CHAPTER - 6

Leasing Practices and Decision Making

- Lease Vs Buy Decisions
- Financial Appraisal Techniques
- Lease Evaluation from Lessee's Angle
- Lease Evaluation from Lessor's Perspective
- Documentation for Credit Evaluation
- Essential Aspects of Leasing
**Lease Vs Buy Decisions**

Cash is king! This mantra is mostly relevant for companies faced with competitive pressures and customer demands for higher productivity and lower prices. Companies that have grown through acquisition are particularly challenged as additional debt must be serviced. Cash generation and conservation become a focal point throughout the organization. Supply management professionals find themselves in a new role working with suppliers of leasing services to evaluate the cost and benefit analysis of leasing.

Quantifying the economic impact of a lease Vs buy decision can be challenging for some of the better financial minds. Though a background in finance is helpful, it is not necessary if you are willing to invest the time to understand the basic concepts of this type of transaction. In addition, leasing decisions may require gaining a better understanding of an asset's economic life and usage costs than ever imagined. Leasing options can range from a simple asset financing arrangement to an all-inclusive, full service program with lease charges based upon actual usage and, if you don’t find the leasing options particularly complex, the “people” factor will surely challenge as leasing advocates and opponents take to the battlefield over this on-going debate. Financial managers are frequently involved in the decision-making process relating to the acquisition of long-term assets carrying colossal amount of capital expenditure.

The important decision for most of the firms is whether to acquire the property, plant and equipment through outright purchase or leasing arrangement.
The decision process appropriates much of the valuable time of the financial manager and requires his critical bent of mind. To help the financial manager in deciding about whether to go for lease or purchase decision, he has to consider the following few important factors:

A) **Whether Leasing is a Financing Decision or an Investment Decision or Both:** In the parlance of business finance, a decision is classified either as a financing decision or an investment decision. In the case of financing decision, the object is to select the best source of financing involving minimum cost. In case of an investment decision, the object is to select the best available outlet, which will maximize the return on investment after taking into account the risk factor associated with the project. Whether financing and investment decisions should be separated or combined.

The issue is whether it is desirable or necessary to separate the investment decision from the financing decision so that the former is not affected by the latter. This is an important aspect of lease versus buy lease analysis. Assuming that it is desirable, is it really possible to do so? This question seems to be particularly applicable for a firm that has a number of projects competing for both equity and debt generated resources, and no single project can be specified as being financed with a particular source. As a result, the two decisions cannot avoid becoming intermingled and it may not be possible to separate the two.

In the context of leasing, T. M. Clark observes that if a firm is deciding between leasing and borrowing, it is purely a financing decision. If a firm is deciding between leasing and buying, it is a combination of both investment and
financing decision. In the same context, Ian Scarman also holds the view that leasing is both i) a way of acquiring the use of an asset and ii) a way of financing that acquisition. The above statements reveal the dual nature of leasing that it is both an acquisition of an asset and also its financing. Likewise, occasionally a firm must evaluate the acquisition of an asset that is only available if it is leased. In such a situation, the financing and the investment decisions are made concurrently. Thus, in essence, leasing is a capital budgeting decision that does not involve initial cash outlay. Since it is possible to acquire plants and equipments by outright purchase or by leasing, the financial manager will attempt to achieve the most profitable combination. The question of buying versus leasing also involves a long term finance planning. Therefore a leasing decision should be considered both a capital budgeting decision as well as a financial structure decision.

In a lease versus buy decision, the decision revolves around the question of whether it would be better to lease or to buy. The value of the firm and the shareholders’ wealth will be maximised so long as management selects the alternative that keeps both the real and the opportunity costs of financing at a minimum and below the level of the expected return from the asset under consideration. While using the present value method the following points should be borne in mind. As per lease evaluation based on various factors, Buy Vs Lease options are shown in detailed in the Table 6.1
Table 6.1  Lease versus Buying Options

<table>
<thead>
<tr>
<th>S.No</th>
<th>Factor</th>
<th>Buying Option</th>
<th>Lease Option</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Initial Cost</td>
<td>Incurred</td>
<td>Not Incurred</td>
</tr>
<tr>
<td>2.</td>
<td>Investment allowance and</td>
<td>Available</td>
<td>Not Available</td>
</tr>
<tr>
<td></td>
<td>depreciation charges</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Salvage value</td>
<td>Available</td>
<td>Not Available</td>
</tr>
<tr>
<td>4.</td>
<td>Lease rentals and management</td>
<td>Not payable</td>
<td>Payable</td>
</tr>
<tr>
<td></td>
<td>fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Discount factor</td>
<td>Opportunity cost or after tax cost of capital</td>
<td>After-tax cost of debt</td>
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B) Determination of an Appropriate Discount Rate for Discounting Cash Flows: On the choice of an appropriate rate of discount for discounting the cash flows in a lease versus buy evaluation, there have emerged conflicting opinions, Is it after-tax cost of borrowing (or any other specific cost of financing) or the weighted average cost of capital? There appears a substantial difference of opinion on this among the authorities. Middleton^ - Gringer,^ and Burrows all favour the
use of the after-tax cost of debt. The after-tax cost of debt appears as an appropriate discount rate considering that leasing is analogous to borrowing. The use of this as discount rate assumes;

i) That the firm’s future taxable income will be sufficient so as to fully utilise the tax shield associated with the lease payments and

ii) The tax rate will not change.

Admitting that there is no agreed consensus as to the appropriate discount rate to employ and the final choice of an appropriate discount rate will ultimately depend on the judgment of the decision maker. We venture to suggest that cost of debt may be used as a discount rate for discounting the cash flows arising from the use of leasing and cost of capital for the cash flows arising from buying option. However, after-tax cost of borrowing should be used as a discount rate in case of those firms, which come in the tax net and before tax cost of borrowing for those firms, which are not subject to tax. It may however be remembered that higher the rate of discount, the more preferable the lease alternatives, and vice versa. It means that if the cost of the capital rather than the after-tax cost of borrowing is used as discounting rate, leasing will have a better chance of being accepted. In this way, the use of cost of capital as a discount rate may bias the analyst in favour of leasing though buying alternative may be more advantageous.
Steps Involved in Evaluation:

In a buy-lease evaluation, the first step is to determine the cash flows and their timings pattern. In this regard, calculations of corporate tax rate should be taken into account and after-tax lease rentals should be calculated. The next step is to discount the cash flows and cash inflows in order to determine their present values. To calculate the present values, a discount rate that can be applied to all cash flows should be determined.

