

Strategic Advisory

Ten financial uses of IT leasing

Leasing has a financial history that dates back into the earliest civilizations of Egypt and Mesopotamia, but IT leasing has only been around for less than a century. IT leasing in the new millennium context has become a modern tool for both IT management and financial management.

While accounting and tax treatments have changed over time (and may yet again) most of the core uses of leasing will remain valuable.

The fast changing technology arena, ever surprising economic conditions, and ever changing regulatory environment creates some unique challenges and opportunities for leveraging innovative IT leases.

This paper discusses ten financial uses of IT leasing—most of which are beyond the simple buy versus lease spreadsheet models often employed. These ten usage scenarios can become effective tools of the savvy senior financial officer.

More traditional uses

Save money — when it is cheaper than buying

This is obvious since this is the traditional use of leasing, but it needs to be noted that this ‘cheaper’ reality is often created by a joint interest in the asset. Macquarie believes in the long-term value of the asset and will invest in the residual value of the asset. This can reasonably be done only by a technology savvy leasing company, and one that monitors economic lifespans of mainstream technologies.

Manage tax liabilities more effectively

This too is a familiar usage of traditional leasing, and it applies to most IT assets as well. Certain leasing structures (most notably the operating lease) generate a tax shield through the stream of lease expense payments for organizations with taxable income. In these cases, the tax shield/credits create additional ‘buying power’ for capital.

Allow cash and low cost debt capital to be used strategically

Allocation of financial resources (cash, credit, assets) to business opportunities is a major task of the financial manager. The general rule is to allocate resources to the projects of highest return with commensurate risk level propriety. In many situations, capital investment decisions are governed by a ‘hurdle rate’ (the IRR below which a project is not funded). Risk management issues dictate that the expected IRR be fairly certain as to its achievability, and ‘nebulous’ projects are often relegated to the ‘if we have anything left over’ folder.

Cash itself is seen as an under-performing asset since it is counter-productive to financial goals while it is still in ‘cash form’ (ie earning no multiple). Cash does, of course, have the advantage of being liquid and legal tender, and so is perfect for acquisition transactions of high IRR. What this

means, though, is that cash (and low-cost capital) should only be used on high and fairly certain IRR projects such as mergers and acquisitions, sales force and/or market expansion, new product introduction, and very specific line of business projects (eg warehouse automation). These types of projects are investments in appreciating assets (instead of depreciating assets) and often meet the hurdle and risk requirements of sound fiscal management.

Most of the projects that are candidates for IT leasing fall outside of these hurdle and risk parameters: server and host upgrades, PC refreshes, additional tape and storage units, migration to alternative network architectures and phone systems. These projects have difficult to quantify IRR/ROI measurements (although they are known by all to be absolutely critical to business success) and although they sometimes theoretically ‘pay for themselves’ within a short period of time, they still don’t yield the kinds of returns harvestable from more strategic investments (eg market share growth from acquiring a large competitor).

These IT projects are perfect cases where leasing (rather than the use of precious cash and credit assets) makes the most sense. Effective uses of cash to buy additional business ‘processes’ should actually lead to an increase in leasing to fund the infrastructure expansion necessary to support those new processes. IT must be funded (by leasing) in order to under-gird and empower all newly-acquired (by cash) business capability and function.

Less traditional uses

Generate cash

In selected situations, a large, successful lessor will perform sale leasebacks for customers. This is a well-known financial operation in which the lessor buys assets owned by the customer (generating cash,

but sometimes creating some book write-down, a tradeoff decision for the CFO), and then leases those assets back to the customer for continued operational usage. This is often done in conjunction with the next type of usage to get out of an existing technology footprint.

Get out of an undesirable technology footprint

Forecasting the future of technology and of a firm’s success in using a technology is fraught with uncertainty, and sometimes less than adequate technologies are chosen. In many cases, this may require a ‘forklift’ upgrade (haul off the old and pour in the new). This normally has some financial downside associated with it, but sometimes the need to change for business viability reasons is extremely acute. Strong, vendor independent lessors can support such a technology overhaul through combinations of sale leasebacks, rolling schedules, remarketing services, and the like. Again, there may be adverse ‘entries in the books’ required, but sometimes the wrong POS technology would destroy the business itself if not changed out quickly enough.

Manage the financial profile more effectively

Various lease structures can affect financial statements (and their resultant ratios) substantially. Important and often public measurements of ROA, debt-to-equity, EVA, and EBIT can be managed through judicious use of operating leases (and EBITDA by capital leases). These ratios are increasingly important to our capital and trading markets (for example, leases may need to be structured such that debt covenants are not violated), and are sometimes even used in determining executive compensation (eg EVA, EBIT). Leasing is another tool in shaping the financial profile of an organization.

