THE TAKE-UP OF LEASE FINANCING IN THE UK MAY HAVE BEEN GRADUAL BUT AS TREASURERS LOOK FOR MORE FLEXIBLE WAYS TO SAVE CAPITAL, ITS GROWTH SEEMS ASSURED, SAYS **KIRSTINE WILSON** OF SIEMENS.

A GROWING AWARENESS OF LEASING IN THE UK

There is continued progress in the use of leasing by UK firms, despite a temporary downturn in business investment and equipment leasing since the turn of the millennium. This gradual increase in the use of flexible asset financing is consistent with the increased pressure on treasurers and financial managers to seek more economically-priced and flexible capital finance. In the boom years, several business sectors took on burdensome swathes of debt in anticipation of revenues that did not materialise – telecoms is the obvious example. Equally, the European and US economic downturn made it difficult to raise equity finance, so financial professionals turned to debt instruments.

Looking at the findings of recent research by Siemens Financial Services, it would appear that companies' enthusiasm for innovative working capital finance is now being mirrored by an increase in the use of leasing. Its attractions are not simply cashflow-friendly finance, but also the ability to tap into additional lines of credit, as well as the flexibility of being able to upgrade equipment during the term of the lease. Since 2000, the proportion of business investment financed through leasing has risen by more than 1% – and this reflects the long-term trend in leasing growth.

This figure does not include the public sector, which, with the enthusiasm for public private partnership (PPP) finance, would have distorted the picture. Instead, the story is one of a more gradual, but inexorable, take-up of the leasing option. Moreover, there is some considerable growth yet to come. In the US, a mature market for capital equipment leasing, lease financing represents some 31% of all equipment investment, whereas in the UK the proportion is just over 24% and rising.

This article describes the state of equipment leasing in the UK, its likely progress in 2004, and how that compares with the scene in Germany and the US. We also look at the impending tax reform by the UK Treasury and how that may affect the ways in which financial managers can take advantage of the leasing option.

EQUIPMENT LEASING TRENDS 2003-2004. One of the challenges about understanding size and growth trends in the leasing market is the partial nature of the available public statistics, which all paint different pictures. Due to this, we conducted primary research among key corporates and financiers in order to fill the gaps and verify our findings. Before describing our findings, which broadly predict an upswing for the coming year, it is important to define what part of the leasing market we are talking about and the wider implications of our research figures.

We examined two areas: information technology (IT) finance and the broader category of commercial equipment leasing. IT is defined as hardware and software, excluding services, whereas commercial equipment embraces all business technology except buildings and cars. There are several reasons why our research figures, positive as they are, probably understate the growth in corporate appetite for equipment leasing.

First, according to the European IT Observatory, IT services, such as configuration, integration, maintenance, support and training, typically make up about 47% of the typical IT deal. Lessees, in general, want a single financing package for those IT deals and do not want to get into the complexities of its structure. So the pure leasing element of those deals will only cover the hardware and possibly the software components, telling us that the lease element understates the total IT finance value by almost half. If we add to this the fact that IT services are predicted to see about 8% compound annual growth, compared with a hardware market value growth of 3-4%, then the effect is amplified still further.

LEASE OPTIONS. Second, software can be leased, but the process is more complex, as it requires the lessor to become part of the licensing chain, and licensing arrangements can be varied. If licensing arrangements preclude a lease being arranged, the software element tends to be financed via a method other than leasing. Additionally, in a market rife with cut-throat competition, hardware unit prices continue to fall, meaning that increases in the value of hardware financed mask an accelerated growth in the number of units leased.

Finally, most commercial equipment installations are built around an IT core nowadays and, as before, lessees are increasingly looking for all-in-one deals that incorporate the entirety of an IT-based system or facility. That is why our report includes figures on growth in the broader commercial equipment market.

When all these factors are taken into account, it becomes clear that the actual appetite for IT financing, incorporating a leasing element, is probably two to three times the scale of our pure leasing figures.

What then has our research revealed? The UK economic situation is showing signs of recovery, with advances expected in 2004.

A worrying lull in manufacturing figures last autumn has now been pushed aside by the latest figures (4% annual growth) from the CBI, and economic growth predictions are no longer viewed with such scepticism as before. Most economists and analysts predict that UK business investment in capital equipment will grow in 2004 compared with 2003. For IT leasing, this growth is expected to be faster than in Germany, and even a little ahead of the US. However, US investment recovery started with positive figures in 2003, so, proportionately, US growth might be expected to be a little less. But US commercial equipment investment had already started to grow substantially in 2003 (3.9%), whereas in Germany it had slowed to a virtual standstill (0.9%) and in the UK had dropped still further (-6.2%)[1].