To calculate cash flows when the firm is considering to buy the asset outright, the tax shield afforded by depreciation and investment allowance, interest and other operating charges should also be considered. While discounting the cash flows, their time horizon should be taken into account. If a firm desires to acquire the use of a given asset through lease financing, the present value of rental payments and the present value of tax savings given by the rental expense deductions should be considered. Thus, in a buy-lease evaluation exercise, by using present value method, the following three steps are involved to arrive at a decision:

1. Define the present value of the after-tax cash flows associated with the buying alternative.
2. Define the present value of the after-tax cash flow associated with the leasing alternative.
3. Either alternative providing lower cost present value of the asset's cost should be selected.
Key Factors to be considered in Decision Making: An analysis of a leasing opportunity should be at a minimum encompass the following factors

i) Asset total cost of ownership

ii) Asset usage restrictions

iii) Lease management requirements

i) Asset total cost of ownership: An evaluation of an asset's Total Cost of Ownership (TCO) must include not only a net present value analysis of the initial cash outlay to obtain the asset, but also the costs to maintain and dispose of the asset. Leasing often provides 100 percent financing of the cost to obtain an asset by avoiding down payments and incorporating shipping and other miscellaneous charges. By diversifying financing sources, leasing can also lower financing costs. By avoiding typical loan covenants, leasing can even provide a less restrictive form of financing however, Wall Street financial analysts typically consider not only capital lease commitments, disclosed in the face of financial statements, but also operating lease commitments, disclosed in the footnotes of financial statements.

Lease terms may dictate a preventive maintenance program different than the one currently utilized for purchased assets. Manufacturer provided maintenance schedules often require lessees to perform more frequent, hence more costly, maintenance services. Potential benefits of outsourcing maintenance services to the lessor are numerous, including improved labour efficiency, equipment up-time, predictability of costs, and compliance with lease maintenance terms and conditions. Of course, union restrictions must be considered whenever services performed by unionised labour are outsourced. Taxes are another important TCO component. Sales
tax costs will vary based upon the lease vs. buy decision. For a purchased asset, sales taxes are calculated on the owner’s tax basis. For a leased asset, sales taxes are calculated on the lease payment amounts. Generally, lease payments will allow an asset to be deducted more quickly for income tax purposes. Finally, lessee’s who are denied the benefit of depreciation deductions due to Alternative Minimum Tax (AMT) can still derive the benefit from lease payment deductions associated with Tax leases.

ii) **Asset Usage Restrictions:** Lease rates are based upon a) expected asset usage b) estimated asset residual value at the end of the lease term and c) financing costs. If actual asset usage exceeds lease terms, the lessee may incur excessive use charges. Therefore, the lessee must carefully select lease terms considering not only the optimal economic life of the asset but also current and future asset usage demands.

On the up side, leasing can instill a discipline to replace assets when they have reached the end of their economic lives (i.e., when their estimated future maintenance costs begin to exceed replacement costs). In addition, the lessor typically bears the risk of asset technological obsolescence during the lease term.

Other typical categories of lease restrictions include the following:

- Asset modifications, such as accessory attachments or component upgrades
- Asset preventive maintenance
- Asset surrender conditions and location
iii) **Lease Management Requirements**: Processes, systems and job descriptions may need to be modified to ensure proper lease management. Granted, good asset management practices require tracking of both leased and purchased assets for the following purposes:

- Timely preventive maintenance
- Balanced asset utilization
- OSHA safety and training records

However, leased assets must also be tracked to ensure (1) lease expirations are recognised and (2) the delivery of replacement assets is well coordinated with lease terminations. Early or late termination can cost a premium due to early termination penalties or rental rates. To assist lessees, lessors can issue advance notifications of lease terminations. In addition, lessors may offer staging of made-to-order equipment to ensure delivery of newly leased assets at time of lease termination.

Utilizing a consistent, internally developed master lease can significantly improve the efficiency of lease evaluation and management. In addition, expensive lease agreement blunders can be avoided by ensuring that the following terms and conditions are clearly documented:

- Asset maintenance
- Lease termination
- Asset surrenders condition and location
- Lease assignment
- Operating vs Capital lease status
• Tax Vs Non-tax lease status

Effective negotiation of lease terms and conditions often requires the assistance of an expert in the usage of the leased asset. Linking lease surrender conditions to an asset maintenance contract can mitigate penalties arising from surrender conditions, one of the biggest deterrents to leasing. For a framework for lease analysis is shown in the Table 6.2.
<table>
<thead>
<tr>
<th>Lease Consideration</th>
<th>NPV Analysis Suggestion</th>
<th>Risk Mitigation Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Complex terms and conditions</td>
<td>Incorporated all variables utilized by lessor to calculate lease rates</td>
<td>Use internally constructed national Master Lease</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Include both leasing and asset experts on lease negotiation team</td>
</tr>
<tr>
<td>Asset usage stipulations</td>
<td>Include estimated penalties for excessive usage. If any</td>
<td>Choose lease terms to best fit asset usage</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Actively mange asset operation to meet lease terms</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Negotiate terms allowing both asset rotation between facilities and lease assignment in the event of a divestiture</td>
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<tr>
<td></td>
<td></td>
<td>Negotiate terms providing compensation for less than expected asset usage</td>
</tr>
<tr>
<td>Monthly lease and sales/use tax payment processing</td>
<td>Include difference in sales/use taxes as well as any additional payment processing costs</td>
<td>Utilize the recurring payment feature of your accounts payable system</td>
</tr>
<tr>
<td>Asset modification stipulations</td>
<td>Include estimated removal costs during and at end of lease</td>
<td>Consider leasing modifications</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Negotiate terms which allow modifications to be removed without penalty</td>
</tr>
<tr>
<td>Asset upgrade options</td>
<td>Include estimated upgrade transaction savings</td>
<td>Negotiate terms for asset upgrades during lease term</td>
</tr>
<tr>
<td>Asset surrender conditions</td>
<td>Include difference in estimated transportation charges and estimated cost of difference in maintenance procedures</td>
<td>Clearly document surrender conditions and location in lease agreement</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Incorporate maintenance services in lease and negotiate guaranteed compliance with surrender conditions</td>
</tr>
<tr>
<td>Asset Disposition</td>
<td>Include estimated lease extension or rental charges</td>
<td>Require lessor to issue advance notifications of lease terminations to</td>
</tr>
</tbody>
</table>
Financial Appraisal Techniques

The concept of present value is extensively used in lease evaluation process. There are two important techniques that incorporate the time value of money. Viz. Internal Rate of Return (IRR) and Net Present Value (NPV). These two techniques are also known as ‘Discounted Cash Flow’ (DCF) techniques. Both forms of DCF techniques discounts the cash flow associated with an investment. The discounting is accomplished by using an interest rate that is the cost of capital and the risk inherent in investment. Discounting is derived from the concept of compounding with the difference that while compounding looks to the future to understand how a value in the present time grows to its future value, discounting works backward to arrive at an answer as to the value in present time of a given or estimated value arising in future.

