Lease Vs. Bank

Which Type of Financing Makes More Sense For Your Business?

The first consideration for most executives is evaluating the objective of the transaction. Number one, is it *owning* equipment or *using* the equipment that will be the source of future profits to the business?

"Invest in Assets That Appreciate In Value… Lease (rent) Assets That Depreciate in Value"

It is generally accepted that "owning" business assets is particularly beneficial when those assets *appreciate* in value—real estate being a prime example. Most assets like computers and other office equipment only depreciate in value, in most cases fairly rapidly. When the objective is getting the maximum use out of a (rapidly) depreciating asset, it is that "use" that brings profits to the business, not the "appreciation" of the asset itself. Maximize the use...minimize the investment.

Leasing Make Business Sense and Tax Sense

Most businesses will ***write off 100% of their lease expenses***. Bank loans for equipment must be capitalized and only gradually depreciated over a period 5, 6, 7 or more years! Operating leases can even effectively accelerate those write-offs even faster, putting your cash, into your pocket sooner.

A Complete Solution

A typical lease covers as much as 110% of the equipment cost because it *also* covers the delivery, installation and other soft costs--in addition to the equipment itself. Our leases only require one (or two) month's rent in advance; there is a UCC filing only against the specific equipment leased; and the leasing company won't bother you for the next 3-5 years as long as you make your payments. At the end of that time, just return the equipment (with no further obligation!) and upgrade to new equipment, or the leasing company will sell you the equipment for its then-current fair market value (probably minimal); *and you will have* ***fully expensed the payments for tax purposes*** (unlike a term loan or credit line).

Is That "Prime Rate" Offer a Good Deal?

As you probably know, there is not a single prime rate; rather each bank is free to establish their own "prime" rate—sometimes it is as low as the Wall Street Journal prime, although we've often seen individual bank's prime (their best rates to *their best customers*), set as much as 4 points above the benchmark WSJ-published rates. Lets assume for the sake of this example that your bank has offered you this month's (March '05) WSJ prime rate of 5.5%, "plus 1.5 points."

Let's Talk Rates…

Obtaining a bank loan at such a "low" rate usually requires that you keep 20-30% of the loan amount in non-interest bearing, "compensating balance" accounts *at that bank*. Using the lower 20% figure for example, the bank is really lending you 80% of their money *and 20% of your own money*.

Is It 7%, or 17%?

When you compute the real yield on that 7% loan offer, you find it is actually a 17% loan. (Because you're paying interest on 100% of the loan amount, but have only received 80% of the money *from the bank,* the rest is your own compensating balance being "loaned" back to you). Using the same formula, a 10% compensating balance brings the bank's effective loan rate "down to" 11.7%. Anyway you cut it, that's a far cry from 7%!

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Some executives say, "we keep $10-20,000 in their checking account *anyway…*" Perhaps so. But that's *your* business decision, for your convenience, today. With a compensating balance clause in a bank loan, it becomes *a requirement*. Fall below that figure for any reason *and you are in default on your loan*. Change financial institutions or move to a "sweep" account format for example and again you would be *in default*. It's all in the fine print.

What Else Is In The "Fine Print?"

Plenty. The following is a list of issues that have come up for many of our clients examining the same lease vs. bank decision. Here are some "bullet points" to compare and contrast typical commercial bank terms with First Capital's lease terms. There are many critical differences.

"Bank Fine Print 101:"

- Bank line rates *float* with interest rates
  - ◊ **Lease rates are *guaranteed fixed*** for the tem of the lease
  - ◊ Short-term rates are low now, but on their way up—where will they "float" to during the next 12, 18 or 24 months?

- Do you have an existing line of credit at the bank?
  - ◊ What effect will a new loan have on the cash available under your business line, for special business opportunities, emergencies etc.? (In most cases your total access to funds will be *reduced*)

- Is the bank actually offering a credit line or a term loan? There are many key differences:
  - ◊ Most banks require that credit lines be brought to zero at least once every 12 months. They want to reserve the option to call the line should your industry start to "go south," or if the regional economy, or your own business prospects start to "soften" (In *their* sole opinion).
  - ◊ Where would you be if the bank elected *not to* renew in 12 months?

