



Developing Your Financial Intelligence

FQ1: Tips for When to Buy, Borrow or Lease

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FQ1: Tips for When to Buy, Borrow or Lease

Introduction

When looking to acquire an asset for business or personal use, a car, a computer, a building or the like, the question that comes up is whether to purchase or lease. The follow-on question if it is a purchase is do you pay the full amount up-front or spread the payments over the life of the asset through a loan. The discussion below will cover when to borrow and when to lease and the reasons for and pitfalls of doing either.

Acquiring Assets

The decision to buy, borrow or lease is generally based on how you answer the following questions, either independently or in some combination:

- How much money you can expend to buy the asset after considering alternative purchasing and projected cash needs?
- Do you want to own the equipment at the end of the financing?
- Is the equipment subject to rapid obsolescence?
- What is the strength of your personal and business credit rating?

Generally assets are purchased outright or through a loan when the assets will last a long time, appreciate in value and can be used as collateral for future borrowing.



What to expect when you borrow

There are several factors and requirements you need to be prepared to satisfy when you decide to finance the asset purchase with a loan:

- Two-three years of historical financial statements and several years of projected income statements and possibly multi-year cash analyses will be required. This means your books and records need to be up-to-date and in order.
- Expect to make a cash down payment of 10-20%.
- Personal and business credit will need to be strong.
- Able and willing to provide a personally guarantee, if required.
- Business cash flow can support monthly payments even if the monthly payments change due to a variable not fixed interest rate.
- Ability to provide periodic financial reports to lender if required. Again, this means your books and records need to be up-to-date and in order.
- Willing to accept potential future borrowing restrictions.
- The useful life of the asset will equal or exceed the term of the loan, i.e. 30 year mortgage matches the average life of a building.

What to Expect When You Lease

When opting to acquire the use of an asset through a lease, be prepared to agree to the following:

- Financing the entire cost of the asset. If necessary you may be able to include any financing/origination fees and service agreement fees.
- Do not expect to need to prepay or renegotiate.
- Cash flow requires a predictable, set payment each month.
- Not your intention to own the asset at end of lease.
- Able and willing to provide a personally guarantee, if required.
- Personal and business credit will need to be strong.
- Willing to accept potential future leasing restrictions. This does not happen often but could.



Pitfalls & Caveats When Borrowing or Leasing

- A personal guarantee usually means the loan is secured by your personal assets which can include your house and other key assets. This can impact your ability to take on additional debt, business and/or personal.
- All agreements come with terms that can invoke fees for non-compliance. Understand what is considered non-compliance. It is critical to read the fine print.
- Understand how the bank will handle the business acquiring other debt or leases. Also understand who has seniority in payoff where there is a bankruptcy.
- While negotiating the loan determine if annual audited or reviewed financial statements will be required, as this represents an additional expense to the business.
- At the end of the lease there can be a substantial payment due if the usage allowed in lease exceeds actual (auto leases particularly).
- For many copier leases there is a pre-determined number of copies. If you exceed the number allowed you will be billed at a ridiculous per copy rate. Make sure to know your copying patterns and negotiate the lease accordingly.
- "Return" of equipment usually means 100%, no partial returns or missing documentation etc. It is important to understand this from the beginning.
- Don't sign anything you don't understand.
- It's a good idea to have another person with you when you are negotiating...two people to hear what is being said or not said.
- It is important to know what you want and what you can live with so you are prepared to walk away if necessary.
- It is important albeit critical you read and understand the fine print. Read it more than once. Have someone your trust also read the fine print, your accountant or attorney would be a good choice.
- Lastly, if the terms of the loan or lease seem too good to be true, they probably are. Don't sign on the dotted line!



Resources

Below are resources to help you become more savvy about credit.

National Foundation for Credit Counseling, www.nfcc.org – their site includes different calculators and worksheets to help you determine what you can carry for debt. The site is more for personal than business debt.

National Endowment for Financial Education, www.nefe.org – the organization is focused on helping individuals acquire financial knowledge.