**Net Present Value (NPV):** This is widely used technique in lease evaluation. The steps involved in such analysis are

Step (i) Calculate the NPV of the purchase option
Where \( \text{NPV}(p) \) = Net present value of purchase option

\[
\text{NPV}(p) = -I + \sum_{t=1}^{n} \frac{(R_t-C_t-D_t)(1-T_c)}{(1+r)^t} + \frac{SV_n}{(1+r)^n}
\]

\( I \) = Initial investment
\( R_t \) = Revenues from the asset in the year \( t \)
\( C_t \) = Costs (other than depreciation, lease rentals and taxes)
\( D_t \) = Tax relevant depreciation for year \( t \)
\( T_c \) = Tax rate
\( r \) = Cost of capital
\( SV_n \) = Net salvage at the end of the year \( n \)
\( n \) = Useful life of the investment

Step (ii) Calculate the NPV of the leasing option

The NPV of leasing option

\[
\text{NPV}(L) = \sum_{t=1}^{n} \frac{(R_t-C_t-L_t)(1-T_c)}{(1+r)^t}
\]

\( \text{NPV}(L) \) = Net present value of leasing option
\( R_t \) = Revenues from the asset in the year ‘\( t \)’
\( C_t \) = Costs (other than depreciation, lease rentals and taxes)
\( L_t \) = Lease rental for the year ‘\( t \)’
\( T_c \) = Tax rate
\( r \) = Discount rate appropriate for the characterising the cash flows associated with leasing option
Step (iii) Decide whether the asset should be purchased or leased or the investment proposal rejected. The following decision rules may be employed to decide whether to a) purchase the equipment or b) lease the equipment or c) reject the proposal altogether. If this NPV is a positive figure, the project is profitable and hence should be accepted. In case one has to select one project out of many, it should be the one which provides the highest positive figure of NPV.

- If NPV (P) is positive and also greater than NPV (L): Purchase the asset
- If NPV (L) is positive and also greater than NPV (P): Lease the asset.
- If NPV (P) as well as NPV (L) is negative, reject the proposal.

Note that the discount rates in steps i and ii are different. In step i, the discount rate, r reflects the risk of the lease-related cash flow, whereas in step ii, the discount rate $r^*$ reflects the risk of the lease-related cash flow. $r^*$ is typically greater than r because the lease-related cash flow is likely to be riskier than the purchase-related cash flow. The purchase-related cash flow is the post-tax cash flow to equity and debt used to purchase the asset, whereas the lease-related cash flow is the post-tax cash flow over and above what is paid by way of lease rentals. In effect, the lease related cash flow is a residual equity cash flow left after discharging a fixed claim in the form of lease rentals. Hence, it is riskier than the purchase related cash flow.

**Internal Rate of Return (IRR):** The IRR is another discounted cash flow technique, in which the rate at which the cash flows associated with an investment are discounted, is calculated. IRR is the discount rate at which the cash flow of a project sum to zero i.e. there is neither any profit nor any loss; such a rate can be calculated mathematically by using the formula
Where \( C_n \) is the cash flow in period \( n \) from 0 to \( t \), \( t \) is time period.

After calculating IRR is to be compared with the cost of capital which is the cut-off rate of return. If the IRR is greater than the cut off rate the investment project should be accepted and in case IRR is less than the cut off rate the project proposal will be rejected.

The question whether or not to acquire a capital asset is properly answered by the discounted cash flow approach. For this, either net present value method or internal rate of return method can be used. In case of IRR, the rate of return promised by the project is compared with the cut-off rate (cost of capital). A survey was conducted in the United States regarding the techniques or models currently being used by some of the nation’s largest firms in making lease-purchase decisions. In all, 48 firms responded to the questionnaire sent to them. The survey has revealed that Internal Rate of Return, Net present value, Bierman and Smith’s Model, Weston and Bringham’s Model, Basic Interest Rate and Bower, Herringer and William’s Model, are being used by the firms in lease-purchase evaluation. Among these models, the IRR is widely used by 50 percent of the respondents, whereas 22 percent of the respondents uses the NPV technique. Thus, over 70 percent of the classified methodologies fall into these two categories.

The wide use of the IRR model apparently reflects a practitioner’s preference for financing costs expressed as a rate. The extensive use of net present value technique, on the other hand, is probably, made due to the fact that it is one of the
oldest, lease versus purchase model in the literature. In addition, this approach is similar to standard capital budgeting models. Thus, it represents an extension of a technique which is well known to financial analysts. Therefore, many analysts prefer to use the net present value technique in a lease-purchase decision, perhaps, because of its straightforwardness and simplicity.

To know the most widely used techniques for lease-purchase decision in Indian companies, a survey conducted through questionnaire, based on the responses from the 12 major leading finance companies as, the study reveals that 50 percent of the respondents said that the first priority is given for IRR and the remaining 50 percent of respondents opted for NPV. Equal importance is given for both techniques.

**Lease Evaluation from the Lessee’s Angle:**

Financial lease effectively transfers the risks and rewards associated with the ownership of equipment from the lessor to the lessee. A lease can be evaluated either as an investment decision or as a financing alternative. Since lease rental payments are similar to payments of interest on debt, leasing in essence is an alternative to borrowing. The lease evaluation from the lessee's point of view, thus essentially involves a choice between Debt financing Vs Lease financing. Most of the lease evaluation models however assume that the decision to acquire the assets has been made and treat ‘Finance Lease’ as a finance alternative. At this point the appropriate model for lease evaluation is still debated by both finance managers and academics. While there are more than half a dozen models available for evaluating a lease. The most important four models are as follows19
• Weigngartner's model
• Equivalent loan model
• Bower-Herringer-Williamson (BHW) model
• Bower model.
• Johnson -Lewellen approach.

1) Weigngartner’s Model: The steps involved in the application of this model is as follows:

Step 1: Compute the net present value of the ‘lease’ alternative – NPV (L)
Step 2: Compute the net present value of the ‘buy’ alternative – NPV (B)
Step 3: Compare the net present values defined in step 1 and step 2.

Lease, if NPV (L) > NPV(B) > 0
Buy, if NPV (B) > NPV(L) > 0

The discount rate (k) to be used for calculating the net present values will be the marginal cost of capital defined as follows:

\[ K = \frac{D}{D+E} \times kD \times (1-T) + \frac{E}{D+E} \times kE \]

Where kD = Marginal Cost of Debt
kE = Marginal Cost of Equity
D:E = Debt-Equity mix in the target capital structure
T = Marginal Tax Rate

It is important to note that ‘Debt’ can be defined here includes ‘Lease Finance’ put differently the model assumes that i) the target capital structure consists of a mix of debt, lease finance and equity and ii) that each investment is deemed to be financed using this mix. The first assumption is important because ‘Lease
Finance' is not normally included as a source of finance in the target capital structure. In fact the other lease evaluation models assume that the target capital structure consists of just debt and equity and treat 'Lease Finance' as a substitute for 'Debt'.

