

WHITE PAPER

Revisiting the Lease Versus Purchase Decision

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IDC OPINION

In today's environment of historically low interest rates, is leasing still a viable alternative to the outright purchase of information technology (IT) assets? IDC believes that in many situations, technology leasing offers greater operational, strategic, and financial benefits than outright ownership. Leasing makes it possible for companies to acquire up-to-date equipment while preserving cash and credit lines for more strategic business uses such as facilities expansion, increased research and development, sales force expansion, or receivables financing. Leasing has a lower impact on budgets than purchasing and therefore provides companies with the opportunity to realize operational savings and productivity improvements in a more timely manner. Finally, leasing provides a hedge against obsolescence, facilitates upgrading, and assists in the disposal of old equipment.

SITUATION OVERVIEW

Continuous improvements in all areas of technology are providing IT managers with numerous opportunities to reduce corporate operating costs and increase productivity. Additionally, increased business activity from a revitalized world economy requires greater capacity and performance as well as new technology investments. This situation, combined with a highly competitive business environment, requires organizations to continually investigate the operating and productivity benefits available with the latest advances across the entire spectrum of technology — application software, servers, storage, networks, and desktops.

All businesses prefer to spend their capital on investments that will provide a directly measurable return, such as new product development or a new, more efficient distribution center. IT may be seen as a financial burden because technology, which may compete for the same capital investment dollar, is expensive and quickly depreciates in value. Conversely, insufficient capacity or inefficient computing resources can stunt growth. The company that waits until it can afford to purchase the right hardware and software may find itself unable to remain competitive. Moreover, although businesses would rather keep their credit lines open for unforeseen events, they must sometimes act quickly to adopt economically attractive new technology.

Technology leasing by independent third-party leasing companies became popular in the 1960s and continues to help corporations of all sizes today. Manufacturers such as IBM recognized the importance of offering financing alternatives to their customers, and as a result, many began offering two- to four-year term leases in the 1970s. IBM Credit Corporation (ICC) was established in 1981 as a wholly owned subsidiary to provide added flexibility and more efficient single-management focus on the financing of installment payment agreements offered by U.S. marketing divisions. ICC has evolved into IBM Global Financing (IGF), which provides a wide variety of financial programs and services for both IBM and non-IBM technology assets on a worldwide basis. IGF offerings cover all aspects of technology financing and asset management services, from short- and long-term leases for large servers and peripherals to desktop management services, while specialized services provide inventory financing for IBM Business Partners and complete project financing for major technology implementations on a global basis.

With technology leasing approaching its 50-year anniversary, there are obviously many satisfied users. Before we examine the attributes that make leasing attractive to so many companies, however, we need to review the generic types of lessors in the market and the two most common types of leasing arrangements.

Lessor types. Three general types of lessors are involved in the financing of IT assets: captive, independent, and bank.

- ☒ A captive lessor is a subsidiary of a manufacturer, and its primary purpose is the financing of its parent's products. Thus its major business objective is to assist the sales process. With intimate knowledge of the equipment and its capabilities, a captive lessor is heavily involved in product transitions, upgrades, and remarketing of older systems.
- ☒ An independent lessor is not associated with a specific vendor and therefore finances equipment based solely on its merits and the financial strength of the lessee. An independent lessor may be a small or large, regional or global, and privately held or publicly traded company. Frequently, an independent lessor will specialize in certain types of assets or provide custom financing programs for specific vendors.
- ☒ Bank leasing organizations cover a broad spectrum of the market, from regional to nationwide in scope. They may provide an alternate funding source primarily for their parents' clients, or they may target specific markets or assets. Like an independent lessor, a bank leasing company may also provide vendor-specific financing.

Lease types. Although many variations of lease financing are available, potential lessees should be familiar with two general types of leases: the full payout lease and the fair market value (FMV) lease. The choice of lease is based upon the lessees' long-term plans for the asset involved.

- ☒ A full payout lease is one in which the present value of the payment stream equals the acquisition cost of the asset. Options at the end of the lease typically include return, renewal, or purchase — often for \$1. The lessee is able to deploy and utilize the equipment, while the periodic payments of the full payout lease ease the financial burden of making a large IT acquisition. This option is a good choice when future ownership is desired, the dollar value of the equipment is substantial, the expected productive life of the assets is longer than five years, and the flexibility of spreading out payments would be an advantage.
- ☒ An FMV lease derives its name from the options available to the lessee at the end of the lease should the lessee wish to retain the equipment. In addition to termination, the lessee has the option to either renew or purchase the assets at the then FMV of the equipment, which is often determined by an independent party. The lessor retains ownership during the lease term, while the lessee is entitled to the use of the technology during that period, with the payments considered operating expenses in most cases. FMV leases represent a very high percentage of all technology leases due to their lower monthly costs and operational advantages.