Independent Means, www.independentmeans.com, *Raising Financially Fit Kids*, the book and programs, provide “a range of solutions for companies, organizations, schools, and families. Our multi-phased approach targets employees, clients, and communities alike to ensure generations of financially empowered kids and parents.”

Money Savvy Generation, www.msgen.com, teaching money management basics to elementary school aged children.

360 Degrees of Financial Literacy, www.360financialliteracy.org, general information for managing personal finances. There are specific areas on the site for entrepreneurs.

Feed the Pig, www.feedthepig.org, This website includes tools, a quiz, tips and other resources to help young people think through their spending and saving habits, identify ways to start saving and commit to making changes that will reduce their debt and grow their savings.

Please check www.schammond.com as additional resources are being added periodically.



**Tips for When to Buy, Borrow or Lease
Comparison of Asset Acquisition Methods**

<u>Type/Use</u>	<u>Characteristic</u>	<u>Info Required</u>	<u>Benefits</u>	<u>Disadvantages</u>	<u>Tricks & Traps</u>
A. Outright Purchase: <ul style="list-style-type: none"> • Have cash • Want to own asset • Not subject to rapid obsolescence 	<ul style="list-style-type: none"> • Title/ownership is immediate 	<ul style="list-style-type: none"> • Very little info required • Payment needs to clear 	<ul style="list-style-type: none"> • Cost is not increased by interest or finance charge • No waiting to be approved 	<ul style="list-style-type: none"> • If technology equipment soon could be outdated 	<ul style="list-style-type: none"> • Doesn't protect against equipment obsolescence
B. Bank Loan: <ul style="list-style-type: none"> • Some cash • Want to own asset • Not subject to rapid obsolescence • Asset life = loan term • Strong credit 	<ul style="list-style-type: none"> • Requires a deposit (10-20%) • Bank holds title until repayment complete • Lots of paperwork 	<ul style="list-style-type: none"> • 3 yrs Co. financial stmts & tax returns • Owners personal fin stmts & tax returns • Ratio analysis • Personal guarantee 	<ul style="list-style-type: none"> • You own equipment when loan is paid off • Interest is deductible • Depreciation is deductible • Asset serves as loan collateral • Prepayment allowed • Asset & Liability on balance sheet effecting Debt to Equity ratio 	<ul style="list-style-type: none"> • 10-20% deposit required • Credit approval required • Sometimes non-fixed interest rate • Drives up cost of equipment etc. • Doesn't protect against equipment obsolescence • Can't use asset as collateral until loan paid-off • Can be restrictions on taking other debt. • Periodic financial reporting • Responsible for all repairs & maintenance 	<ul style="list-style-type: none"> • Personal guarantee usually includes your house & other key assets. • Look for fees to negotiate. • Bank can dictate other borrowing. • May require audited or reviewed financial stmts
C. Lease: <ul style="list-style-type: none"> • No cash • Don't want to own asset • Asset subject to rapid obsolescence • Need predictable payments 	<ul style="list-style-type: none"> • No upfront deposit generally • Lessor retains ownership 	<ul style="list-style-type: none"> • Historical financial information for larger leases required • Company credit reports 	<ul style="list-style-type: none"> • Conserves cash as down payment is limited & applied to balance • Can finance equipment cost, fees & maintenance • Level rental payments which are deductible • Certain leases will let you add on • Protects against equipment obsolescence • Asset & Liability off balance sheet in certain cases 	<ul style="list-style-type: none"> • Drives up cost of equipment • No prepayment or renegotiating • Don't own asset though responsible for repair & maintenance • Sometimes restrictions on taking other debt • New co's may have a guarantee requirement • FASB #13 may apply • May effect debt to equity ratio 	<ul style="list-style-type: none"> • Can be substantial payment due at the end of lease if usage allowed in lease exceeds actual (auto leases particularly) • "Return" of equipment usually 100%, no partial returns or missing documentation etc.