2) **Equivalent Loan Model:** The Net Advantage of Leasing (NAL) is called the Net Value of Lease (NVL) under the equivalent loan model NVL is calculated by using the below stated formula

\[
NVL = \text{Initial Investment} - PV (\text{Lease payments discounted at } kd) + PV (\text{Tax shield on lease payments discounted at } kd) - PV (\text{Depreciation tax shields discounted at } kd) - PV (\text{Net salvage value discounted at } kd) - PV (\text{Interest tax shields on displaced debt discounted at } kd)
\]

Where \( Kd \) = Pre-tax marginal cost of debt

\[ Kd = \text{Post-tax marginal cost of debt} = kd (1-T) \] and

\[ T = \text{Marginal tax rate} \]

3) **Bower-Herringer-Williamson (BHW) Model:** Under this model, the lease related cash flow stream is divided into two parts – the one part relating to financing and the other part relating to tax shields and residual value. The cash flow stream related to financing is called the Financial Advantage of Leasing (FA) and can be calculated as

\[ FA (L) = \text{Initial investment} - PV \text{ of lease payments} \]

The BHW model assumes that the debt which will be raised in lieu of the lease will be equal to the initial investment (as opposed to the assumption underlying the
equivalent loan model that the amount of debt that will be raised in lieu of the lease will be equal to the present value of the lease payments). Therefore, the model defines $\text{FA (L)}$ as

$$\text{FA (L)} = \text{PV of loan payments} - \text{PV of lease payments}$$

The cash flow stream related to tax shields and residual value is called the Operating Advantage of leasing (OA) and is defined as

$$\text{OA (L)} = \text{PV of lease related tax shields} - \text{PV of loan-related tax shields} - \text{PV of residual value}.$$ 

The discount rate to be used for determining the PV of lease payments in the equation will be the pre-tax marginal cost of debt and the discount rate to be employed in equation will be the post-tax marginal cost of capital.

It is important to note that either $\text{FA (L)}$ or $\text{OA (L)}$ or both can be negative. A negative $\text{FA (L)}$ signifies financial disadvantage of leasing and a negative $\text{OA (L)}$ denotes operating disadvantage of leasing. If $\text{FA (L)} + \text{OA (L)}$ is negative, then leasing has an overall disadvantage. If $\text{FA (L)} + \text{OA (L)}$ is positive, then go for lease. If $\text{FA (L)} + \text{OA (L)}$ is negative go for Buy or purchase.

4) **Bower's Model:** The lease evaluation model developed by Richard Bower is a synthesis of the alternative models developed for evaluating lease as a financing alternative. He developed a model which recognizes the point of disagreement and still permits the decision-maker to take advantage of the broad agreement on other matters.

The steps involved in the application of the model are

i) Define the Cost Of Purchase (COP) as
COP = Initial investment – PV (Tax shields on depreciation discounted at an unspecified rate) – PV (Net salvage value discounted at marginal cost of capital)

ii) Define the Cost Of Leasing (COL) as COL = PV (Lease rentals discounted at pre-tax cost of debt) – PV (Tax shield on lease rentals discounted at an unspecified rate) + PV (Tax shield on interest discounted at an unspecified rate)

The decision maker can specify a discount rate which in his opinion reflects reasonably well the risk associated with the realisation of the tax shelters and can evaluate the costs of purchase and leasing. If COL < COP, the decision will be to lease and COL > COP, the decision will be to purchase. The advantage of this model over the other models is that it permits the decision maker to choose the appropriate discount rate for valuing the tax shelters.

5) Johnson-Lewellen Approach: Johnson-Lewellen viewed the question of purchase or lease as two distinct, independent, and mutually exclusive projects. Further, it is not necessary to make any assumption of borrowing to meet the purchase of the asset. These modifications change the structure of the calculations in three ways:

a) It is necessary to calculate the differences between net present value of ownership and the net present value of leasing as a basis for the decision.

b) The approach follows the general rule in capital budgeting of separating the return on a project from the cost of financing. Specifically, we delete the interest charges from the costs of ownership in determining net present value.
c) Allowance is made for the uncertainties of the operating cash flows, tax shields, and residuals by discounting the first two by the firm's cost of capital and the latter by a rate appropriate to the risk level.

The net present value anticipated from purchase of the asset, then the sum of the present value of the net after-tax operating profits (revenues less operating costs) plus the discounted after-tax cash proceeds from salvage less the cost of the asset. Similarly, the net present value of the leasing project would be the present value of the revenues less the lease payments and other costs, if any, associated with leasing. In comparing the net present values of the two alternatives, the revenues are assumed to be the same in both cases, which allows their deletion from the analysis.

In practice, two steps are required. First determine whether the project is acceptable if purchased. Then compare the net present values of ownership versus leasing using equation as:

\[ \text{NPV} = \text{NPV (Purchase)} - \text{NPV (Lease)} \]

\[ \text{n} \]

\[ \sum_{t=1}^{n} \left( \frac{tc(D_t)}{(1+K_t)^t} \right) - \sum_{t=1}^{n} \left( \frac{SN-(SN-B)t_{g}}{(1+K_s)^t} - C \right) \]

Where

- \( \text{NPV} = \text{difference between NPV (Purchase) and NPV (Lease)} \)
- \( k = \text{firm's marginal cost of capital} \)
- \( t_c(D_t) \) is the after-tax operating costs,
- \( O_t(1-t_c) \), for each period discounted at the firm's cost of capital
- \( SN-(SN-B)t_{g} \) discounted at some high rate (Ks) less the cost of equipment (c).

The present value of leasing in the comparison, the sum of after tax rented for
each period, $Lt(1-tc)$, discounted at the cost of debt capital ($kd$).

If $\text{NPV}$ is positive, purchasing is better while $\text{LNPV}$ is negative leasing is preferred.

Although there are various models available in evaluating lease or buy as explained above, the mostly and widely accepted model is to evaluate leasing and buying as two mutually exclusive investment alternatives the recommended model is $\text{NPV}$ and appropriate discount rate is marginal cost of capital of all cash flows. Lease evaluation in practice based on few studies that have been carried out in the U.S.A. and in India.

**Lease Evaluation from Lessor’s Perspective:**

The most critical part of a leasing transaction is the financial evaluation of the proposal both to the lessor and lessee. The objective of the evaluation is to identify the cheaper source of finance to a lessee and better investment alternative to the lessor. Lease evaluation focuses on the pricing of a lease using the risk-return framework. The first part dwells on the computation of the break even rental which sets the floor-price of a lease. For calculating lease rentals there are few important methods given below.