What factors should today's technology buyer consider when determining the correct acquisition method for new technology?

WHY LEASE?

Independent of the size of organizations, how businesses handle the expense of IT hardware, software, and services is often a determining factor in when and whether they can acquire the new technology necessary to sustain business growth while improving productivity. For smaller organizations, an expenditure of \$1 million for a server and storage upgrade may have to compete for the same budget that would fund a sales force expansion designed to increase revenue. Larger corporations may weigh the relative merits of a \$20 million distribution expansion against a corporatwide IT infrastructure upgrade providing significant operational savings. Due to its inherent flexibility, leasing offers innovative ways to acquire IT equipment that can reduce much of the risk and uncertainty associated with new technology purchases and increase the leverage of the operating budget.

Although the full payout lease and a traditional financing/payment model share similarities, the FMV lease offers end users some unique benefits beyond spreading out hardware payments. What are those potential benefits?

Conservation of capital. A major benefit of leasing is that it allows a company to conserve capital for investment in its business rather than in the infrastructure required to run it. Unlike other methods of financing, leasing does not typically involve up-front commitment fees or require down payments or deposits. Additionally, many organizations are subject to regulatory requirements regarding the financial liquidity of a percentage of their asset base. In these cases, leasing allows a company's assets to be invested in fluid financial instruments rather than in hard assets, which are typically difficult to convert and illiquid.

The majority of FMV technology leases are written in such a way as to qualify under approved accounting standards as operating leases. Although operating lease obligations are typically footnoted on a company's balance sheet, the present value of the future rental stream is not included as a liability. Further, the leased equipment is not included as an asset. Due to the combination of these factors, in many instances a lease may have little or no impact on a company's ability to borrow, and it could improve key financial measurements such as a company's return on assets or debt-to-equity ratio.

Payment flexibility. Lessors provide payment flexibility tailored to the user's specific cash flow or budgetary requirements. Frequency of payment may be monthly, quarterly, semiannually, or annually, with payment dates either in advance or arrears. Lessors can also provide payment and term flexibility tailored to match either project or revenue-generation milestones. Additionally, unlike a flat depreciation schedule or typical purchase financing, a lease can provide stepped payments, which either increase or decrease at specific times. An example of this payment flexibility would be financing a project that had a significant start-up period prior to revenue generation.

The purchase of assets often requires payment on delivery, at installation, or within 30 days. As a result, a user may incur out-of-pocket expenses many months in advance of the productive use of the asset. With a lease, a user can defer the start of the payments until the equipment is fully operational — often for 90 to 180 days after installation. Further flexibility may be gained through a payment deferral option, which provides companies with the opportunity to delay payments for equipment until it can be put into a revenue-generating position. Although such deferrals will typically result in a higher lease rate, reflective of the costs of funds during the deferral period, they also allow companies to more closely manage expense recognition. In addition, some captive lessors may offer this option with the costs borne by their parent, not the lessee.

Operational flexibility. An FMV lease term can vary from a few months to four or more years, depending on the asset class involved. Corporations, however, depreciate most major new assets over five years, in contrast to shorter lease terms. By contrast, technology moves in two- to three-year cycles. Leasing provides the user with the opportunity to take advantage of technologies' two- to three-year cycles of performance increases while paying for only the expected reduction in value during the term of the lease. Leasing enables the user to take advantage of the continually improving price/performance curve rather than being locked into equipment that might become obsolete before it is fully depreciated. Many organizations that routinely use leasing find that it provides a flexible, cost-efficient vehicle to fund new projects.

Upgrade flexibility. Leasing can provide additional flexibility when normal growth or new demands require the user to consider upgrading an asset. Where additional capacity or performance can be added directly to the original equipment, a lease can frequently be tailored to provide a predetermined periodic cost for the upgrade, based on the remaining finance term at the time of the upgrade. If physical replacement of the original asset is required, the lessor will often work with both the manufacturer and user to provide an optimum finance solution for the upgrade. Both of these upgrade scenarios can be addressed at lease inception, if the lessor is a finance arm of the manufacturer. Upgrade provisions can be negotiated that define upgrade costs in terms of cost per unit of capacity and performance. An example would be additional storage capacity financed for a guaranteed \$/MB per month cost based on the timing of the upgrade.

