A number of factors in the world of commerce and government have worked together to change both the operational and financial landscape of information technology management. Increasing penetration of IT functionality into every sphere of business and consumer experience, when coupled with rapid change within the IT arena itself, create strong forces on the financial structures under-girding the financing of IT assets. Increasing government regulation and reporting requirements have added new layers of cost and complexity to our IT management challenge.

One of the results of this technological turbulence has been a dramatic change in the very purpose and usage of IT leasing. Much of the older conventional wisdom has become myth, while new, more operations-oriented approaches to lease versus buy discussions are coming to the forefront of management decisions.

This paper examines eight IT finance myths sometimes still being held as conventional wisdom.
We are moving to public Cloud computing, so leasing would not help us.

The use of public cloud computing resources (eg Amazon EC2, Microsoft Azure) has already proven its value in a number of use-cases, and further improvements in security and reliability will no doubt expand these.

In all of these cases, there are several classes of IT assets which cannot be "moved to the cloud", including:

- the end-user client systems which access the cloud (eg workstations, desktops, laptops, tablets, smartphones, IP phones, monitors, point-of-sale terminals)
- the network equipment which connects those client systems to the cloud (eg routers, switches, security appliances, wireless infrastructure)
- document-handling devices (eg printers, copiers, high-end scanners, legal archive systems)
- data storage devices that cannot be moved off-premises due to regulatory requirements
- devices used for physical infrastructure management (eg badge readers, surveillance devices, environmental controls, emergency management systems)
- other critical systems which must be kept 'in-house' for operational reasons.

Many of these items are in the class of "distributed assets" which form the bulk of the administrative workload for IT and IT finance, and most of these will still need a regular refresh cycle— for TCO reasons as well as so that their functional capability 'keeps up with' the improvements in public cloud technologies. And this need will be best addressed—financially and operationally—with a streamlined leasing operation and asset management process.

The upcoming lease accounting changes will make leasing unattractive.

The main accounting standards boards (FASB, IASB) have been working since 2006 on making changes to how certain leases are reflected on the financial statements. Although it is not at all certain that any changes will actually be made, what those changes might eventually look like, or when and how extensively they might apply, it is still wise for an organisation to review the reasons people currently lease IT assets.

Most enterprises lease for reasons of management control, process discipline, financial predictability, convenience, and risk reduction (eg obsolescence, flexibility). None of these advantages of leasing would be affected by any of the proposed changes. Some use leasing as a simple financing (pay over time) vehicle—and that will not be affected. And others use it as a less expensive way to harvest the continual improvements in price-performance in hardware—and that will not change either.

Some clients use a certain type of lease because it has a characteristic useful for financial profile management. Under current accounting rules, leased assets can either be placed ‘on the Balance Sheet’ (ie capital leases) or keep ‘off the Balance Sheet’ (ie operating leases—which look like rentals). How one classifies these assets affects certain financial ratios. Operating leases are good for debt ratios and asset-based ratios (eg RONA—Return on Net Assets), whereas capital leases are better for profit-based ratios (eg EBITDA—Earnings Before Interest, Taxes, Depreciation, and Amortisation). If the standards groups end up requiring all leased assets— no matter how small nor how short a rental term of—to be placed onto the balance sheet, then this flexibility will be greatly reduced.

For some firms this will be a loss of an important advantage of leasing—but it will not be decisive enough to forego the other benefits of leasing they currently enjoy. And for many organisations, it will not be material enough of a change to warrant any change in policy.

IT leasing is only for companies who cannot afford to buy.

Actually, that this is a myth should be obvious from the widespread existence of non-IT leasing. Many large and financially sound companies lease automotive fleets, airplanes, buildings, furniture, land, and many other forms of durable goods. These Fortune 1000 companies obviously could afford to buy these assets, but choose to lease instead.

A quick review of the published financial statements of Fortune 500 companies will reveal that the majority of these enterprises lease some of their IT equipment and systems. These would be just a small sampling of the many successful organisations who choose every day to selectively lease instead of buy. While these companies can certainly afford to buy, they apply management savvy and financial acumen to investment decisions—and decide to lease in many cases.

Leasing is not only for companies who cannot afford to buy. Instead, it is a tool used by many powerful firms to better realise their business objectives.

IT leasing is only for companies with high and/or unfavourable cost of capital.

