that Wall Street financial analysts typically consider not only capital lease commitments, disclosed in the face of financial statements, but also operating lease commitments, disclosed in the footnotes of financial statements.

Lease terms may dictate a preventive maintenance program different than the one currently utilized for purchased assets. Manufacturer provided maintenance schedules often require lessees to perform more frequent, hence more costly, maintenance services. Potential benefits of outsourcing maintenance services to the lessor are numerous, including improved labor efficiency, equipment up-time, predictability of costs, and compliance with lease maintenance terms and conditions. Of course, union restrictions must be considered whenever services performed by unionized labor are outsourced.

Taxes are another important TCO component. Sales tax costs will vary based upon the lease vs. buy decision. For a purchased asset, sales taxes are calculated on the owner's tax basis. For a leased asset, sales taxes are calculated on the lease payment amounts. Generally, lease payments will allow an asset to be deducted more quickly for income tax purposes. Finally, lessee's who are denied the benefit of depreciation deductions due to ATM (Alternative Minimum Tax) can still derive the benefit from lease payment deductions associated with Tax leases.

**Asset Usage Restrictions.** Lease rates are based upon (1) expected asset usage, (2) estimated asset residual value at the end of the lease term and (3) financing costs. If actual

asset usage exceeds lease terms, the lessee may incur excessive use charges. Therefore, the lessee must carefully select lease terms considering not only the optimal economic life of the asset but also current and future asset usage demands.

On the up side, leasing can instill a discipline to replace assets when they have reached the end of their economic lives (i.e., when their estimated future maintenance costs begin to exceed replacement costs). In addition, the lessor typically bears the risk of asset technological obsolescence during the lease term.

Other typical categories of lease restrictions include the following:

- asset modifications, such as accessory attachments or component upgrades
- asset preventive maintenance
- asset surrender conditions and location

**Lease Management Requirements.** Processes, systems and job descriptions may need to be modified to ensure proper lease management. Granted, good asset management practices require tracking of both leased and purchased assets for the following purposes:

- timely preventive maintenance
- balanced asset utilization
- OSHA safety and training records

However, leased assets must also be tracked to ensure (1) lease expirations are recognized and (2) the delivery of replacement assets is well coordinated with lease terminations. Early or late termination can cost a premium due to early termination penalties or rental rates. To assist lessees, lessors can issue advance notifications of lease terminations. In addition, lessors may offer staging of made-to-order equipment to ensure delivery of newly leased assets at time of lease termination.

Utilizing a consistent, internally developed master lease can significantly improve the efficiency of lease evaluation and management. In addition, expensive lease agreement blunders can be avoided by ensuring the following terms and conditions are clearly documented:

- asset maintenance
- lease termination
- asset surrender condition and location
- lease assignment
- operating vs. capital lease status
- tax vs. non-tax lease status

Effective negotiation of lease terms and conditions often requires the assistance of an expert in the usage of the leased asset. Linking lease surrender conditions to an asset maintenance contract can mitigate penalties arising from surrender conditions, one of the biggest deterrents to leasing.

**Objectives.** Our objective is to provide (a) a framework for lease analysis (see Figure 2), (b) a sample lease agreement which attempts to level the playing field between lessee and lessor and (c) real-life examples of leasing do's and don'ts. Colorful commentary from both sides of this hotly debated topic should provide both an entertaining and informative workshop.

**Figure 2. Lease Analysis Framework**

<b>Lease Consideration</b>	<b>NPV Analysis Suggestion</b>	<b>Risk Mitigation Strategy</b>
Complex terms and conditions	<ul style="list-style-type: none"> <li>Incorporate all variables utilized by lessor to calculate lease rates</li> </ul>	<ul style="list-style-type: none"> <li>Use internally constructed National Master Lease</li> <li>Include both leasing and asset experts on lease negotiation team</li> </ul>
Asset usage stipulations	<ul style="list-style-type: none"> <li>Include estimated penalties for excessive usage, if any</li> </ul>	<ul style="list-style-type: none"> <li>Choose lease terms to best fit asset usage</li> <li>Actively manage asset operation (e.g., rotate assets) to meet lease terms</li> <li>Negotiate terms allowing both asset rotation between facilities and lease assignment in the event of a divestiture</li> <li>Negotiate terms providing compensation for less than expected asset usage</li> </ul>
Monthly lease and sales/use tax payment processing	<ul style="list-style-type: none"> <li>Include difference in sales/use taxes as well as any additional payment processing costs</li> </ul>	<ul style="list-style-type: none"> <li>Utilize the recurring payment feature of your accounts payable system</li> </ul>
Asset modification stipulations	<ul style="list-style-type: none"> <li>Include estimated removal costs during and at end of lease</li> </ul>	<ul style="list-style-type: none"> <li>Consider leasing “modifications”</li> <li>Negotiate terms which allow modifications to be removed without penalty</li> </ul>
Asset upgrade options	<ul style="list-style-type: none"> <li>Include estimated upgrade transaction savings</li> </ul>	<ul style="list-style-type: none"> <li>Negotiate terms for asset upgrades during lease term</li> </ul>
Asset surrender conditions	<ul style="list-style-type: none"> <li>Include difference in estimated transportation charges</li> <li>Include estimated cost of difference in maintenance procedures</li> </ul>	<ul style="list-style-type: none"> <li>Clearly document surrender conditions and location in lease agreement</li> <li>Incorporate maintenance services in lease and negotiate guaranteed compliance with surrender conditions</li> </ul>
Asset disposition	<ul style="list-style-type: none"> <li>Include estimated lease extension or rental charges</li> <li>Include any disposition cost savings, such as broker commissions</li> </ul>	<ul style="list-style-type: none"> <li>Require lessor to issue advance notifications of lease terminations to allow planning for replacement assets</li> <li>Require supplier to “stage” same time pick-up of disposed asset and delivery of leased asset to avoid redundant assets</li> </ul>
Residual value and other stipulations	<ul style="list-style-type: none"> <li>Include value of risk mitigation, such as cost of comparable insurance</li> </ul>	<ul style="list-style-type: none"> <li>Require lessor to bear risk of technological obsolescence during lease</li> <li>Require lessor to bear risk of subsequent law suits if asset involved in injury/damage</li> </ul>
Income tax deductions	<ul style="list-style-type: none"> <li>Include differences in both timing and benefits</li> </ul>	<ul style="list-style-type: none"> <li>Ensure lease qualifies as an accounting Operating lease and IRS Tax lease</li> </ul>