Changing requirements. When circumstances change and the lessee finds it advantageous to keep equipment longer than originally anticipated — either from a requirements or operational perspective — the lessee has the option to renew (often at a reduced rental rate) or purchase the equipment at the end of the lease at market prices. Conversely, lessors are always willing to entertain midterm upgrades or replacements, if business volumes justify this action.

Companies also encounter situations in which equipment is required for a relatively short period of time (6–24 months) and leasing may be the only economically viable way to acquire the equipment. Examples include situations in which a user needs equipment to fulfill proof-of-concept requirements, interim equipment prior to a major new deployment, or temporary equipment necessitated by a natural disaster. In such cases, the lessee is best served by utilizing a lessor with remarketing expertise in the class of assets required. An economically attractive short-term lease is a direct result of the lessor's ability to capitalize on the accuracy of the projected value at the end of the lease.

Residual value risk. Leasing transfers the risk of obsolescence to the lessor while allowing the lessee to benefit from the use of the technology at a predefined cost. With a wide variety of vendors, configurations, and lease expirations, a typical lessor's technology risk is spread across a broad spectrum of clients. When this portfolio diversity is combined with an efficient remarketing operation, the lessee benefits further — initially with a lower lease rate and later with an efficient source of additional capacity. In contrast to the lessor's large, diversified portfolio, most end-user buyers of technology have a great deal of concentrated remarketing risk as a result of standardization on a single technology and single supplier for a given solution. Few users of technology have developed a core competency in equipment remarketing because it is not core to their business. The lessor, on the other hand, is clearly in a better position to assess, manage, and absorb the residual asset risk associated with a technology acquisition.

WHY PURCHASE?

Having looked at the financial and operational advantages of leasing, we now consider under what set of circumstances a purchase would be the best business decision. Organizations that historically purchase IT assets often cite a number of reasons that typically focus on the following areas: 1) the projected productive or useful life of the asset is longer than economically viable leases, 2) purchasing is simpler, and 3) previous leasing experiences have ended badly.

Each reason may be valid at a given point in time; however, further consideration of these objections shows that they are not always valid.

Useful life considerations. In some instances, the user determines that the useful life of an asset in his or her environment is long enough to make a purchase attractive. This is typically the case when the lease versus buy financial analysis points to buy. An example would be the installation of a new system for a specific project. The technology may be robust enough that a five- to seven-year operational life can be reasonably projected. Additionally, some assets offer the potential for significant upgrades in performance or capacity in excess of projected business needs. In these cases, a purchase may be the correct economic and operational decision. However, in the scenarios above, a well-positioned captive lessor may offer an equally attractive FMV lease alternative.

Finally, previous experience may influence the estimate of the life span of equipment. An example would be the replacement of fully depreciated equipment that has been used longer than originally anticipated. Although fully depreciated equipment is often considered to be free, it usually is not. When high maintenance costs, operational issues, and facility costs (space, cooling, power) are considered, this "free" equipment is often more expensive than new replacement equipment that utilizes lease financing.

Easier to purchase. A busy IT staff may find it easier to put together a requisition to simply purchase an asset. Assuming a capital budget exists for the acquisition, a purchase requires only that the vendor be chosen and a purchase order or contract be executed. Leasing, on the other hand, may require the additional step of choosing a financing source. This can be a time-consuming process, which may include a lengthy contract negotiation and frequently involves other internal groups, such as Finance or Treasury. Some of this additional time may be eliminated if a captive lessor provides the financing, typically in conjunction with the initial proposal. It should also be noted that in cases in which an approved capital budget is not available, a lease with a fixed-price purchase option might allow a needed acquisition to continue.

Previous leasing experience. An issue for many companies may be a past lease relationship that ended badly. There have been numerous situations involving the bankruptcy or change of ownership of a lessor that caused a strain between the lessee and the new portfolio owner. More frequently, end-of-lease issues — especially prevalent in the 1980s and 1990s — have left many organizations with memories of expensive end-of-lease obligations. Misunderstandings concerning end-of-lease notice periods, lease extensions, and upgrade pricing often resulted in significantly higher costs than those for which the lessee had budgeted. Although history can't be changed, these issues can be addressed during contract negotiation. Paying special attention to the lessor's financial condition, references, and administrative capabilities — in addition to the lease rate offered — can eliminate most areas of misunderstanding.