This is similar to the above and warrants the same type of response. These blue-chip companies have access to some of the lowest cost capital in the market—yet they still choose to lease. What do they know that non-leasing firms don’t?
What criteria do they use to decide between leasing and buying? A look at their individual balance sheets reveals that they certainly buy, but that they also carefully evaluate the alternatives. A look at their balance sheet reveals that they certainly buy, but they also carefully evaluate the alternatives—and ‘cost of capital’ cannot be the deciding factor for their decision. There may be many financial factors that go into their decision, but it is clear that cost of capital is not the deciding factor by a long stretch.

Buy versus lease models and spreadsheets tell the whole story.

Most of us are aware that ‘pure quant’ approaches tell only part of the story, and sometimes don’t even tell the most important part of the story. For example, spreadsheets would dictate that we:

- fire all of our experienced workers and replace them with new hires (since the spreadsheets rarely factor in costs of quality, learning curve costs and/or customer relationship benefits)
- outsource all IT functions overseas (since the spreadsheets rarely factor in costs of customer satisfaction and interaction, benefits of IT business unit proximity, and/or organisational learning curve costs)
- everything goes to the lowest bidder (since they cannot reflect the true business benefits of long-term relationships, higher product quality, upgrade cost avoidance, preferential treatment).

In fact, it could easily be the case that in most of our key business decisions, lowest price is often over-ridden by values related to reliability of the supplier and logistics stream, quality of the product, flexibility of the terms, and long-term relationships with a key vendor partner.

While it would be foolish to not run the spreadsheet and equally foolish to ignore its results, the wise decision maker will ask other questions such as: what other factors are critical to the success of this decision and how should those factors be weighted relative to price. Spreadsheets are important, but they can be misleading if interpreted outside the broader business context.

If leasing costs more than buying, then it’s a bad deal.

Leasing sometimes costs more than buying, but since the price differential is ‘buying something extra’ above the product, it is often a better deal than the product alone. The ‘buying’ process itself involves administrative and managerial labour, already adding cost on top of the simple equipment invoice. The occasional extra cost of leasing (generally very small) is used by the leasing company to fund other services or benefits for the client. Of course, in equity-based leasing (where the lessor is investing in the equipment up-front), the cost of leasing is often less than that of purchasing.

For example, the incremental cost can be seen as ‘buying’ end-of-lease flexibility, or remarketing services when the gear is old, or increased bargaining power with the equipment maker, or regulatory-compliant disposal services, or shared investment risk (when the lessor takes an investment position in the asset), or asset tracking systems, or technological advisory services to help make IT choices a little less risky.

It’s not that leasing is always ‘cheaper financing’ than debt or equity—it sometimes is, of course, due to other financial elements such as tax credits or debt covenants—it’s just that it can be a better business deal for ‘getting the job done’. The ‘job’ is almost always about leveraging an asset for business utility throughout its lifetime, rather than just getting it to the loading dock that first day. In the IT space, specifically, there is a growing emphasis on the non-financial uses of leasing—most of which are ‘funded’ by a small cost differential above simple product cost.

We have plenty of cash, so we should buy instead of lease.

Allocation of financial resources—cash, credit, and assets to business opportunities is a major task of the financial manager. The general rule is to allocate resources to the projects of highest return (with commensurate risk-level propriety). In many situations, capital investment decisions are governed by a ‘hurdle rate”—the IRR below which a project is not funded. Risk management issues dictate that the expected IRR be fairly certain as to its achievability, and ‘nebulous’ projects are often relegated to the ‘if we have anything left over’ folder.

Cash itself is seen as an under-performing asset as it is counter-productive to financial goals while it is still in ‘cash form’ (ie earning no multiple). Cash does, of course, have the massive advantage of being liquid and legal tender, and so is perfect for acquisition transactions of high IRR. What this means, though, is that cash should only be used on ‘high and fairly certain’ IRR projects: M & A, sales force expansion, new product introduction, market development, and very specific line-of-business projects (eg warehouse automation). These types of projects are investments in appreciating assets (instead of depreciating assets) and often meet the hurdle and risk requirements of sound fiscal management.

