Lease Financing: 
An Attractive Method of Financing 
For Small Firms 

Oswald D. Bowlin*
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*Professor of Finance, Texas Tech University.

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LEASE FINANCING: AN ATTRACTIVE METHOD OF FINANCING FOR SMALL FIRMS

I. Introduction

The leasing of assets by business firms has grown rapidly during the past decade. As a result, leasing has become one of the more important methods of financing in the United States. In a study completed in 1980, Paul F. Anderson estimated that approximately 20 percent of new acquisitions of capital goods in the nation were being financed by leases. Although hard data are not available specifically for small firms, the evidence indicates that they too are making significant use of this method of financing.

Economic conditions since the early 1970's have been the most important factor causing the growth in asset leasing. Inflationary pressures during the period precipitated a "credit crunch" which severely limited to availability of external funds at tolerable costs for many firms. High interest rates and the lack of direct access to long-term capital markets have created a major problem for the growth and well-being of small firms. Because these firms are restricted to a relatively small trade area, they also have limited access to intermediate-term funds from banks and insurance companies. The opportunity to lease needed assets has provided some relief from these financing limitations. Continued growth of the leasing industry and the aggressiveness of lessors in tailoring their services to fit the needs of individual firms will doubtless be of great benefit to the financing of small business in coming years.

The objective of this paper is to examine the attractiveness and benefits of lease financing to the small firm. The study is theoretical in nature.
since sufficient data for an empirical investigation are not currently available. However, the attractiveness of leasing can be inferred from an examination of the nature of leasing vis-a-vis the financing needs of small firms.

II. The Justification of Leasing as a Method of Financing by Small Firms

From a theoretical point of view, the only economic basis for leasing assets are market imperfections. In a perfect market, the lessor would be an added market participant—a middleman—who demands a return but who adds no positive economic function. Thus, leasing could not exist as a method of financing assets. But market imperfections prevail in the real world, and asset leasing has become an important and rapidly growing financing method for firms of all sizes.

Income taxes appear to be the major market imperfection stimulating the use of the lease in most cases. If a lessor has certain tax advantages which the lessee does not have, the lessor may be able to pass on some or all of the tax benefits to the lessee, with the result that leasing will sometimes become the lowest cost method of financing. However, the effects of other imperfections in the market may also be sufficient to offset the expense of the middleman lessor. Two factors suggest this possibility. First, in other areas of industry and finance, middlemen often provide the economic function of making the market more perfect. Second, the rapid growth of leasing during the 1970's strongly suggests that the management of many firms, at least, thought that leasing provided advantages other than those caused by taxes. Asset leasing was frequently used by
firms which could have obtained the same or more tax benefits from pur-
chasing the assets.

The primary objective of this section is to examine the possible
benefits of asset leasing from the standpoint of the small firm. Three
areas in which advantages as well as disadvantages can occur will be
considered: cost, risk and convenience. Each of these areas will be
examined separately.

Cost of Financing

The cost of financing an asset is a function of the amount and timing
of the cash flows required for the purchase or use of the asset. In Exhibit
I, the more important factors which can cause a cost difference in leasing
and purchasing are presented in a horizontally-comparative format. The
assumption made in the left-hand column of the exhibit is that the firm
which needs the asset for use in its' operations (frequently referred to
hereafter as the user firm) would finance a purchase by a loan. This
assumption is necessary in order to make the lease and purchase alternatives
comparable in terms of financial risk for the firm. Since the lease is a
debt method of financing the asset, a purchase should also be financed
with a debt for consistency. Note, however, that the lessor may finance
the asset in any manner without affecting the comparability of the lessee's
alternatives.

With the exception of the return required by the lessor, each item in
the lease column mirrors an item in the purchase column in respect to type.
However, the items in the purchase column will affect the cash flows of
the user firm directly, whereas the items in the lease column will affect
the cash flows of the firm only indirectly through the rental payments
required by the lessor. If the size and timing of the cash flows caused
by the equivalent types of factors in the two columns are the same, the
Exhibit 1
FACTORS THAT CAN CAUSE A COST DIFFERENCE IN LEASING AND PURCHASING AN ASSET

<table>
<thead>
<tr>
<th>ITEM</th>
<th>PURCHASE</th>
<th>LEASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Purchase price of the asset for the user firm</td>
<td>Purchase price of the asset for the lessor</td>
</tr>
<tr>
<td>2</td>
<td>Investment tax credit</td>
<td>Investment tax credit</td>
</tr>
<tr>
<td>3</td>
<td>Covenants in the loan contract</td>
<td>Covenants in the lease contract (other than a covenant pertaining to the disposition of the investment tax credit, which is noted above)</td>
</tr>
<tr>
<td>4</td>
<td>Method and rate of depreciation used by the user firm</td>
<td>Method and rate of depreciation used by lessor</td>
</tr>
<tr>
<td>5</td>
<td>Interest on the loan obtained by the user firm to finance the purchase</td>
<td>Expenses applicable to the lessor's financing of the asset</td>
</tr>
<tr>
<td>6</td>
<td>User firm's marginal tax rate on income</td>
<td>Lessor's marginal tax rate on income</td>
</tr>
<tr>
<td>7</td>
<td>Estimated value of the asset at the time the lease would expire</td>
<td>Estimated residual value of the asset at the end of lease</td>
</tr>
<tr>
<td>8</td>
<td></td>
<td>Required return of lessor</td>
</tr>
</tbody>
</table>
return required by the lessor on his investment will result in the lease being the higher cost method of financing the asset for the firm. But the other items will not always be the same. There are many combinations of possible differences in the other items which can result in a lower cost for leasing.

