business
Services Wales

a guide to asset finance options

Asset Finance

This where you can find out all you need to know about asset financing, it's options and which is best suited to you specifically. It's not an exhaustive guide but does cover the main points. It takes a little time to read through this one, but it's worth it as it will give you a very good idea of what type of leasing schedule is just right for you and your circumstances....

Overview

Paying cash for an asset can be a significant drain on your working capital. Leasing the asset, however, gives you access to the asset without paying for it all at once .
All forms of leasing are basically rental agreements giving you (the lessee) the right to use an asset owned by the lessor (finance company) for a specific period of time in return for regular payments (rental payments). You can lease almost anything , from equipment valued at a few thousand pounds to assets worth millions. Leasing contracts are flexible and can be tailored to your needs.

When leasing, consider its effects on accounting, reporting, tax, and your cash flow. This section will give you a general overview. It does not replace professional advice. You may wish to consult your accounting and tax advisors before finalising a lease transaction to reap the maximum benefit and avoid complications.

How It Works

There are many types of leasing but, fundamentally, all fit one of two categories :

Direct Lease . You identify the asset (and negotiate the price) and arrange for the leasing company to buy it from the manufacturer (if new) or the previous owner (if used) to rent it to you.

Sale-and-leaseback (also called purchase leaseback). You sell an asset you already own to the leasing company for fair market value or book written down value (whichever is less) and then lease it back.

In both cases, the lessor owns the asset , not you, and rents it to you. As with any other rental agreement, you return the asset at the end of the lease to the lessor.
Some leases grant you an end-of-lease option to renew the lease at a minimal cost (secondary period) or to sell the asset to a third party as agent of the lessor.

Often equipment manufacturers themselves act as lessors or have an affiliated leasing company. This allows them to more easily help their customers finance transactions. The other two groups of lessors are banks and independent leasing companies.

Types of Asset Finance

We can generally distinguish three major types of leasing: finance leasing , operating leasing and contract hire . Although strictly speaking not a type of leasing, we also include hire purchase in the following discussion:

Finance Leasing (Full Payout Lease). You effectively acquire all financial benefits and risks without actually acquiring legal title. The leasing rate is computed to collect the full value of the asset (plus finance charges) during the contract period. At the end of the lease, the asset is sold to a third party and you can receive a share of the sale proceeds (if the lease is not being extended). Generally, you will not be able to become the owner of the asset at any time - unless a private arrangement is made with the third party. However, you usually have the option to extend your lease and as you will have paid for almost the full value during your initial lease period, the rental payments for subsequent periods will be minimal (sometimes referred to as "peppercorn rental").

Operating Lease . Often with a shorter time frame than financial leasing (always significantly shorter than the working life of the asset), operating leasing is more like a regular rental. The lessor expects to be able to either sell the asset in the second-hand market or to lease it again and will therefore not need to recover the total asset value through lease payments. There may be an option to extend the leasing period at the end (this negotiation can only take place at the end of the initial rental period). As with finance leases, you will not be able to become owner of the asset at any time but, contrary to financial leases, you will not share in the sale proceeds.

Contract Hire . A form of operating lease (often used with cars and other vehicles) that includes a number of additional services such as maintenance, management or replacement if asset is in repair.

Hire Purchase . This is an agreement for the hiring of an asset with an option to purchase. The legal title will pass to you when all payments have been made. The term of a hire purchase must be significantly shorter than the working life of the asset. You are able to claim capital allowances as if you had purchased the asset outright, gaining immediate use of it. Hire Purchase agreements are typically written for domestic users, not so much for business users.

End of Lease Options

At the end of the lease term, you have various options . Lease contracts can stipulate that you

return the asset ;

have the right to act as an agent to sell the asset to an independent third party; and/or
can renew the contract or enter into secondary periods.

It is important for you to anticipate your future needs as each option has its advantages and disadvantages and will affect your monthly payments.

Seek the assistance of a professional advisor if you feel you need help!

Choosing the Right Type of Finance

All types of financing offer different advantages and it is important that you assess your circumstances and needs before committing to a specific finance contract.

For example, if you

want to own the asset straight away, an outright purchase (cash or loan/overdraft) might be appropriate;

may want to own the asset at some point in time and want to take advantage of instalment payments, hire purchase might be the best option;

do not want to own the asset at all but require it for most of its useful life, consider a financial lease; and require the asset for a period of time significantly shorter than the useful life of it, consider an operating lease.

