

[Academic Script]

Lease Financing

Subject:	Business Economics
Course:	B.A., 3rd Semester, Undergraduate
Paper No. & Title:	Paper – 303 Business Finance
Unit No. & Title:	Unit - 5 Lease Financing
Lecture No. & Title:	Lecture – 2 Lease Financing

Academic Script

Academic Script

1. Introduction

There are mainly two types of sources of finance, Owners' Capital Financing through shares and Borrowed Capital Financing through Debentures and Loans. From the last few decades apart from these two types of Financing, Lease financing is emerged as another significant way of financing. In India, healthy practices of lease financing system developed only after 1973 when first leasing company started in Chennai. But now a days hundreds of leasing companies have been established in India. Bajaj Finance and M&M Financing Company are most famous company in India for Lease Financing.

2. What is lease financing?

In this chapter we are going to discuss lease financing. Let us start our discussion with what is lease financing?

When any one wants to use property, Place, or equipment but they do not have enough finance or may be having more profitable another opportunity, they usually select the rent option to use such things, and when it turns into official agreement for conveying the right to use of such things for specific period of time especially for a long period of time. They are to have opted for leasing.

Lease financing means the person who is the owner of the assets, gives the assets on lease for financing purpose, same as

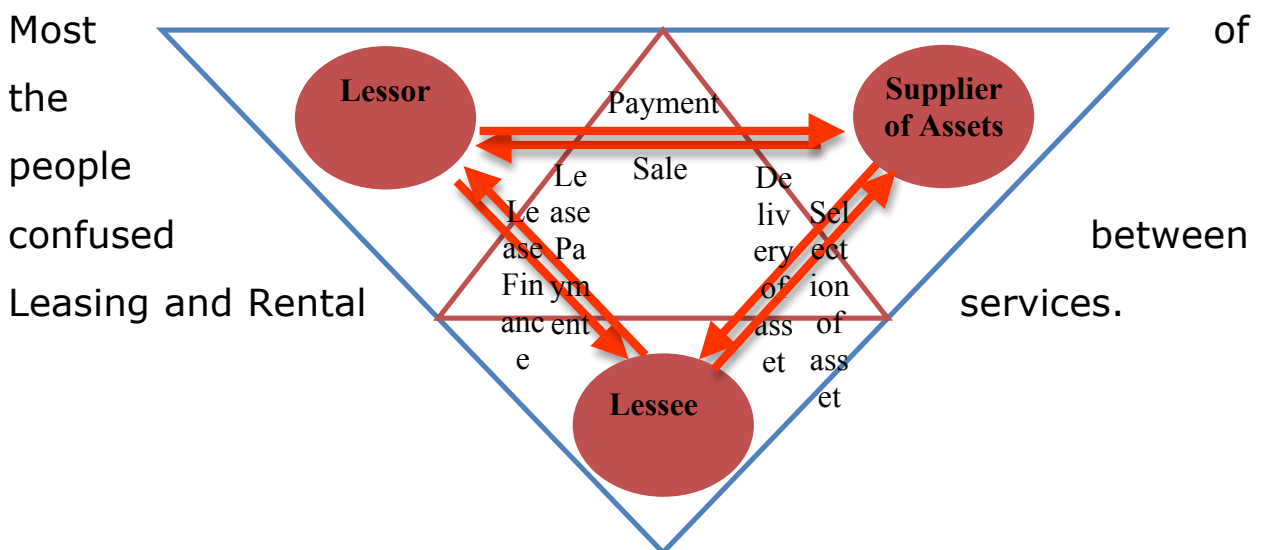
house owner rented let out his house for a rent. The fundamental objective of the lease financing is to earn lease amount as well as get the benefit of tax deductible depreciation.

The person who is the owner of the asset given on lease is called **Lessor** and the person who uses the asset of lessor on lease is called as **Lessee**.

As per Prof. I. M. Pandey -

"Lease is a contract between a lessor, the owner of the asset and a lessee, the user of the asset under which, the owner gives the right to use the asset to the user over an agreed period of time for a consideration called the lease rental."

M.Y.Khan defines as *"Leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a series of contractual periodic tax-deductible payments of lease as a rental"*



3. Difference between Leasing and Rental Services

1) Basic difference is all rental service providers are the owner of the assets and are maintained, serviced and insured the assets by themselves. Their income generation is based on renting the same assets again and again, over and over to different-different customer.

While lease financing service providers are becoming owners after purchasing the assets for lessee in most of the cases. They finances single asset for the long term contract with a single person.

2) Most of the rental companies fulfil needs of people with the certain conditions like tourists can fulfil their hobby or needs in tourist places to run luxury car or sport bike, like tenant rented a house for 11 month contract to fulfil its residential need.

On the other hand leasing companies fulfil the needs of people for maintaining long term relationship with its customer in a so friendly manners that the customer feels that they are the owner of the assets.

3) In rental contract, customer must have to select the assets from existing stock of the rental company.

While in lease contract, customer have an option to choose any of the asset from many distribution channel.

4) Rent of the assets in case of rental service providers may vary widely on daily, weekly or monthly basis. Even it may vary from season to season.

While lease is easy to calculate with a well-defined formula and remain same within lease period.

4. Types of Lease

Now Let us discuss the different types of Lease Agreements

1) Financial Lease :

A contract which extends almost over the whole useful life of an asset and which cannot be cancelled is known as Financial Lease. Some times this types of lease is also known as *Capital Lease*.

2) Operating Lease :

A contract which extends for a short period and can be cancellable after giving notice of a fixed period is known as Operating Lease.