For commercial equipment leasing, UK growth is expected to be ahead of the US and Germany. In 2004, new business in this area is estimated to grow by almost £1bn[2]. Measured as a proportion of all commercial equipment investment, the UK is showing a small net growth (1%) since 2000, in contrast to the US, which is showing little long-term growth as a proportion of total investment. Germany, on the other hand, shows more substantial proportionate growth over the same period (2.5%), which is probably a result of the country's more severe recession.

PROPOSED TAX CHANGES. In its broadest sense, any simplification of business taxation is a welcome development. In August 2003, the Inland Revenue and HM Treasury published a consultation document on corporation tax reform. It deals with how the system for taxing companies could be "modernised" so that it does not "impede the drive to greater economic efficiency, productivity and growth, and keeps pace with European and international developments".

Relevant to the subject of this article, however, concern has been expressed at the proposals' aim to change radically the system of giving tax relief for the cost of plant and machinery (known as capital allowances), with reference to finance leasing. UK companies can currently claim capital allowances as a tax relief against the acquisition of commercial equipment. In general, 25% of the purchase price is deducted on a reducing balance basis from the firm's taxable profit each year (or 6% if the equipment is deemed to have a long life).

The tax savings given by capital allowances reduce the cost of purchasing commercial equipment for UK companies, but only if the company is profitable and paying tax. If a company is not paying tax, the cost of purchasing equipment is higher, as it is not able to benefit from the relief. So instead of buying equipment, non-tax-paying companies often lease equipment from a finance company that is tax-paying. The finance company buys the equipment, leases it out, takes advantage of the capital allowances and passes any relief on to the user. Where such a transaction economically equates to a loan secured on the equipment, it is suggested that the tax treatment should follow more closely the accounting treatment.

To understand the potential impact of the proposed changes, a differentiation needs to be made between big-ticket (£20m+) leasing and the vast majority of the leasing market (£5,000-£20m). Big-ticket is a highly price-sensitive market, where tax-efficient structuring within the UK, or even intra-country, can make a substantial difference to the competitive leasing proposition. This simply does not apply to the rest of the leasing industry, where the primary motivating forces for the lessee are to obtain cashflow-friendly capital financing, upgrade options and available sources of credit. In other words, all but the largest leasing clients tend to look for overall business requirements relating to flexibility, upgradeability and service, rather than purely tax arbitrage in marginal financing decisions. The impact of the proposed tax review on capital allowances would particularly affect big-ticket lessors and lessees. There is a sound argument that the current system of capital allowances is economically stimulating and therefore a good thing for the country. For leasing below the multi-million pound level, the tax advantages, although a factor, are outweighed by the attraction of available capital finance.

> 'THE IMPACT OF THE PROPOSED TAX REVIEW ON CAPITAL ALLOWANCES WOULD PARTICULARLY AFFECT BIG-TICKET LESSORS AND LESSEES'

DRIVING LEASING GROWTH. There is one final factor likely to fuel the growth of lease finance of commercial equipment in the UK – non-discretionary spending. Whereas with many of the big IT developments of the last decade, such as enterprise resource planning (ERP) and credit risk mitigation, where the company had a choice of whether or not to invest, we now appear to be in an era of regulation and security spending. The impending requirements of IAS 39, Sarbanes-Oxley for US-listed UK corporates, and other regulations have been estimated to be considerable.

Recent reports put the Sarbanes-Oxley cost burden on the 200+ affected European firms at an extra €370m per year, according to HandySoft, and the cost of IAS 39 changes on UK companies to be £495m (source: JMH Demica). Security is also driving non-discretionary spending, not just by airlines, but all organisations that have a legal and commercial requirement to store data securely. Those whose insurance has been either partially withdrawn, or where certain risks have been made uneconomic in the light of the current terrorist threat, have often had to mitigate their risks and responsibilities by improving their own physical and systems security measures. Finally, there are powerful competitive forces that are raising certain technology and equipment investments to 'must have' status, such as the introduction of chip and PIN in the retail industry.

ON THE UP. From its current 24% penetration of all UK commercial equipment investment, we expect there to be steady progress over the next few years towards the US benchmark of over 31%. This is likely to happen despite the potential threat to big-ticket leasing posed by the proposed changes to UK tax law. As IT-based deals, in particular, are structured as mixed lease and loan packages, the indicators from our report should be taken as understating the whole capital equipment finance scene by a factor of probably over three times. One thing is clear, however, corporate appetite for lease financing seems to be showing no signs of abating.

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Notes

[1] Based on Finance and Leasing Association and Office of National Statistics data.

[2] Siemens Financial Services research, January 2004: primary research among top 100 global corporates and top 20 finance providers; secondary research among over 30 sources.