1) **Break-Even Rental for the Lessor:** The break-even lease rental from the lessor’s angle is the minimum lease rental which the lessor can accept. At this rental, the Net Advantage of Leasing (NAL) from the lessor’s point of view will be equal to zero. To determine the break-even rental from the lessor’s angle we set the present value of the lessor’s cash flow stream equal to zero and solve for the lease rental which is the unknown variable. The discount rate to be used will be the cost of funds to the
\[ K' = k_E \times \frac{E}{D+E} + k_D (1-T) \times \frac{D}{D+E} \]

Where \( K' \) = Marginal Cost of Funds
\( k_E \) = Marginal Cost of Equity
\( k_D \) = Marginal Cost of Debt and
\( D: E \) = Target Debt-Equity ratio of the Lessor.

b) Negotiating Lease Rentals: The knowledge of the break-even rentals of the lessor and the lessee helps in defining the range in which the rental can negotiate. The break even rental of the lessor defines the lower limit of this range which shall be denoted as \( LB \). The break even rental of the lessee defines the upper limit of the range which we shall denote as \( LB \). The difference between \( LB - LB \) is defined as spread between the break even rentals of the lessor and lessee. A rental that is depend upon the factors like prevailing market conditions, the credit worthiness of the lessee and the prospects of doing business with the lessee on a continuing basis. With this it encounters leases where \( LB \) exceeds \( LB \) and under such conditions a lease cannot be structured with a positive NAL for both the lessor and the lessee.

c) Gross Yield and Add-on Yield: The leasing companies use gross yield on investment as the basis for pricing a lease. The gross yield of a lease can be defined as that compounded rate of return (discount rate) that equates \( PV(lease rentals) + PV(residual value) + Management Fees = Investment Cost + Initial Direct costs. \)

d) Internal Rate of Return (IRR): Some leasing companies evaluate lease investments using the criterion of internal rate of return (IRR). The IRR of a lease
investment is that rate of interest at which the NAL is equal to zero. The lease investment is accepted if and only if the IRR exceeds the marginal cost of capital.

**IRR based pricing:** The risk adjusted rate of return is defined as

\[ i = i_f + i_e + i_d \]

Where:
- **i** = Risk-adjusted rate of return
- **i_f** = Risk-free rate
- **i_e** = Premium for the risk characterising the existing lease investments and
- **i_d** = Premium for the differential risk

**Flexibility in Structuring the Lease Rentals:** The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so made that the lessee is able to pay the rentals from the funds generated from operations. The lease period is also chosen so as to suit the lessee's capacity to pay rentals and considering the operating life-span of the asset. Apart from the above stated methods, there are some more methods available in India used to calculate lease rentals. The methods are as follows:

a) **Equated lease rental:** Assume that the lease rental is to be equated for the given period (20 percent for 5 years).

b) **Stepped rentals:** Assume that the lease rental is to be stepped up at a rate of 10 percent per period.

c) **Ballooned lease rental:** Assume that the lease rental is to be annual rental as same for some period (annual rental as Rs. 100,000 for 1 to 4 years).

d) **Deferred rentals:** Assume that the lease rental is deferred for two periods.
e) Zig Zag rentals: Assume that the lease rental is to be stepped up and down at the rate of 50 percent

f) Bell shaped lease rental: Assume that the lease rental is to be stepped by 20 percent, and then 40 percent and stepped down in the reverse order.

As already explained above about various methods of calculating lease rentals, but in the given study the data reveals that all the techniques are known and will be used accordingly. There is flexibility in selecting and using various methods. Periodicity of lease rentals for collection varies from monthly to quarterly then to annually. In the study equally the selected companies are using both monthly and quarterly as the period for payment of rentals.

**Forms of Leasing:**

There are various forms of leasing in India, the following are some of the important types of lease finances as

A) Financial Lease Vs Operating Lease

B) Sales & Lease back Vs Direct Lease

C) Single Investor Lease Vs Leveraged Lease

D) Domestic Lease Vs International Lease

E) Other Types

**A) Financial Lease vs Operating Lease:**

i) Financial Lease: Financial leases are very popular with high cost and high technology equipment. According to International Accounting Standards (IAS) in financial lease the Lessor transfers to the lessee, substantially the entire risks and rewards incidental to the ownership of the asset whether or not the title is eventually
transferred, payment of rentals over a non cancellable lease period. Financial lease is a non-cancellable, fully amortized contract typically covering intermediate to long terms where the lessee (user) normally is responsible for maintenance, insurance and taxes. For example Plant and Machinery, Land and Buildings, Ships and Aircrafts.

ii) Operating Lease: According to (IAS17) an operating lease is one which is not a financial lease. In an operating lease the lessor does not transfer all the risks and rewards incidental to the ownership of the cost of asset is not fully amortised during primary leasing period. For this reason operating lease is also called service lease. For example providing mobile cranes with operators, hiring of computers, hiring a taxi for a particular travel (which includes service of driver), xerox machines, office equipment and vehicles.

B) Sale and Lease back vs Direct Lease

i) Sale and Lease back: A firm sells an asset to another party, and this party leases it back to the firm usually the asset is sold at approximately its market value. The firm receives the sales price in cash and the economic use of the asset during basic lease period (is an arrangement in which a firm or individual owning an asset sells it to another party and then leases it back) e.g., Safe deposits vaults by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turns offers these lockers on a long term basis to the bank. The bank sub leases the lockers to its customers.

ii) Direct Leasing: A company acquires the use of an asset it did not own previously. A firm may lease an asset from the manufacturer. It is a mix of operating
and finance leases on a full payout basis and provides for the purchase option to the lessee.

Direct lease can be of two types. a) Bi-Partite b) Tri-Partite

a) Bi-Partite: There are two parties in the lease transaction Viz., equipment supplier cum lessor, lessee such a type of a lease is typically structured as an operating lease with-in-built facilities (upgrade lease) the lessor maintains the asset.

b) Tri-Partite: Such type of lease includes three different parties in the lease agreement Viz. equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales aid lease under which the equipment supplier arranges for lease finance in various forms. Providing references about the customer to the leasing company.

C) Single Investor Lease Vs Leveraged Lease

i) Single Investor Lease: There are only two parties to the lease transaction, the lessor and lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds.

ii) Leveraged Lease: A special form of leasing sometimes is used in financing assets requiring large capital outlays. It is known as leveraged leasing. There will be three parties involved in leveraged leasing, lessee, lessor or equity participant and lender. A lease in which the lessor borrows a substantial part of the purchase price of the asset to be leased under this arrangement lease payments would go directly to the lender, who would deduct principal and interest payments due on the loan and then send the balance to the lessor-risk to the lender. Therefore is the
risk of default by the lessee even though loan was made to the lessor. Leveraged lease involves lessor, lessee and financier. Lessor (leasing company) provides equity equal to about 25 percent of asset's cost while remaining amount is provided by the financier (bank or financial institute) mainly as loan.