First, consider the possible difference in the purchase price of the asset for the lessor and for the firm. A large lessor may be able to obtain significant cost reductions due to bulk purchases of the asset, perhaps directly from the manufacturer. These savings will not be available to the small firm. This type of situation appears to be fairly typical in some areas, e.g., in the automobile and truck leasing fields. It is not unreasonable to assume that the difference in asset costs to a large lessor and a small firm may often be as much as 20 percent. A 20 percent difference for an asset costing the user firm $20,000 amounts to $4,000, a rather sizeable savings which could be passed on to the lessee over the lease period by reducing the required rental payments.

The second factor in the exhibit which may cause a difference in the cost of leasing and purchasing an asset is the investment tax credit. Since this credit is a direct reduction in income taxes, it can result in substantial savings for the purchaser of a qualified asset. For example, if the cost recovery period for a qualified asset is five years or longer, the tax reduction for the purchaser would be 10 percent of the cost of the asset. An asset which costs $20,000 and which has a recovery period of five years could save the firm $2,000 in taxes. However, a savings will occur only if the firm has a tax liability against which the credit can be applied. In the numerical example, if the firm's taxes for the year are only $1,000, the savings would be only $1,000 even though the firm was eligible for a credit of $2,000. If the firm's taxable income for the is zero or less, the investment tax credit will be of no benefit in a
purchase. However, if the credit is available to a lessor from purchasing the asset, some or part of the tax savings can be passed on to the firm by a lower lease rental. In this event, the cost of leasing may be the cheapest form of financing the asset from the standpoint of the user firms.

Third, covenants in the lease and loan contracts may differ. Important possibilities in this regard (in addition to any covenant pertaining to the investment tax credit in the lease) include prepayment and collateral requirements, maturities of the contracts and rights of the lessee to renew the lease or purchase the asset. It is difficult to generalize about the net impact of all of these factors. For example, a covenant which grants the user firm special privileges may increase the direct cost of the financing in either a lease or a loan, but the net impact may be beneficial if the privileges prove to have economic value. Any covenant which tends to reduce the risk to the lender (i.e., to the lessor in a lease or financial institution in a loan) should reduce the cost of the financing to the user firm.

Fourth, the lessor may be able to obtain cash flow benefits early in the life of the asset due to the use of an accelerated method of depreciation for tax purposes. Since money has a positive time value, the early tax savings will more than offset the higher taxes in the later years of the life of the asset when depreciation expense must be reduced. If the user firm's method of depreciation is less accelerated, the relative cost of leasing will be lowered if the lessor passes on some of the tax savings through a lower rental.

Fifth, the cost of financing the asset may be less for the lessor than for the user firm. This will more likely be the case when the lessor is a large, relatively low-risk firm with a lower cost of capital than a small lessee. The benefit of the lessor's lower cost of financing can be passed
on to the lessee by a lower rental. Note that theoretically, the small firm's risk should be reflected in the lease rental as well as in either the interest charged on a loan or in the cost of any other method of financing the asset. However, this degree of market perfection does not always prevail.

The sixth factor listed in Exhibit I are the marginal tax rates of the user firm and the lessor. A tax deductible expense creates a tax shield (saving) which is equal to the amount of the expense multiplied by the firm's marginal tax rate, the latter expressed as a decimal. If the lessor's marginal tax rate is higher than the marginal tax rate of the user firm, a larger tax shield will be created if the expense is incurred by the lessor rather than by the user firm. In this event, a cost advantage for leasing can result. An example of this type of cost saving will be given with reference to depreciation expense.

Assume that a user firm, A, purchases an asset for $20,000. Assume also that, due to recent losses, the firm is not expected to pay income taxes during the depreciable life of the asset. Thus, depreciation expense will not provide a tax shield if the firm retains ownership. Now assume that firm A sells the asset to firm B, but A retains use of the asset via a lease. If B (the lessor) is profitable and is paying income taxes, depreciation of the asset will provide tax savings. The sale contract can be written so that B will be allowed to depreciate the entire $20,000 original purchase price, even though B pays A less than that amount. Assume that the management of B estimates that the value of the tax savings at the time of the purchase from A is, say, $8,000. In effect, B can pass this saving on to A by a cash payment and/or by lowering the size of A's lease payments.
In most cases, only part of the tax savings will be passed on by the lessor. The above example assumed that the lessee, firm A, was not expected to pay any income taxes during the depreciable life of the asset. However, a lease can provide for tax savings even though the lessee is profitable and is paying taxes. As indicated earlier, savings can be obtained whenever the lessee's marginal tax rate is lower than the marginal tax rate of the lessor.

