

# Strategic Advisory

## Six modern myths about IT leasing

A number of factors in the world of commerce and government have worked together to change both the operational and financial landscape of information technology management. Increasing penetration of IT functionality into every sphere of business and consumer experience, when coupled with rapid change within the IT arena itself, create strong forces on the financial structures under-girding the financing of IT assets. Increasing government regulation and reporting requirements have added new layers of cost and complexity to our IT management challenge.

One of the results of this technological turbulence has been a dramatic change in the very purpose and usage of IT leasing. Much of the older conventional wisdom has become myth, while new, more operational approaches to lease versus buy are coming to the forefront of management decisions.

This paper examines six IT myths sometimes still being held as conventional wisdom.

## IT leasing is only for companies who cannot afford to buy

Actually, that this is a myth should be obvious from the widespread existence of non-IT leasing. Many large and financially sound companies lease automotive fleets, airplanes, buildings, furniture, land, and many other forms of durable goods. These Fortune 1000 companies obviously could afford to buy these assets, but choose to lease instead.

Similarly, the same can be said relative to IT assets. Firms such as AT&T, Aetna, Liberty Mutual, ADP, CSX, EDS, Mitsubishi, National Semiconductor, Honda, AOL, Black & Decker, Southern Company, Sunguard, and Hughes Network Systems are just a sampling of the many solid companies who choose every day to lease instead of buy. These companies can certainly afford to buy, but they apply management savvy and financial acumen to investment decisions—and decide to lease in many cases.

Leasing is not only for companies who cannot afford to buy. Instead, it is a tool used by many powerful firms to better realize their business objectives.

## IT leasing is only for companies with high and/or unfavorable cost of capital

This is similar to the above and warrants the same type of response. These blue-chip companies have access to some of the lowest cost capital in the market—yet they still choose to lease. What do they know that non-leasing firms don't? What criteria do they use to decide between leasing and buying? A look at their balance sheet reveals that they certainly buy, but they also carefully evaluate the alternatives—and 'cost of capital' cannot be the deciding factor for their decision. There may be many financial factors that go into their

decision, but it is clear that cost of capital is not the deciding factor by a long stretch.

## Buy versus lease models and spreadsheets tell the whole story

Most of us are aware that 'pure quant' approaches tell only part of the story, and sometimes don't even tell the most important part of the story. For example, spreadsheets would dictate that we:

- fire all of our experienced workers and replace them with new hires (since the spreadsheets rarely factor in costs of quality, learning curve costs and/or customer relationship benefits)
- outsource all IT functions overseas (since the spreadsheets rarely factor in costs of customer satisfaction and interaction, benefits of IT business unit proximity, and/or organizational learning curve costs)
- everything goes to the lowest bidder (since they cannot reflect the true business benefits of long-term relationships, preferential treatment terms, guarantees, and a highly productive vendor relationship).

In fact, it could easily be the case that in most of our key business decisions, lowest price is often over-ridden by values related to reliability of the supplier and logistics stream, quality of the product, flexibility of the terms, and long-term relationships with a key vendor partner.

While it would be foolish to not run the spreadsheet and equally foolish to ignore its results, the wise decision maker will ask other questions such as: what other factors are critical to the success of this decision and how should those factors be weighted relative to price. Spreadsheets are important, but they can be misleading if interpreted outside the broader business context.

## If leasing costs more than buying, then it's a bad deal

Leasing sometimes costs more than buying, but since the price differential is buying something 'extra' above the product, it is often a better deal than the product alone. 'Buying' is itself a process involving administrative and managerial labor, making it cost more than the simple equipment invoice. The occasional extra cost (generally very small) is used by the leasing company to fund other services or values to the deal.

For example, the incremental cost can be seen as 'buying' end-of-lease flexibility, or remarketing services when the gear is old, or increased bargaining power with the equipment maker, or regulatory-compliant disposal services, or shared investment risk (when the lessor takes an investment position in the asset), or asset tracking systems, or technological advisory services to help make IT choices a little less risky.