Although a purchase may be the right decision initially, purchased assets may ultimately have an adverse effect on a company's ability to adopt new technology. Replacing a fully depreciated asset may be difficult to justify, or there may be a capital budget deficiency. In contrast, leasing can provide a company with multiple opportunities to take advantage of applicable new technology rather than being held hostage to a depreciation schedule or the approval of a capital budget.

WHAT TO LOOK FOR IN A LEASE PARTNER

To maximize the benefits of leasing, companies should carefully consider the following characteristics of a lessor because they can be as important as obtaining the lowest lease rate:

Financial strength. A lessor's financial strength is important in providing market-rate financing initially and during the lease term because a changing operating environment requires unexpected alterations, upgrades, or early termination of a lease. Whether the lessor is a public or private corporation, current audited financial statements should be reviewed prior to any major financing partner selection.

Technology expertise. Although most lessors offer financing across a broad range of vendors and equipment classifications, their expertise is usually greater in specific areas — such as servers, telecom, or networking. Remarketing strength in the asset class to be leased can not only lower the initial lease rate but can also provide a source of economical upgrades and capacity expansions.

Terms and conditions. Leases from all sources contain common language regarding obligations, default, representations, and warranties. Flexibility can and often must be negotiated in areas such as notice periods, renewal terms, upgrade options, and return provisions. In some cases, the right of limited substitution may be negotiated, while in other cases, advantageous upgrade provisions may be more important. The lessee should determine what flexibility is most important and communicate this need to the lessor. Flexibility is seldom free, but it may be an operational necessity.

Administration. The ability to administer multiple lease schedules easily, ideally through a Web interface, becomes increasingly important as the volume of equipment and locations multiplies. Detailed information by schedule, lease start and end date, notice period, and location is invaluable in managing a leased infrastructure.

Although the preceding list is not all-inclusive, it represents the major areas that companies should consider prior to entering into a business relationship with a new financing source or when contemplating leasing a new technology.

IGF AS A LEASE PARTNER

When the financial, operational, and technology issues surrounding the financing of technology assets all point to a lease, why should IGF be selected as the lessor?

Financial strength. As one of the largest financing organizations in the world, IGF has the capability to provide competitive rates either in international currencies, such as the dollar or euro, or in local currencies. With an investment-grade credit rating, IGF obtains funds at below market rates, which results in lower lease rates for the user. But a leasing company must offer more than low rates, and it is in this value-add area that IGF stands out.

Worldwide scope. IGF offers direct leasing services in 42 countries around the world and several financing products for multinational customers. Offerings include:

- ☒ International Lease and Finance Agreement (ILFA) is available for larger customers that require a single set of terms and conditions. (These would cover the basic conditions found in the Term Lease Master Agreement or TLMA.)
- ☒ Asset Manager solutions are available in Europe, Asia/Pacific, and North America that enable customers to centrally manage their global leasing portfolios on a country, regional, or global basis.

Additionally, IGF financial sales executives, who cover multinational corporations' headquarters, act as the coordination points for multinationals with centralized operations.

Contract flexibility. IGF offers a variety of lease structures and payment terms that can be tailored to any situation. Payments may be structured on a monthly or quarterly basis, and they can be either level or stepped in a manner to match anticipated revenues. Each line item on a lease schedule can be handled separately at the end of the lease — renewed, purchased, or returned — eliminating the inflexibility of the all-or-nothing approach. In addition to FMV leases, IGF offers \$1 buyout options as well as special financing for IBM's On Demand offerings. Finally, IGF's standard master agreement includes casualty insurance in the lease payment, eliminating an additional complexity for the lessee.

Special programs. A major benefit of dealing with a captive lessor is its ability to offer programs designed to enhance its parent's product offerings. IGF provides a wide variety of options across a broad range of hardware, software, and services offerings. These options can include predetermined upgrade/expansion costs, significant midlease flexibility, and special low-rate financing offers. Recent offerings have included deferred payment options, zero percent financing, and rebates for leasing certain types of equipment. Specialized desktop offerings are also available that provide per-seat pricing and can include a wide variety of specialized support and asset disposition services.