Most of the projects that are candidates for IT leasing fall outside of these hurdle and risk parameters: server and host upgrades, PC refreshes, additional tape and storage units, migration to alternative network architectures,
and phone systems. These projects have difficult to quantify IRR/ROI measurements (although they are known by all to be absolutely critical to business success), and although they sometimes theoretically ‘pay for themselves’ within a short period of time, they still don’t yield the kinds of returns harvestable from more strategic investments (eg market share growth from acquiring a large competitor).

These projects are perfect cases where leasing (rather than the use of precious cash assets) makes the most sense. Effective uses of cash to buy additional business ‘processes’ should actually lead to an increase in leasing to fund the infrastructure expansion necessary to support those new processes. It must be funded (by leasing) in order to under-grid and empower all newly acquired (by cash) business capability and function.

You always get a better lease deal from the equipment manufacturer, than from an independent lessor.

As a matter of fact, you probably don’t. It only just looks better because the ‘lower rate’ is being funded from extra profit margins on the equipment − profit margins that were not given to you as a discount during negotiations. You are paying more for the equipment and that extra money is being used to offset the ‘bargain basement lease rate’ you are offered.

Think about this for a second. The equipment maker wouldn’t have that much lower cost of capital than your firm or a large independent lessor, would they? Wouldn’t their emphasis on new product sales imply that their residual on the equipment couldn’t be any higher than the market would allow (and would typically be lower)? Since the equipment vendor is typically a well-managed business, with solid financial decision processes, we know that this ‘deal’ must be measured against some kind of internal IRR hurdle and risk thresholds too, right? Why would the vendor accept such a loss on the deal? It’s because they know from experience they can make it up by additional higher margin sales to your firm in the future. Once they hold the lease, they know they have considerable power over your future architectural decisions. Equipment manufacturers have built a good portion of their success on that knowledge. This is not necessarily a better deal at all—especially when the lease draws near to the end.

Here’s an instructive example. Recently, one of the largest systems vendors in the world completed a leasing deal for their largest competitor’s equipment. They underbid both the market and their competitor in terms of the leasing rate, for a multi-million dollar system deal. Without any profits from the leasing/finance stream and without any ‘subsidies’ from the profit from the sale of the equipment, this systems vendor would incur considerable financial losses from such a deal. In effect, they bought their competitor’s equipment thereby helping their competitor’s sales and profit numbers, and they stand to lose even more money on the back-end of the lease, when the equipment is returned to them (with little to no resale value).

Think about this—why would a financially savvy firm knowingly incur such a financial loss? The experienced IT executive knows by experience the rationale. When a manufacturer holds the lease, they have considerable ability to influence future decisions, especially end-of-lease directions. This company was investing heavily in being able to ‘influence future directions’ in ways that would pay back the loss, and eventually net out a profit. The means to do this was to steer the customer (perhaps through the use of ‘bundling’) in the direction of their brand of hardware and software—whether this was the optimum architecture or not.

Conclusion

The world of IT leasing has changed and continues to change. Tech refresh cycles are shortening, rather than stabilising. New architecture options for servers and mobile devices are emerging. New opportunities for business empowerment and support are arising. IT leasing is no longer a straightforward spreadsheet decision. The savvy financial manager today will critically think through these myths and re-architect the decision process for future lease versus buy situations in the IT arena.

At Macquarie Equipment Finance, we stand ready to assist you in evaluating these options and in helping you realise the operational benefits of IT leasing to achieve your organisational goals and mandates.

For more information

MACQUARIE EQUIPMENT FINANCE
Asia +82 2 3705 8500 | Australia +61 2 8232 7769 | Canada +1 866 606 1429 | Europe +44 75 8598 5542

Disclaimer: This brochure is provided for information only and as a description of Macquarie Equipment Finance and is not an expression of opinion or recommendation. Macquarie Equipment Finance makes no representation, warranty or promise that the information contained in this brochure accurately describes the provision of finance or leasing services in any particular jurisdiction. Macquarie Equipment Finance does not purport to provide legal, taxation, accounting or financial advice to prospective clients. The recipient should make its own assessment of any product or service referred to herein and seek appropriate advice. Macquarie Equipment Finance is not an authorized deposit-taking institution for the purposes of the Banking Act 1959 (Commonwealth of Australia) and its obligations do not represent deposits or other liabilities of Macquarie Bank Limited ABN 46 008 583 542. Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of Macquarie Equipment Finance. 090112