D) Domestic Lease Vs International Lease:

i) Domestic Lease: If the parties to lease transaction are domiciled in the same country.

ii) International lease: if the parties to lease transaction are domiciled in different countries known as international lease.

E) Other Types:

i) Closed Vs Open ended Lease: In closed ended lease the asset gets transferred to the lessor at the end & the risk of obsolescence, residual value etc remain with the lessor being the legal owner of the asset. In the open ended lease, the lessee has the option of purchasing asset at the end of lease.

ii) Master Lease: Master lease provides for a period longer than the assets life and holds the lessor responsible for providing equipment in good operating condition during the lease period.

iii) Net, Net, Net Lease: n the triple net (n,n,n) lease the lessee is obliged to take care of maintenance, taxes and insurance of the equipment.

As explained above that there are several kinds of lease financing. An enquiry is made to identify the various types of leases adopted by the companies. The study reveals that the selected companies are offering financial lease, operating lease, leverage lease and sale and lease back. The leasing companies adopt different
<table>
<thead>
<tr>
<th>S.No</th>
<th>Company Name</th>
<th>Finance Lease</th>
<th>Operating Lease</th>
<th>Leverage Lease</th>
<th>Sale and Lease Back</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Finance Companies</td>
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</tr>
<tr>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td>3</td>
<td>KCFL</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td>5</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td>6</td>
<td>TFL</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
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<td>H AH</td>
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</tr>
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<td>7</td>
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<td>H AH</td>
<td>H AH</td>
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<td>L AH</td>
<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td></td>
<td>Leasing as Subsidiary</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td>9</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td>10</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
<td></td>
<td>Independent Leasing Companies</td>
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<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
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<td>H AH</td>
<td>H AH</td>
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<tr>
<td>12</td>
<td>MIL</td>
<td>L AH</td>
<td>H AH</td>
<td>H AH</td>
<td>H AH</td>
</tr>
<tr>
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<td>Total</td>
<td>3 4 5</td>
<td>3 8 1</td>
<td>2 1</td>
<td>2 1</td>
</tr>
</tbody>
</table>

Source: Primary data through Questionnaire.
Note: H = High, A = Average, L = Low
types of leases based on their policy. Table 6.3 reveals that all the companies have extended financial lease and operating lease at different levels from low through average to high. As per the data financial leasing is adhered by five companies extended to high level and four companies extended to average level and the remaining two to a low level. A majority of the companies extended operating lease to the average level. A low level of leverage lease and sale and lease back was offered by ALL and MFL. It can be concluded from the above that almost all the companies are granting finance lease and operating lease and very few companies (Two) are offering leveraged lease and only one company i.e. MFL is offering sale and lease back.

**Documentation for Credit Evaluation**

The following information and documents\(^{23}\) from lessees are considered for judging their credit worthiness by the lessor.

**a) Background:**

- Brief particulars about the company, location, year in which incorporated, history of build up of capabilities,

- Details of financial technical collaborations entered in, background of main promoters, directors including list of other directorships held by them.

- Details of existing activities of the company including licensed and installed capacities. Production and sales of all the items in quantity and value during last three financial years and during the succeeding period up to the time of application.
• Note on fluctuations in production and sales. Quantity and value of exports during last three years export incentives available to the company and countries to which exported.

• Details about proposed expansion, diversification, modernization or investment program on hand and details of technical collaboration if any.

• Present total number of employees.

• Note on selling arrangements of the company including terms of payment with selling agents or distributors etc.

The study conducted through questionnaires, the responses for the questionnaire collected from major leading companies in India. The findings of the study are to know about the pre requisites for a lease deal. The study reveals that 50 percent of the respondents wants documents like legal, project details, asset details and company details. Where as remaining 50 percent of the respondents are looking forward for annual reports for past two to three years. One or two selected companies are also asking for security and IT statements.

Apart from the above requirements, lease decision making power or authority is with the regional offices, head offices finally with the branch offices. The maximum ceiling amount in making decisions will be with the head offices as between Rs. five to ten lakhs. From Rs. fifty thousand to Rs.2 lakhs will be at branch level. Much depends upon the company’s financial position and their policies which provide finance for lease contract. Other than these most of the companies will be checking for at least two guarantors for the finalising an agreement.
b) Financial Performance

- Copies of last three years Audited Accounts.
- Note on capital expenditure incurred during last three years.
- Depreciation methods provided for depreciation calculation.
- Area-wise analysis of finished goods and receivables as at the end of the last accounting year.
- Break-up of loans and advances for capital expenditure and manufacturing expenses as at the end of last accounting year, rate of interest on loans given, the security and repayment schedule. Break up of shareholding into promoters and associates nationalized banks, financial institutions, and other government bodies.
- Details of outstanding term loans and deferred credits are also required. Note on fluctuations in profitability during last three financial years. Projected profit and loss account for the period the following year to the last financial year.

For the calculation of depreciation, there are various techniques available which used by the companies. To know these techniques a survey is conducted in India. The survey is conducted through questionnaire, the findings are majority of the respondents said that they are using Written Down Value (WDV) technique then few are using straight line technique for the calculation of depreciation. These techniques are very simple, easy to calculate and mostly known to the public.
c) Details of Lease Proposals: Provide a detailed write up on the proposal. Indicating full details of cost including invoices, details of sales tax payable etc. the eligibility for depreciation i.e. rate, number of shifts and the benefits that would arise from the proposed scheme.

**Essential Aspects of the Leasing:** Some of the essential factors identified in leasing are collected through survey. The factors are mentioned below

**Time taken for a Lease Deal:** Time factor is most important in lease proposal. An enquiry is made in this regard reveals 50 percent of the companies expressed that they take one week time for finalising one lease proposal. 30 percent of the respondents said that at least two to three days required for completing a deal. Two companies of the given sample require 10 to 20 days to finalise a single deal.