Avoid asset ownership

There are occasionally situations in which firms need to reduce or cap asset ownership at an aggregate level or in reference to specific types of assets. Sometimes this is for the simple reason of reducing obsolescence, but other reasons for this vary by industry sector. They can range from legal issues, compliance requirements, and liability exposure to debt covenants and disposal risks. Leasing structures allow a firm to distance themselves from legal and economic asset ownership when desired.

Acquire critical equipment in the fourth quarter without violating the 40 percent rule

The 40 percent rule virtually dictates that we 'front load' most capital expenditures into the first three quarters of the year. This rule says that if we place 40 percent or more of our assets into service in the last quarter of the year, then we have to calculate first-year depreciation according to the mid-quarter convention instead of the more attractive half-year convention.

This typically 'delays' depreciation benefits and raises first year taxes. If our firm is in a cash-flush position and are buying assets for some reason, we have to watch the fourth quarter cutoff, to make sure we don't lose valuable depreciation benefits that first year of the newly acquired asset's life. If we find ourselves in the position of still needing a large portion of new equipment in the fourth quarter to finish a critical project for example, we can always turn to leasing during that quarter to ensure we do not lose some of the deduction benefits on our purchased assets (or at least, to ensure that we do not postpone those benefits).

Project related uses

Best match project expenditures with project needs

Financial managers today have noticed two aberrant behaviors on the part of project managers. First, the project manager sometimes cannot buy all the equipment needed to ensure that a project achieves the committed ROI in a timely fashion. The project manager instead buys half the needed system due to capital budgeting caps or policies and then has to wait until next year to get the other half of the system. Since the ROI is dependent on the full system being in operation, this is counterproductive.

Second, the project manager sometimes buys more capacity than is needed for the first few periods, reasoning that it is 'too hard' to go back and ask for money again. Hence, the systems are over specified, the equipment is over configured, and costs are excessive. This latter situation creates a waste of capital, as the first one created a delay of ROI.

Leasing as a tool, when assigned to a specific project, enables the project manager to get closer to 'JIT' equipment expense, ie just the right amount at the right time knowing that when the upgrade is required in a later period, the leasing structure can accommodate the additional demand.

Better track project returns

Leasing has the distinct advantage of 'itemized' costs. When leasing a project's equipment, you can exactly associate those costs with that specific project. This avoids some of the vagueness (and controversy) of 'allocations' and can be used to hold the project management financially accountable for asset costs and asset utilization. This is a financial control use for IT leasing.

Leasing as a flexible and sophisticated tool

There are specialty uses of IT leasing, too, such as using a sale leaseback to generate cash when buying a thriving competitor (to switch out the systems and generate a little cash to boot), or using a lease to use up net operating losses acquired when buying intellectual property from a not so thriving competitor.

The savvy CFO will recognize that many of the scenarios presented above involve values which would not be reflected in our traditional buy versus lease spreadsheet models. Leasing has become so much more a tool for financial management than simply a tool of cash management, and accordingly needs the guidance of the CFO to determine where it should be exploited. IT management has its specialty skills related to operational uses of leasing and sourcing management has its own specialty skills in structuring and ensuring process compliance and efficiency, but neither group is tasked with (nor generally trained for) making these wider financial 'where to exploit' decisions.

Given the substantial impact of leasing on financial performance and public valuation today, major projects involving the possible use of leasing should not be left to either an 'automatic process', or to a simple 'we do not lease' cultural default. Major projects should be initially evaluated under the guidance of the CFO, with input from the other groups and in light of the above possible usage scenarios. All three groups must work together to ensure that the best mix of values are realized for the organization.

At Macquarie Equipment Finance, we stand ready to work with you in assessing your financial and operational options and effectively exploiting modern and innovative IT leasing structures for your organizational goals and mandates.

For more information, contact:

North America

US	+1 248 253 9000
Canada	+1 866 606 1429

Europe

Ireland	+353 1 238 3451
UK	+44 0 20 3037 5585
Central Europe	+42 0 602 449 467

Australia/NZ

Australia	+61 2 8232 7769
New Zealand	+64 9 357 5876

Asia

China	+66 10 6518 8938
Hong Kong	+852 392 21888
India	+91 22 4230 1200
Japan	+813 3512 7272
Korea	+82 2 3705 8500
Malaysia	+60 3 2059 8833
Singapore	+65 6601 0888

macquarie.com/mef