- Banks typically do not fund more than 75-80% of the net hard equipment cost.
  - ◊ Our lease can cover as much as 110% of the cost as, unlike your bank we *will* include shipping, training, installation, initial maintenance and other "soft" costs.

- Banks are far more restrictive than leasing companies, about the equipment they will finance.
  - ◊ Many banks will only do "hard" collateral (machinery, etc.) First Capital will lease all kinds of business or commercial equipment, even 100% software transactions.
  - ◊ Most banks will not even consider "used" equipment. We do it all the time!

- The bank will place **a "blanket lien" on *all* of your assets**.
  - ◊ Our UCC will be filed on *the leased* equipment ONLY. Nothing else is encumbered. None of your financial flexibility will be compromised.
  - ◊ Keep in mind that if the bank were to decline to renew your line (at any point in the term) that those "blanket liens" *would still be in effect,* blocking your attempt to use your own assets as collateral for any new (replacement) funding.

- Most banks require ongoing financial disclosure. Make no mistake about it, with a bank line **you have a new "partner."** Almost every bank will *require* you to submit annual or quarterly financial statements and/or tax returns *for their review*. Further, bank loans are often conditioned on your maintaining certain bank-specified key financial ratios. Working capital tests, debt-to-equity, current and quick ratios are commonly used and specified.

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- ◊ Will this hinder your ability to run your business, *as you deem prudent?*
- ◊ It is routine for banks *to restrict your access* to any new debt obligations *from any other sources* without their express consent—and you cannot assume that you will receive it.
- ◊ If you fall below the bank's mandated ratios, *you* will be in default.
- ◊ There are absolutely no financial reporting requirements with a First Capital lease.

- The bank will likely require you to cross-collateralize *any new obligation* with all of the accounts you maintain at that institution—personal checking, savings, trusts etc. (this is often buried in the fine print)
  - ◊ Your lease with First Capital is a freestanding obligation.

- Even if you are not signing "personally" for *this* obligation with your bank, you may find that any previously signed, personal guarantee is deemed "continuing and unconditional" vis-à-vis all new obligations at that same institution.

- Banks fees and closing costs typically run 1-4% of the transaction amount. These fees can have a significant effect on the real interest rate you are paying. Ask for a copy in writing before you sign…and do the math.
  - ◊ First Capital's *only* fee on a transaction under $50,000 is $150. ($350 for larger amounts)

- Are you a "key customer?" That may sound flattering, but it usually means that the bank is extending its offer based on your "entire banking relationship"—your other accounts, the other balances that you maintain *and* the service fees/income that you generate for them.
  - ◊ It also means that you are tied to that bank exclusively for the term of the loan. If you move accounts and/or services, your rates will almost certainly jump up--way up. Not sure? Ask the bank specifically about this.

- Are bank-mandated "compensating balances" your best use of your own cash and operating capital? Where else could those funds be working (earning) for you, if they were not "committed" to the bank line?

- The bank can call your loan! There is probably a clause that permits the bank to call your loan if they feel "uncomfortable" about the prospects for your industry, *without regard to your payment history.* (This too is often buried in the fine print. Check it out.)

- Merger Mania—Banks are "merging" and restructuring *all the time*. Your bank may be purchased by another bank. The surviving bank might have different lending criteria or may not like your industry, or the equipment. Because default provisions are so loosely worded (intentionally); they probably have the ability to call your loan. They get their money back, you may be out in the cold.

Are You Ready To Pay These Very High Prices… For Those "Very Low Rates?"

Most customers find that they are being asked to pay a very high price for those seemingly "very low rates." Operating & financial restrictions, capital "frozen" as unproductive "compensating balances," business assets encumbered, future rate float risk, reduced availability of their own critical business credit lines etc., etc. Leasing has become a trillion dollar industry right alongside the commercial banking industry and for good reason. The points we have raised are just some of the many reasons why businesses from giant multi-nationals to local "mom & pops," have decided to "just say no" to their bankers overtures and have chosen to lease instead.

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