Finally, a leased asset's expected residual value when the lease expires may be relatively large because of opportunities of the lessor to lease the asset again or dispose of it at a favorable price. Since these opportunities may not be available to the user firm in a purchase, the value of the asset at the time a lease would expire may not be as great. The benefits of the high residual value of the lessor can be passed on to the lessee, lowering the cost of leasing.

The factors discussed above can make lease financing an attractive and beneficial method of financing assets. These effects are particularly important to small firms which typically do not have direct access to long-term capital markets and have only limited access to intermediate-term funds. In addition, the tax savings from depreciation will generally be less for the small firm because of a lower marginal tax rate on income. Thus, the small firm may find leasing to be the only feasible method of financing in some cases; a term loan may be unavailable or more expensive.

Of course, the financing alternative which a firm finds least expensive will depend on the particular set of circumstances prevailing at the time. Leasing may be the cheapest alternative if the economic benefits of ownership available to the lessor, but not to the user firm, are passed on by reducing the lease rental. The passing on of tax savings is only one reason, albeit an important one, for the growing popularity of asset
leasing by both small and large firms.

Risk

Although state laws differ in some respects, a lease is typically somewhat less risky than a loan from the standpoint of the user firm. The lender in a loan transaction often has both a lien against specific assets and a general credit claim against all of the earnings and assets of the borrowing firm. On the other hand, legal recourse by a lessor is usually limited to repossession of the leased asset and a general credit claim against the lessee for the lease payments for only one year. Nevertheless, a finance lease should be considered debt financing by the firm. Financing the purchase of an asset with some form of equity will be less risky since legally-required payments are avoided.

Both the purchase and the lease of an asset involve the risk that the asset will become obsolete due to technological advances. Obsolescence risk may be somewhat less for the user firm in a lease than in a purchase, at least, if the lessor agrees initially to renegotiate the lease before it expires in the event of significant technological advances in competitive assets.

A cancellable lease, such as many service leases, has less financial and obsolescence risks than a purchase financed by a loan. However, since the lessor is faced with greater risks when the lease is cancellable, rentals will be higher for the lessee than in a finance lease. As in most areas of finance, obtaining lower risk results in higher cost and/or lower return.
Convenience

An important noneconomic factor that can affect the lease-purchase decision is the relative convenience of the alternative methods of financing available. For example, a firm may find a lease or conditional sale particularly attractive as a method of financing if the firm will have to deal with only a lessor to obtain the use of the asset. The lessor provides both the asset and the financing in this case, whereas different organizations provide the two functions in a purchase financed by a loan. Lessees also often believe that complaints they have about an asset will be attended to more quickly by a lessor than by a seller of the asset, particularly if the seller has already received his money from the sale when the complaint is made. Routine service of the asset may be better in a lease than in a purchase, unless a service contract is purchased in the latter case. Although the importance of the above convenience factors in a lease-purchase decision depends on the particular set of circumstances prevailing at the time, one or more of the factors have been overriding in many small business decisions.

Lessees often tout leasing as a very flexible method of financing for the firm. According to this position, the lease contract can be specially tailored to fit the needs of the user firm. Flexibility in writing the contract may be an advantage for leasing in some cases, but there is no inherent advantage of a lease in this regard. Bankers may be even more flexible in setting up term loans for good customers.
III. Conclusions

The numerous factors discussed in this paper clearly indicate that leasing frequently offers significant advantages to small firms in their financing activities. Leasing may be less expensive than purchasing an asset because of the particular set of circumstances prevailing at the time. The passing on of tax benefits available to the lessor, but not available to the lessee, is probably the primary cause of cost effectiveness in most instances. Lease financing may also be less risky than other forms of debt financing, although it is more risky than equity financing. Further, leasing will ordinarily be more convenient than purchasing the asset, if the latter involves arranging the financing as a separate step.

The potential cost advantage and convenience of lease financing are of fundamental importance to the small business manager in his financing activities. These two benefits suggest that small firms have participated to a great extent in the leasing boom of the past decade. However, data on the leasing activities of small firms per se are unavailable. These firms were particularly hard pressed to raise needed capital during the period. High interest rates and limited availability of external capital in most cases also would have contributed to small firms turning increasingly to asset leasing. In all likelihood, the factors discussed here will lead to even greater use of lease financing by small business during the next decade.
REFERENCES


FOOTNOTES

1. Anderson also found from a survey of 343 U.S. firms that "...22 percent of the respondents were leasing some portion of their production equipment." [1, p.2]

2. Survey data provided in [2] indicates growth during the past decade in (a) leases of the types of assets used by small firms and (b) the number of small leases.