3) Sale and Lease Back :

When owner of an asset sells the asset to another party and the same asset is taken on lease from that party. In that case lessor gets the benefit of depreciation deductions while lessee gets the benefit to use the fund and assets both.

4) Service Lease :

Assets which require after sale services are generally leased under such types of contracts. Lessor provides the finance but also undertakes servicing of the asset.

5) Direct Lease :

When lessors purchase or finance an assets for the usage of lessee, it is known as Direct Lease. In this lessors are finance companies, commercial banks, leasing companies and even individuals.

6) Leveraged Lease :

When any expensive asset is planned to take on lease and lessor is not capable to provide the complete finance, financial institution provides the remaining finance. It is known as leveraged Lease. Here three parties are involved

I) The Lessor

II) The Lessee

III) The Financier.

7) Other types of Lease :

There are some other types of lease contract also to be seen for specific types of work such as ballon lease having zero residual value, conveyance lease for 99 years, close end leasing, swap leasing , wrap leasing, import leasing, partial pay-out lease, consumer leasing etc.

5. Hire Purchase

❖ **Hire Purchase in Lease both are sources of finance having certain similarities and hence confused. Let us clarify the difference between Hire Purchase and Lease Financing**

Sr	Points	Hire Purchase	Lease Financing
1.	Meaning	When buyer undertakes any assets by making an instalment payment, it is called Hire Purchase	When User undertakes any assets on rent or lease arrangement it is called Lease
2.	User Name	Under Hire Purchase, Buyer is generally user or he may purchase the asset for	Under Lease Financing, User are Lessee.

		another consumer.	
3.	Transfer of Ownership	Ownership transfers immediately after the payment of last instalment of purchasing an assets.	Ownership is never passed to lessee in lease contract.
4.	Benefits	Buyer gets the benefit of depreciation on assets from the view point of taxation benefit.	Lessee gets the benefit of using an assets by paying lease and can save the opportunity cost of purchasing an assets, and lessor gets the benefit of depreciation.

5.	Finance	Buyer needs to pay down payment first and then instalments for the rest of the price with interest.	Lessee needs to lease rent only regularly as decided in the contract.
6.	Repairs and Maintenance	In Hire Purchase, Buyer is the real owner and he is responsible for repairs and maintenance.	In Lease Financing, Lessee is just a user, so Lessor is responsible for repairs and maintenance.
7.	Types of Assets	Generally, less expensive type of Individual usage assets are purchased under Hire	In case of lease, High priced industrial types of assets are undertaken like

		purchase like T.V., Air conditioner etc.	machines, Computer s etc.
--	--	---	---------------------------------

6. Advantages and limitations of Leasing

The Advantages are:

(1) Leasing is very famous in the recent era as it **finance 100%** of the value of asset compared to 70 to 80% finance by bank. Though it finance 100%, its procedure is faster than money borrowed from bank.

(2) Another main benefit of leasing is to get **tax benefit**. In leasing both the parties get the benefit of certain deductions from income tax. Lessee get the benefits for rent or lease paid as a deduction from tax which generally higher than depreciation and Lessor gets the benefit of depreciation as a deduction from tax.

(3) In the technological world, the risk of obsolescence is increasing day by day. If the company doesn't want to increase its risk of **technological obsolescence**, leasing is the best way to use the asset on lease.

(4) When any company takes any assets on lease by not purchasing the same assets, it can **save the fund** and can apply the same fund into another profitable investment so as to increase the wealth of its business.

(5) Instead of leasing, if the company opts to purchase assets, company requires fund which may be raised from either borrowed capital or owners' capital, company has **to pay cost of capital** on it. The company can save such types of cost of capital by entering into lease contract.

(6) If the company uses the option of collecting funds from bank, all the **requirements and conditions of the bank must have to be fulfilled**, moreover bank also asks to put some mortgage. In leasing, one can free from all such requirements, conditions, mortgaging and other restrictions.

(7) Leasing is obviously **less expensive** than purchasing assets, and hence one can only fulfil his objectives and can use the asset even if he has no capacity of purchasing the asset.

Now Let us move on to disadvantages of Leasing

Disadvantages of Leasing are:

(1) Lessee may end up the lease contract with high total cost than cost of purchasing asset.

(2) High quality equipment might not be available to lessee for product manufacturing

(3) It is difficult to change the contract if operations needs flexibility in production.

(4) Lease amount generally includes high cost of interest which is even more than interest charged on term loan by banks.

(5) Sometimes warranties or guarantees may not be received by lessee as lessor is the owner of the assets.

(6) Lessee must have to pay lease even though the asset become obsolete for him as per the lease contract.

7. Lease Evaluation

We will end our discussion with Lease Evaluation

There are two ways to evaluate lease financing because though the term of lease is same for both lessee and lessor, value for the same is different for them. This is just happening because of cost of capital is different for them.

(1) From the view point of Lessee: Lessee is the person who takes decision to borrow the assets in terms of lease. He must have to think upon whether he is beneficiary in terms of buying or in leasing. Therefore he has to find the benefit receivable in terms of buying as well as in terms of leasing. For that he must be aware about the two types of value of benefit associated with it.

I) Difference between Leasing and Rental Services in buying option

II) Net present value in Leasing option

Lessee can choose the option from Lease or Buy on the basis of whichever is having higher Net present value.

(2) From the view point of Lessor : lessor can evaluate the lease financing by two way

I) Present Value Method :

In the present value method Net present value is found out by deducting Taxation effect from both cash inflow and outflow and then discounting it with weighted average cost of capital of the lessor.

II) Internal rate of return method :

Internal rate of return method is to find out the rate of return at which the present value of cash inflow equal to present value of cash outflows. IRR is basically trial and error method which can be determined either by mathematical formula or by present value tables.