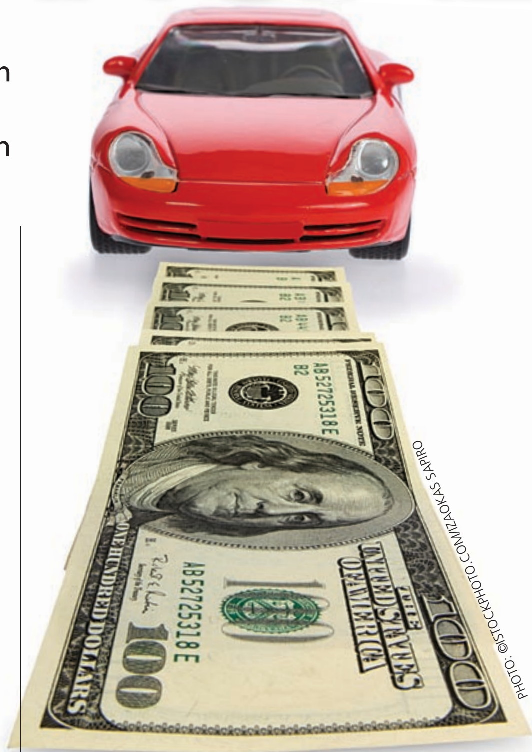
WHY LEASING FINANCIAL

While owning vehicles offers some advantages, leasing vehicles can provide cash flow benefits, reduce administrative headaches, and make available a variety of fleet management tools. By Gary Scanlon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The two forms of fleet vehicle acquisition – leasing and purchasing outright – both offer pros and cons. An individual fleet's determination of the best method depends on its unique business needs and circumstances.

Cash Flow Benefits Provided

The most significant benefit to fleet vehicle leasing is greater corporate cash flow options. A smaller up-front investment is required for a lease than for an outright purchase. A well-written lease agreement reduces fleet costs to a monthly operating expense, while keeping credit lines clear and cash on hand to reinvest in the company. Cash that would have been committed to fleet purchases can be used to grow the core business.

Companies that choose to own a fleet must either use their own capital or take out a loan, both require significant up-front investment. In addition, the company balance sheet takes a hit — reduced cash on hand or greater debt. This financial position, in turn, can make the company less attractive to investors or lenders, potentially handcuffing plans to grow corporate business.

AT A GLANCE

The advantages of leasing versus owning fleet vehicles include:

- Better corporate cash flow considerations.
- Reduced in-house administrative and recordkeeping tasks.
- Maintenance programs built into lease agreements.
- Online fleet data management tools provided by lessor.
- Access to less-expensive, late-model vehicles.
- Tax benefits.

Two Categories Available

Additional leasing benefits depend on the type of fleet lease. A commercial vehicle lease is typically either open-end or closed-end. Open-end leases are generally shorter in term — lasting one year at minimum and continuing on a month-to-month basis thereafter. Open-end leases avoid long contracts, but usually present an amount of lease-end financial risk. Closed-end leases — also known as "walk away leases" — generally run longer (typically about three years), but carry no risk at lease end.

Most open-end leases contain a terminal rental adjustment clause (TRAC). A TRAC guarantees the vehicle owner (the leasing provider) a predetermined value for the vehicle upon sale at lease end. If the selling price is more than this value, the lessee is credited the surplus. If the vehicle is sold for less, the lessee is responsible for paying the difference. Therein lies the inherent risk of the open-end lease.

In a closed-end lease, the lease provider bears 100 percent of the responsibility for the vehicle at lease end. A closed-end lease may be slightly more expensive in month-to-month costs, and most are subject to mileage restrictions and "wear-and-tear" provisions. However, costs are fixed.

Additional Savings Opportunities

Aside from cash flow and balance sheet considerations, a commercial vehicle lease can save money in other ways, including eliminating admin-

MAKES GOOD SENSE FOR FLEET

istrative tasks. The vehicle titleholder must handle everything from taxes owed to license renewals. A lease provider typically handles a variety of fleet management tasks, including paperwork and recordkeeping, allowing the company fleet manager to concentrate on core fleet operations.

Many fleet lease providers also offer routine maintenance and roadside assistance programs. These services can readily be included in a flat monthly fee, allowing company fleet management to build the cost into an operations expense budget.

Companies that own their fleet vehicles can outsource administrative and maintenance services. Lease providers typically leverage relationships with service providers to negotiate reduced rates the user can enjoy.

Expense Management Aided

Fleet leasing providers also offer a

CLOSED-END LEASES: SIMPLE & COMPLETE

A closed-end lease is a simple transaction. The lessor purchases a vehicle, and the lessee pays for use of that vehicle for a fixed period of time. When the lease term is over, the lessee returns the vehicle to the lessor, who then sells it, with the hope of making a profit.

The lessee is responsible for "excess wear and tear," including mileage in excess of that stipulated in the contract (since the lessor accepts residual risk.) The lessee bears this risk under an open-end lease as well, since condition and mileage impact resale value.

➤ CLOSED-END LEASES CHARACTERIZED BY FIXED TERMS

A closed-end lease is characterized by the following general terms:

- A fixed term, usually from two to five years.
- A mileage limit.
- A lessee purchase option.
- A lease-end adjustment (cents per mile) for mileage exceeding the contract-stipulated amount.
- The lessee pays for "excess" wear and tear — mechanical or physical damage.
- Lessor assumes residual risk/benefit.