Advantages

Better Cash Flow . Leasing gives you access to the asset with minimal up-front payments and spreads the cost over time. You to pay for the asset with the income it generates while minimising the drain on your working capital.

No debt . An operating lease preserves your credit options and does not influence your credit limit as it is generally not classified as debt but as expense
(note that this advantage does not apply to finance leases!).

Maximise Financial Leverage . Your lease can often finance everything related to the purchase and installation of the asset and may free up cash flow to pay for items such as training.

Simplified cash flow management . Lease payments are usually flat, making cash management more predictable and easier than with a variable rate loan.
The fixed interest rate of a lease also helps if interest rates rise.

Tax advantage . Operating lease payments are generally tax deductible just like depreciation charges but are made with pre-tax money. Cash purchases, in contrast, are made with after-tax money. Hire purchase agreements allow the lessee to claim capital allowances.

Flexible time frames . Leasing contracts can be structured to fit your requirements. Use an asset as long as you need it without owning it forever.

Hedge against obsolescence . Depending on your end-of-lease option, just return the asset to the lessor. You will not have the hassle of selling the used asset or run the risks related to residual value and (technical) obsolescence.

Additional advantages . Some leases offer additional advantages such as cancellation options or asset maintenance.

Disadvantages

More expensive . A finance lease is usually more expensive than an outright cash purchase as the payments include finance charges. However, leasing may cost less than other forms of financing. Also consider the tax advantages when making this calculation.

Additional Guarantees . Depending on the credit rating of your company, the lessor might require additional guarantees. These may be provided by you, your partners or your bank and could affect your personal credit rating or your standing with your bank.

Fixed Term . It may be impossible, or at least costly, to terminate a leasing contract early.

Fixed Interest Rates . Interest rates are usually fixed throughout the lease which may prove a disadvantage in times of falling interest rates.

Things to Watch out for:

Return of Asset Conditions. If you choose to return the asset at the end of your lease, the condition in which and the place where it must be returned are important aspects to consider carefully.

Notice Period. If your lease includes the option to renew take note of any time periods in which to give notice in case you do not want to renew the contract. Some leasing companies will automatically renew the contract if you fail to give notice.

Purchase Rights. If negotiating the right to purchase the asset at the end of your lease, a predetermined fixed price offers more value as the 'fair market value', which theoretically is always available to you.

Maintenance Responsibility. Clarify which service and maintenance programs are included in the lease. If you are responsible for service and maintenance, make sure you do not have to provide an unreasonably high degree of it.

Frequently Asked Questions (FAQs)

What kind of equipment can be leased?
lease almost anything, from equipment valued at a few thousand pounds to assets worth millions.

What is the lease rate or payment?
It is the regular "rental" payment you make under the lease agreement to gain access to the asset. The lease rate or payment is primarily determined by the total cost of the asset, the duration of the lease and the interest rate level.

What is the lease term?
The period of time you agree to rent the asset from the lessor.

Glossary

Direct lease . You identify the asset (and negotiate the price) and arrange for the leasing company to buy it from the manufacturer (if new) or the previous owner (if used) to rent it to you. (see also sale-and-leaseback)

Economic life (useful life). The period of time during which an asset has economic value and is usable.

Fair Market Value . Price at which an asset is sold and bought in the open market.

Lease . A lease is a contract in which the lessor purchases the asset selected by you and conveys the use of an asset to you for a specific period of time at a predetermined rate.

Lease Rate . The periodic rental payment to the lessor for the use of the asset. The lease rate is primarily determined by the total cost of the asset, the duration of the lease and the interest rate level.

Lessee . The lessee is the user of the asset being leased, i.e. you.

Lessor . The lessor is the party who has legal or tax title to the equipment, grants the lessee the right to use the equipment for the lease term, and is entitled to the rentals, i.e. the leasing company.

Master lease . A contractual arrangement which allows you to lease other assets under the same basic terms and conditions without negotiating a new contract.

Purchase option . A provision by which you have the right to purchase the asset at the end of the lease term, either at a predetermined amount or its fair market value.

Residual value . The resale value of the asset at the end of the lease.

Sale-and-leaseback (also called purchase leaseback). You sell an asset you already own to the leasing company for fair market value or book written down value (whichever is less) and then lease it back (see also direct lease).

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