**Leasing and its Promotional Strategies:** Just like any company leasing companies, do follow business promotional techniques. As per the leasing companies promotional methods are through references from parent company, financial companies financial institutions, lease brokers the agreement with manufacturers, dealers and with the help of media, public relations, press interactions, exhibitions and hand outs are also used as a major source for promoting their business. The companies use all the above stated strategies for promoting lease business, but most effective promotional methods are identified through survey are public relations and media.
### Table 6.4 Extent of Financing to Different Items

<table>
<thead>
<tr>
<th>S.No</th>
<th>Company Name</th>
<th>Industrial Equipment</th>
<th>Land &amp; Buildings</th>
<th>Office Equipment</th>
<th>Vehicles</th>
<th>Computers Households</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>L</td>
<td>A</td>
<td>H</td>
<td>L</td>
<td>A</td>
</tr>
<tr>
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<td>ALL</td>
<td>1</td>
<td>1</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
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<td>1</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>KCFL</td>
<td>1</td>
<td></td>
<td></td>
<td>1</td>
<td></td>
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<tr>
<td>4</td>
<td>KMFL</td>
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<td>1</td>
<td></td>
<td>1</td>
<td>1</td>
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<tr>
<td>5</td>
<td>SFL</td>
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<td></td>
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</tr>
<tr>
<td>6</td>
<td>TFL</td>
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<td></td>
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<tr>
<td>8</td>
<td>IFCI</td>
<td></td>
<td>1</td>
<td></td>
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<td></td>
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<tr>
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<td>BCL</td>
<td></td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>RCL</td>
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<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>MFL</td>
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<tr>
<td>12</td>
<td>MIL</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td>4</td>
<td>3</td>
<td>5</td>
<td>5</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Primary data through Questionnaire

Note: L=Low, A=Average, H=High
Extent of Finance Provided for Different Items: There are different types of items for which companies provide lease financing. The lease financing mostly provided for the items like plant and machinery, vehicles, earth moving machines, office equipment, computers, furniture, land and buildings, medical equipment and other household items. Each company will adopt its own policies for extending finance. The company will also consider factors like demand in the market and nature of the product. However, there are few companies, which has Specialised leasing business. E.g. Standard Medical and Pharmaceutical Limited (SMPL) has specialized in leasing of medical equipment. Motor and General Finance (MGF) focuses on earth moving equipment. Kinetic, Bajaj and ALL are specialises in lease financing for vehicles. An enquiry was conducted to know about the items for which lease finance is provided.

The findings are shown in the Table 6.4 indicates that the extent of financing provided by the 12 companies for the period of 5 years (1993 to 2002). The amount given for the items for lease varies from low to high. High means that finance is given to those items for more number of times and more amount where as low means as less in amount and for few times. The High, Average and Low are assigned weightage points as H = 3 points A = 2 points and L =1 Point, based on this weightage points the total score for each item as Industrial Equipment (25 points), followed by Vehicles (15), then office equipment (14), Computers (12) and finally land and buildings carries (8 points). Hence, it can be concluded that in present scenario first priority is given to Industrial Equipment due to their cost and usage, followed by
### Table 6.5 Value of the Asset given for Leasing

<table>
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<tr>
<th>S.No</th>
<th>Company Name</th>
<th>&lt;1 lakh</th>
<th>1-5 lakhs</th>
<th>5-10 lakhs</th>
<th>10-20 lakhs</th>
<th>20-50 lakhs</th>
<th>&gt;50 lakhs</th>
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<td>H</td>
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<td></td>
<td>1</td>
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</tr>
<tr>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
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<td></td>
<td></td>
</tr>
<tr>
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<td>1</td>
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</tr>
<tr>
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<td>4</td>
</tr>
</tbody>
</table>

Source: Primary data through Questionnaire

Note: H=High, A=Average, L=Low
vehicles. Automation and computerization have accounted computers and office equipment as the final criteria.

**Value of the Assets Given for Leasing:**

The company based on their capacity and financial feasibility and according to company policies, lease amount is given to those few selected companies. The study reveals that the amount for lease financing varies from below 1 lakh to above 50 lakhs. Generally companies do provide amount primarily to known and then to unknown companies. Even in known companies those which have sound financial background and those maintaining good relations with the concerned company will be considered. This is to avoid risk in transaction and certainty in collection of income through rentals and maintenance. The study shows that equal preference is given for both i.e. known as well as unknown companies.

To identify the value of assets given for leasing, a survey was conducted. The survey details are shown in Table 6.5. The table reveals that the value of asset can be categorised into six as, below Rs.1 lakh, Rs.1-5 lakhs, Rs.5-10 lakhs, Rs.10-20 lakhs, Rs.20-50 lakhs and above Rs.50 lakhs. In these categories majority of the companies given finance for leasing of worth Rs.1-5 lakhs. Next category suggested by the respondents are Rs. 20-50 lakhs then Rs.5-10 lakhs and finally both extremes as below Rs.1 lakh and above Rs.50 lakhs are at a minimum level. So, it can be concluded that the amount of Rs.1-5 lakhs is given for vehicles and computers. Then industrial and office equipment vary between Rs.20 to 50 lakhs.
### Table 6.6  Primary and Secondary Lease Tenure

<table>
<thead>
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<th>S.No</th>
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<th>Secondary Period</th>
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<tr>
<td>12</td>
<td>MIL</td>
<td>1</td>
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</tr>
</tbody>
</table>

**Total** 5 5 4 6

Source: Primary data through Questionnaire
**Lease Tenure for Primary and Secondary Periods:**

In general leasing companies provide lease tenure for two different periods: primary and secondary periods. Primary period is the period in the financial lease, during which the lessor expects to recover the full capital cost of the asset, along with the calculated profit. The lease term is usually non-cancellable during primary period. Secondary period is the period in a financial lease, which follows the primary lease period during which lease rentals are usually placed at a nominal value, as the lessor would already have recovered his investment and profit during the primary period. The lease tenure of selected leasing companies is shown in Table 6.6. The table gives details about primary period, which varies from 1 to 5 years. Out of 10 companies in the sample 5 companies are providing 1-3 years and 3-5 years as equally (5 each) for the primary period, and then Secondary period followed by primary period varies from 1 to 5 years. Six of the respondents are providing 3-5 years as under secondary after primary period.

**Other Factors:**

The survey revealed that the decisions to lease is also influenced by some of these factors as hundred percent financing, technology, flexibility, implicit interest rate, off the balance sheet, income tax, obsolescence and depreciation etc. The survey data explains about the factors which influence more. So the related data is depicted in the Table 6.7. For the purpose of income tax (28 points) maximum given by the respondents then implicit interest rate (25), off the balance sheet (23) likewise shown in the table, the least scoring factor is depreciation with only 3 points. The figures in
Table 6.7: Extent of Impact of the Factors for Lease Decisions

<table>
<thead>
<tr>
<th>S.No</th>
<th>Company Name</th>
<th>Income tax</th>
<th>Off the b/s</th>
<th>Implicit Interest rate</th>
<th>Technology</th>
<th>Obsolescence</th>
<th>Flexibility</th>
<th>Working Capital</th>
<th>Others (Dep)</th>
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<tr>
<th>S.No</th>
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<th>Off the b/s</th>
<th>Implicit Interest rate</th>
<th>Technology</th>
<th>Obsolescence</th>
<th>Flexibility</th>
<th>Working Capital</th>
<th>Others (Dep)</th>
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<td>3</td>
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<td>2</td>
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<tr>
<td></td>
<td><strong>Total Points</strong></td>
<td><strong>28</strong></td>
<td><strong>23</strong></td>
<td><strong>25</strong></td>
<td><strong>21</strong></td>
<td><strong>18</strong></td>
<td><strong>10</strong></td>
<td><strong>4</strong></td>
<td><strong>3</strong></td>
</tr>
</tbody>
</table>

Source: Primary data through Questionnaire
Note: The extent of impact was enquired from maximum through average to low. The Maximum (M), Average (A), and Low (L) are assigned weightage points as M=3, A=2, L=1.
the parenthesis indicate the total score of each factor. The finance manager has to keep in mind the above factors while taking lease decision.