Closed-end leasing offers other available services, such as insurance and maintenance. Companies that wish to focus on their core business can remove themselves from the "car business" via closed-end leasing, eliminating risk and enabling exact budgeting of all vehicle expense, save for fuel.

➤ CONSIDER MID-TERM ADJUSTMENTS AND OTHER CLOSED-END LEASE FACTORS

Most closed-end lessors allow "mid-term" adjustments of the time and mileage parameters established at the onset of the lease. Should the actual utilization of the vehicle change dramatically from the original intent (i.e., mileage is accumulated at a faster rate), the lessor often agrees to reset the terms based on the new reality of the situation.

A common misconception about closed-end lease terms occurs when concerns arise that a lease may need to be terminated early due to downturns in business. While the closed-end lease does contain specific early termination language and it can be costly to the lessee, often overlooked is the fact the same exposure is present under an open-end lease.

If, under a an open-end lease the original term was set assuming the vehicle would remain in service for 36 months and a certain mileage, a depreciation rate is set to closely match the book value and anticipated market value after 36 months. If this vehicle remains in service only for the 12-month minimum, the market value at that point will be considerably below the "undepreciated" book value, a cost absorbed by the lessee. Therefor, exposure exists under both closed-end and open-end leases.

number of expense management tools. Online fleet management tools track a fleet's costs, history, and lease terms, as well as other important and necessary data. With these tools, fleet management has become much less time-consuming, resulting in reduced costs. By monitoring expenses more closely and accurately, problems can be identified and dealt with immediately.

Many fleet leasing providers also offer fuel programs that help control spending at the pump through regular odometer updates and other tools. Fuel programs also often provide preventive maintenance scheduling and fleet cycling, which can help control fleet costs over the longer term.

'Value Leasing' Can Save Costs

Fleets can also take advantage of "value leasing" programs. These programs offer late-model vehicles that typically look and perform "like new," yet can save up to $100 per month, per vehicle, depending on the type of vehicle and terms of the lease. For many of these vehicles, original manufacturer's warranty coverage remains.

Corporate vehicle leasing can also provide tax benefits, which vary according to lease type. With an operating lease (the most common commercial enterprise lease), lease payments are treated as an income statement expense with the lease obligation footnoted on the balance sheet. In this way, lessees can gain significant financial tax benefits without the balance sheet impact of a full lease obligation.

Alternatively, in a capital lease, the lessee is considered the vehicle owner for tax purposes. By assuming some risks of ownership, a lessee can claim depreciation on the asset each year and deduct the interest expense of the fleet lease payments.

Finally, a less-tangible benefit to commercial vehicle leasing is the ability to keep a modern, reliable, and better-looking fleet on the road. Sometimes overlooked is the public perception created by a fleet vehicle as a representation of the company itself. A fleet comprising vehicles of varying quality, age, and looks can send an undesirable message. ■

About the Author

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OPEN-END LEASES: FUTURE MAY HOLD CHANGES

Historically, open-end leases have been the most popular structure among commercial fleets. In recent years, however, a noticeable shift to the closed-end option has occurred, primarily attributable to significant volatility in the used-vehicle market. Many companies can not tolerate such swings and the resulting impact to their budgets.

In addition, as we move closer to a "world economy," pressure is mounting to standardize to an internationally acceptable set of accounting principles. Today, most European companies do not recognize open-end leases written in the U.S. as meeting the requirements for operating lease (off balance sheet) treatment. Many U.S. entities with European-based companies will utilize only available closed-end leases in the U.S. market. As accounting standards setters unify areas not in sync today, the current version of the U.S.-written open-end lease may not exist or may be rewritten to meet new standards.

➤ HOW A TRAC OPEN-END LEASE WORKS

A master lease agreement exists between lessee and lessor outlining the general terms and conditions that apply to any vehicles leased under the agreement. The lessee selects a vehicle and works with the lessor to determine the length of vehicle service based on the lessee's replacement criteria. These criteria are usually a combination of mileage and time, i.e., 36 months or 65,000 miles, whichever occurs first.

With projected monthly driver mileage at 3,000 miles, the 65,000 limit is reached after roughly 22 months in service. The vehicle's residual value is projected and the capitalized cost of the vehicle reduced, via the monthly payment, in equal amounts until the unamortized value at 22 months reflects the resale value originally projected.

At this point, the TRAC is applied. The vehicle is taken out of service and sold by the lessor to a third party. If resale proceeds exceed the unamortized "book" value, the excess accrues to the lessee. If proceeds are less than book value, the lessee is charged the difference. The TRAC lease provides the kind of flexibility large or geographically spread fleets need.

The basic difference between a closed-end (or net) lease and the open-end TRAC lease lies in the vehicle's residual. In an open-end lease TRAC, the residual risk lies with the lessee; in closed-end leases, the lessor assumes residual risk.

Most open-end/TRAC lease contracts allow lessees to choose between fixed and floating rates for funding. In addition, they usually provide the option to change from floating to fixed at a point during the life of vehicles already in service. The question is when and if to do so.

The decision to opt for fixed or floating rates is similar to choices investors make in deciding when to buy or sell stocks. Timing is the most important criterion. Fleet lessees must make relatively certain they do not fix rates too soon or too late to maximize the impact on the value of the chosen rate type.