It's not that leasing is always 'cheaper financing' than debt or equity—it sometimes is, of course, due to other financial elements such as tax, credits, or debt covenants—it's just that it can be a better business deal for 'getting the job done'. The 'job' is almost always about leveraging an asset for business utility throughout its lifetime, rather than just getting it to the loading dock that first day. In the IT space, specifically, there is a growing emphasis on the non-financial uses of leasing—most of which are 'funded' by a small cost differential above simple product cost.

## We have plenty of cash, so we should buy instead of lease

Allocation of financial resources—cash, credit, and 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 as it is counter-productive to financial goals while it is still in 'cash form' (ie earning no multiple). Cash does, of course, have the massive advantage of being liquid and legal tender, and so is perfect for acquisition transactions of high IRR. What this means, though, is that cash should only be used on 'high and fairly certain' IRR projects: M & A, sales force expansion, new product introduction, market expansion, 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 projects are perfect cases where leasing (rather than the use of precious cash 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-grid and empower all newly acquired (by cash) business capability and function.

## You always get a better lease deal from the equipment manufacturer, than from an independent lessor

As a matter of fact, you actually get a same or as close a deal. It only just looks better because the 'lower rate' is being funded from additional discount on the equipment. Think about this for a second. The equipment maker wouldn't have that much lower cost of capital than your firm or a large independent lessor, would they? Wouldn't their emphasis on new product sales imply that their residual on the equipment couldn't be any higher than the market would allow (and would typically be lower)? Since the equipment vendor is typically a well-managed business, with solid financial decision processes, we know that this 'deal' must be measured against some kind of internal IRR hurdle and risk thresholds too, right? Why would the vendor accept such a loss on the deal? It's because they know from experience they can make it up by additional higher margin sales to your firm in the future. Once they hold the lease, they know they have considerable power over your future architectural decisions. Equipment manufacturers have built a good portion of their success on that knowledge. This is not necessarily a better deal at all—especially when the lease draws near to the end.

Here's an instructive example. Recently, one of the largest systems vendors in the world completed a leasing deal for their largest competitor's equipment. They underbid both the market and their

competitor in terms of the leasing rate, for a multi-million dollar system deal. Without any profits from the leasing/finance stream and without any 'subsidies' from the profit from the sale of the equipment, this systems vendor would incur considerable financial losses from such a deal. In effect, they bought their competitor's equipment thereby helping their competitor's sales and profit numbers, and they stand to lose even more money on the back-end of the lease, when the equipment is returned to them (with little to no resale value).

Think about this—why would a financially savvy firm knowingly incur such a financial loss? The experienced IT executive knows by experience the rationale. When a manufacturer holds the lease, they have considerable ability to influence future decisions, especially end-of-lease directions. This company was investing heavily in being able to 'influence future directions' in ways that would pay back the loss, and eventually net out a profit. The means to do this was to steer the customer (perhaps through the use of 'bundling') in the direction of their brand of hardware and software—whether this was the optimum architecture or not.

## Conclusion

The world of IT leasing has changed and continues to change. Tech refresh cycles are shortening, rather than stabilizing. New software capabilities for servers and server clusters are emerging. New opportunities for business empowerment and support are arising.

IT leasing is no longer a straight-forward spreadsheet decision, but is rather more like an alternative tool on the financial manager's and IT manager's tool belts. As many well-heeled corporations demonstrate daily by their use of leasing, this tool can be effectively utilized by the savvy

manager, in ways that optimize use of premium resources (such as cash) without compromising the ability to grow the IT infrastructure to support the business.

The savvy financial manager today will critically think through these myths and re-architect the decision process and decision criteria for future lease versus buy situations in the IT arena.

At Macquarie Equipment Finance, we stand ready to assist you in evaluating these options and in helping you realize the operational benefits of IT leasing to achieve your organizational goals and mandates.

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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

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