Administrative capability. IGF offers lessees the opportunity to manage their portfolios online using the IGF Customer Centre lease management tool. This On Demand business tool supports clients managing their leased asset portfolio from origination to end of lease. It is available on a worldwide basis, with 24 x 7 access using common Web browser software. The Customer Centre provides access to a database of leased assets and includes a complete repository of information for each schedule under lease. Activities such as end-of-lease information reviews as well as available options are presented. Additionally, in some instances, equipment schedules can be originated and an installation acceptance can be generated online.

Portfolio expertise. With a portfolio consisting of equipment from IBM and other vendors, IGF has developed unique remarketing capabilities that maximize the value of returned equipment and are manifested in lower initial lease rates for new acquisitions. These capabilities include the ability to offer refurbished equipment to users and IBM Business Partners desiring a more cost-efficient solution. With unsurpassed engineering capabilities, IGF can offer hybrid (mix of new and used) systems, field upgrades, and spare parts with equal proficiency.

Asset recovery. Through its Global Asset Recovery Services (GARS), IGF offers the lessee the option to transfer the burden of complying with environmental and regulatory issues surrounding the disposal of obsolete computer equipment. GARS manages a world-class reverse logistics operation that optimizes the resale, dismantling, and reduction of IT equipment to its basic commodities for recycling. Anything of value, from components such as disk drives to resources such as precious metals, is removed to be sold. The remainder is disposed of in compliance with state, local, federal, and Environmental Protection Agency (EPA) guidelines.

CHALLENGES

Although leasing has many potential benefits — conservation of capital, payment and term flexibility, and the flexibility to obtain the benefits of new technology on a regular basis — issues exist that could negate some or all of these benefits. IDC feels special attention should be given to the following:

Unanticipated costs at end of lease caused by missing a termination notice, lost or damaged (incomplete) assets, and so on. A frequent complaint of lessees is that they experienced higher-than-anticipated charges at the end of the lease. In some cases, these charges are incurred because the lessees missed the notice period (often six months prior to the termination date) or because they were required to renew unwanted items due to their placement on a particular lease schedule. Another issue frequently encountered is the lessees' inability to return the leased asset because of operational considerations.

IDC believes that many of the issues outlined above can be mitigated or eliminated by a more in-depth analysis of a lessor's administrative capabilities. The lessee's ability to monitor and manage its lease portfolio with lessor-provided tools should be a prerequisite to entering into a new relationship. Where possible, provisions should be included to address the lessee's operational inability to return an asset — either through substitution of a comparable asset or a predetermined reasonable casualty value.

Poorly negotiated terms and conditions may result in unacceptable operational or financial consequences, either during the lease or when an unanticipated change is required. Some potential problem areas include the financial consequences of an early termination, change of lessor management control, or higher-than-projected upgrade costs. In many cases, these issues are left intentionally vague by both parties, with sometimes disappointing consequences.

Careful attention to these areas can minimize or eliminate unexpected costs. In the area of upgrades, for example, pricing factors should be included in each schedule that contains upgradeable equipment, defining the monthly cost of the upgrade based on the number of months remaining on the original term.

As a lessor, IGF has worked to mitigate these risks by providing the following in the normal course of business:

- Line-item termination, renewal, or purchase options at the end of the lease, combined with a 30-day notification period
- Assured upgrade pricing and availability
- A 14-day grace period at the end of the lease, providing the lessee with additional operational flexibility in managing an asset's return

As with any major business decision, a thorough understanding of the risks and their potential costs is most valuable when undertaken during the negotiation phase of an acquisition rather than in crisis mode.

CONCLUSION

Significant nonfinancial issues should be considered at the same time that the more traditional lease versus buy financial calculation is made. Leasing can provide additional operational flexibility, offer an easier migration path to new technologies, and eliminate asset disposition issues at the same time that it frees up capital for other critical business investments. Leasing is a particularly good solution when there is a business need for rapid technological change either to grow or to remain competitive or when an organization is downsizing or reorganizing.

Both large and medium-sized businesses can benefit from leasing because it makes the use of new technology more affordable on a limited monthly budget. Fast-growing companies that do not have extensive credit histories may be able to acquire equipment quickly utilizing a lease. With the continued emphasis on operational efficiency and improved productivity, leasing offers companies of all sizes a solution for acquiring new technology at minimum operating costs.

Although not the ideal solution for every acquisition, leasing should be considered during major application implementation reviews, operational reviews, or new technology assessments.

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