Leasing Vs. Bank Financing White Paper

The Pros and Pitfalls of Leasing, Bank Financing & Cash

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 are likely to *appreciate* in value—real estate used to be 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.

Here's Why Leasing Makes Business Sense *and* Tax Sense

Most businesses will write off 100% of their lease expenses. Bank loans for equipment must be capitalized and depreciated under I.R.S. schedules over a period of 5, 6, 7 or more years. (The interest component can be deducted in the year incurred). Operating leases allow you deduct the entire payment and can effectively accelerate those write-offs, putting your cash, into your pocket sooner. This topic changes frequently:

(Take a look here for the latest: **https://www.LeaseExperts.com/TAX_ADVANTAGES.htm**)

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 against the specific equipment leased only; 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 no single prime rate; rather each bank is free to establish their own "prime" rate — sometimes it is as low (or lower) than the Wall Street Journal prime, although we've often seen individual bank's prime ("their best rates" to their most credit-worthy customers), set as much as 4% above the benchmark WSJ-published rates. Let's assume for this example that your business qualifies and that your bank has offered you this month's (Jan 2019) WSJ prime rate of 5.50% plus a very modest 1.25% **= 6.75%.** Sounds pretty good doesn't it? Maybe, but let's take a closer look.

Let's Talk Fine Print…

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*. Some business owners might say, "No big deal, we keep $30-40,000 in our business checking account anyway…" Perhaps so, but that's your business decision, for your convenience, today. What else could that same money—invested by you, or used for business opportunities or other capital acquisitions, be doing for you? With a compensating balance clause in the bank's loan/line offer, 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 more efficient interest bearing "sweep" account format for example and again you may be in default. It's all in the fine print.

Is That a 6.75% Rate or a 16.92% Rate?

(For this example, let's assume a $200,000 business financing for 60 months)

*When you compute the real interest on the bank's 6.75% loan offer (in this example), you find it is actually closer to 16.92%. (**Here's why**: Because you're paying interest on 100% of the "loan" amount (all $200,000), but the bank figures it (in essence) as 80% of the money from their side of the ledger; the rest is the customer's "compensating balance" being loaned back to themselves!) Your bank's "compensating balance" clause may be higher or lower; but any way you slice it, the actual rate is a far cry from their original "prime +" offer, when you do the math.*

What Else Is in the "Fine Print?" Plenty!

"Bank Fine Print 101" ● Questions to Ask. 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.

- Most bank *line of credit* rates (and most bank term *loan* rates) ***float*** with the published interest rates. As of this writing, rates are rising sharply. (3 increases in 2017 and 4 increases in 2018!)
  - ◊ Our **lease rates are *fixed*** for the term of the lease and **do not float**.
  - ◊ Short-term rates may be low now, but they are on their way up. Where will they "float" up to during the next 12, 24 or 60 months?
  - ◊ Are you comfortable pinning your business' budget to a constantly moving loan payment target?

- Do you have an existing line of credit at the bank?
  - ◊ What effect will a new loan from them 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 by the amount of any new loan/borrowing*)

- Is the bank actually offering a credit *line* or a *term loan*? There are some BIG differences:
  - ◊ Did you know that most banks require that credit lines be paid down to zero at least once every 12 months? Most also will reserve the option to call the line or loan should your industry start to "go south" in general, 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 value of the equipment (whatever it is).
  - ◊ Our lease can cover as much as 110% of the full cost and unlike most banks; we *will* include shipping, training, installation, initial maintenance and other "soft" costs. So, you don't get "nickeled and dimed" at/after delivery for the additional things you need.

- Banks are far more restrictive than leasing companies, about the equipment they will finance.
  - ◊ Many banks will only finance "hard" collateral (machinery, printing presses, construction equipment, etc.) First Capital will lease all kinds of business or commercial equipment, computers, networking gear, restaurant equipment -- <u>even 100% software</u>.
  - ◊ Most banks will not touch "used" equipment. First Capital does it all the time!

A Potentially UGLY Surprise!

- A bank will place a **"blanket lien" <u>on</u> <u>*all*</u> <u>of</u> <u>your</u> <u>assets</u>**-business and personal (**This is very important to watch out for!**)
  - ◊ First Capital's UCC will be filed *on the leased equipment <u>ONLY</u>*. In most cases, (subject to credit) 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 business "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 financial ratios. Working capital tests, debt-to-equity, current and quick ratios are commonly used and specified.
  - ◊ 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 <u>*from*</u> <u>*any*</u> <u>*other*</u> <u>*sources*</u> without their permission—and you cannot assume that you will receive it.
  - ◊ If you fall below the bank's mandated financial ratios, *you* will be in default.
  - ◊ There are <u>no</u> <u>financial</u> <u>reporting</u> <u>requirements</u> with a First Capital lease.

- The bank will likely require you to <u>cross-collateralize</u> *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 as well)
  - ◊ Your lease with First Capital is a freestanding obligation—with only the equipment as collateral.

- Even if you are not signing "personally" for <u>*this*</u> obligation with your bank, you may find that any <u>previously</u> signed, personal guarantee is deemed "<u>continuing</u> <u>and</u> <u>unconditional</u>" vis-à-vis all new obligations at that same institution. More fine print "hocus pocus!" Check this one out.

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

- Are you a "Key Account?" 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 your accounts generates <u>for</u> <u>them</u>.
  - ◊ It also means that you are tied to that bank exclusively for the term of the loan. If you move accounts and/or services, <u>you</u> are "changing the deal," for them and your rates will almost certainly jump 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 maintaining the bank line?

- 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 "favor" 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.

  - Lastly, it's still mostly about credit. Less than perfect credit? Start-Up (brand new)? or young business? Banks walk away; we put them together every day!

Are You Ready to Pay These Very High Prices… For Seemingly "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. Loans and lines that can be called. Leasing has become a trillion-dollar industry right alongside the commercial banking industry *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 banker's overtures for additional services, selecting leasing instead!

❖