Lease evaluation in practice based on few studies that have been carried out in the U.S.A. and in India. Most of the literature on leasing reveals that financial contract chosen focuses primarily on the tax shelters associated with leasing. Managerial analysis in leasing practices carried out by Smith and Wakeman\textsuperscript{24} has revealed a set of non-tax incentives which are typically not factored in a lease evaluation model. According to them leasing is more likely

- The value of the asset is less sensitive to use and maintenance decisions.
- The asset is not specialized to the firm (Lessee).
- The expected use of the asset is short, relative to the useful life of the asset.
- The corporate bond contracts (loan agreements) contain specific financial policy (restrictive) covenants.
- The management compensation contracts contain provisions specifying pay-offs as a function of the return on invested capital.
- The lessor has a comparative advantage in asset disposal.

In Indian context a survey conducted by Kamath\textsuperscript{25} has revealed that the decisions to lease are primarily influenced by

- Hundred percent financing provided under a finance lease.
- Simple documentation
- Expeditious sanctions
Absence of restrictive financial covenants in the lease agreement

No requirement for detailed post-sanction reporting

Flexibility in terms of structuring lease rentals

Off-balance sheet feature of finance lease all these factors stated above while lease decision making.

Major Clauses in the Lease Agreement

The lease clauses vary from one to other lease agreements, however the following clauses are found in most of the agreements.

a) **Description of the Parties:** The names and description of parties is contained in the caption of the agreement.

b) **Grant of Leases:** One of the foremost operative clauses is the clause by which the lease is agreed and affected. This clause forms the basis of the lease.

c) **Lease Rentals:** The amount of lease rentals to be paid is mentioned in this clause. Further this clause also specifies the place of payment, the mode and periodicity of payment.

d) **Tenure of the Lease and Right to Renew:** The period for which the equipment is leased and the option available to the lessor for renewing the lease on expiry of the primary lease period is covered in this clause.

e) **Description of the Equipment:** Description of the equipment is an essential part of the agreement. It should be such that it enables the lessor to identify the equipment.
f) **Security Deposit:** If a security deposit is taken, it is necessary to specify when and how it to be refunded is, with or without interest, and what are all the claims against which it may be adjusted or retained.

g) **Lessee’s Initial Covenants:** i) selection of the equipment by the lessee and exclusion of any warranties.

ii) Affirmation of cost and antecedent negotiations.

iii) Abstention of all permissions regarding the goods.

h) **Lessee’s Continued Obligations during the Lease Period:** They consist of usual care and maintenance of the asset, proper use etc., and the most important of these covenants are given here.

- All costs relating to equipment to be borne by lessee.

- Lessee not to convert property.

- Additions/ alterations belong to lessor

This is a useful clause-1 assets the lessor’s right over the equipment. The lessee is a mere user and without the lessor’s consent, he shall not make any additions or alteration to the equipment.

i) **Assured Residual Value Clauses:** This clause is very significant in finance. Leases in that the lessor is no expert of the asset and wants to take no asset bared with risk. He must have the terminal value of the asset assured by the lessee.

j) **Insurance Clause:** The lessor must insure the equipment at his cost and expenses for the benefit of and on behalf of the lessor against all normal risks that are specific t the equipment.
k) **Surrender Clause:** When the tenure of lease is expired the lessee must deliver the equipment to the lessor in good working condition.

l) **Default Clauses:** This clause is central to take enforcement of the right of the lessor to terminate the lease and proceed to recover the asset, upon the occurrence of any such event of default.

m) **Arbitration Clause:** In clause disputes or difference arbitration procedure should be followed. The arbitrator should be named in the agreement, and he should not be a party having interest in agreement.

n) **Miscellaneous Clauses:** This clause include interest variation clause which provides for varying the lease rentals with respect to changes in the short term lending rates of commercial banks. It also has the confirmation of acceptance clause, recovery of taxes etc., on the goods.

**The Structure of a Lease Agreement**

A lease agreement is a statement indicating the intention of the parties concerned and a document providing the terms and conditions under which the performance of the intention is to be undertaken. A lease agreement therefore is a set of self-made and mutually acceptable rules of a commercial transaction that is consistent with law.

Steps in the formation of lease-contract as follows

- The lessee decides on the precise nature and type of equipment that he proposes to purchase.
- The lessee then approaches the manufacturers or vendors who deal in the equipment required and begins negotiations.
The lessee simultaneously makes an application to a lessor stating his intention to enter into a lease agreement. The lessee may approach more than one lessor, in which case negotiations are carried out and a lessor offering the most convenient terms is chosen.

The lessee completes negotiations with the supplier or suppliers, as the case may be, and the purchase agreement is communicated to the lessor.

The lessee is expected to furnish such details to the lessor as: the specification of the equipment, the price, the terms of payment, terms of warranties, delivery period, installation costs, transportation cost and other costs pertaining to bring the equipment into operation.

The negotiations between the lessor and the lessee are finalised with respect to the length of the lease period, the distribution of rentals over the period, the amount of rentals to be collected and the mechanism of collecting rentals. This results in a lease agreement.

The lessee, if a corporate entity, would be required to submit in writing a confirmation with respect to a) that it has the corporate power to enter into the agreement b) that the agreement will not violate any provision of the company's memorandum or articles of association, or any other contract to which the lessee is subject to c) that all necessary licenses and consents in connection with the execution, performance and validity of the agreement have been obtained and are in full force.

The lessee is then allowed to take possession of the asset, for which the necessary ownership papers are processed in favour of the lessor. The lessor
undertakes to pay the supplier on the terms agreed to between the supplier and the lessee. The lessee in turn undertakes to take full responsibility for the performance of the equipment, to this end the lessee is expected to provide a certificate to the lessor, that the lessee has inspected the equipment and that it is as per the specifications asked for. The lessee is further expected to certify that the equipment is in good working condition and that it can be used for the purpose for which it was obtained.

The lessor makes the payment to the supplier and lessee takes possession of the asset. The lessee continues thereafter to discharge his obligation under the agreement.
REFERENCES


2 ibid


4 ibid.


21 Sriram, op. cite. pp73-79.


25 ibid.


27 ibid.