Leasing rolls on

Executive summary

- Banks have responded to the revised tax treatment of long-funded leases by generating innovative and integrated forms of lease finance.

As companies seek to drive down the amount of capital tied up in assets, as well as to protect themselves from future equipment value risks, choosing the most appropriate instrument to finance assets is becoming increasingly vital.

In broad terms, the available capex funding options include utilising working capital, raising a loan, or seeking a partner bank to purchase the assets and make them available through leasing arrangements for a pre-defined period. The physical results may be largely the same – gaining use of the assets in question – but the financial impact of these three options can bear little resemblance to one another.

One option seemingly under threat is that of working with a partner bank using leasing. Indeed, many may have seen the reform of leasing contained in the 2006 Finance Act as a material challenge for the leasing industry. In fact, the change has provided an impetus for banks to develop their asset finance products beyond the traditional vanilla finance lease.

Certainly, the lease tax changes have come at a time when more companies are focusing on unlocking the working capital they have tied up in depreciating assets. In an age of lean manufacturing and on-demand business, managers are questioning the very existence of working capital, let alone locking it up in physical assets. The managerial focus on return on capital means that any available money needs to provide a real return to the business – for example, in R&D, training or as a financial investment.

Given these concerns, companies are moving away from the traditional forms of loan finance to more innovative options.

EVOLUTION AND RESPONSE This year has been a turning point in the legislative framework surrounding asset and lease finance. After more than 30 years of gradual evolution, the 2006 Finance Act has made major changes. For longer-term leasing, banks will now often be taxed as if they provide straight loan finance, rather than gaining the benefit of capital allowances.

This change in tax treatment applies specifically to long-funded leases (those that run for more than five years). Those that run for under five years – and under certain conditions leases that run from five to seven years – can continue to benefit from capital allowances.

In addition, lessors will continue to be able to claim for capital

THE DEATH OF LEASING AS A MEANS OF FINANCING CORPORATE ASSETS HAS BEEN GREATLY EXAGGERATED, SAYS **VASGEN EDWARDS**.

CENTRAL TO THE NEW APPROACH IS AN ABILITY TO ADOPT A BROAD VIEW OF RESIDUAL VALUE POSITIONS ON PLUS-FIVE-YEAR LEASES SO THAT THE BENEFITS OF THE LESSOR'S CAPITAL ALLOWANCES ARE STILL AVAILABLE TO LESSEES

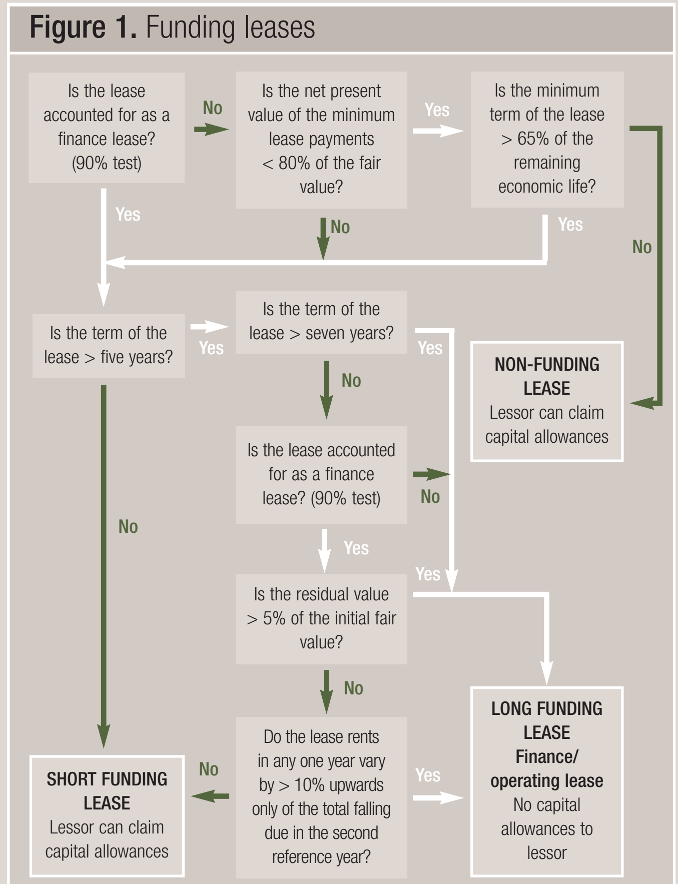

Figure 1. Funding leases

allowances on eligible operating leases almost regardless of the length of the lease. With long-funded leases now taxed as straight loans, the lessor is not allowed any capital allowances; the lessee is entitled to capital allowances but can only deduct that element of rental payments that are equivalent to interest payments (see *Figure 1*).

Financial providers therefore need to be more innovative, offering solutions underpinned by the key tenets of value for money, predictable cashflow and flexible finance.

Banks have had to rethink the best way to deal with equipment finance. Central to the new approach is an ability to adopt a broad view of residual value positions on plus-five-year leases so that the benefits of the lessor's capital allowances are still available to lessees.

Taking residual positions on equipment needed by clients – which may be for a very specific purpose – requires a greater degree of hands-on market and technical knowledge from the financier. Some banks continue to outsource this asset management role to third parties, potentially generating additional costs for the client, but specialist asset finance can be economically compelling for potential lessees, particularly from a cashflow angle.

SPECIALIST EQUIPMENT FINANCIERS Success in the new leasing environment will hinge on whether in-house equipment managers,

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including sector specialists, are closely aligned with the bank's specialist equipment financiers, who will need to work in parallel to understand the customer's business and future equipment needs. If this is done well, the bank can, with reasonable confidence, estimate the future value of a client's residual position, as well as provide the client with the best financing solution for their business.

The importance of knowing the market, combined with technical expertise of the asset, is vital. Improving their calculation of the residual value of assets allows banks to assess risk better and structure a financing solution that meets clients' individual requirements.

In an age of agile manufacturing, companies want to be able to alter production facilities easily so they can manage changes in demand without incurring a sudden financial strain.

A willing asset financing partner should have the relevant expertise to work alongside a client to resolve such issues, rather than adopting a rigid pre-agreed financing structure.

Banks also need to cover a broad range of equipment sector specialists. Equipment financiers should be able to provide financial solutions for elements as diverse as IT, packaging, printing, engineering and logistics as well as core manufacturing processes and incorporate the fundamentals of the equipment life cycle.

IMPACT OF FURTHER REGULATORY CHANGES As well as accounting for equipment maintenance, control of asset exposures, obsolescence risk and market conditions, companies need to consider how they will dispose of equipment.

The EU's Waste Electrical and Electronic Equipment (WEEE) Directive puts the onus on producers to treat and recycle redundant electrical and electronic equipment. Once again, innovation is possible. One solution is for equipment financiers to work closely with IT service providers who take responsibility for disposing of the equipment at the end of its term.

The future of asset finance is bright. Leasing deals will increasingly be provided with integrated solutions aimed at enabling clients to improve their productive capacities while hedging any asset risk. In this new environment, clients will, in the vast majority of cases, have much more to gain by choosing the correct leasing option.

Vasgen Edwards is Head of Corporate Asset Finance at Lloyds TSB.
vasgen.edwards@lloydstsb.co.uk
www.hmrc.gov.uk/leasing/
www.environment-agency.gov.uk/business

FIGURE 2. Worked example

Option A **Hire purchase (loan equivalent)**	**Option B** **Finance lease**	**Option C** **Operating lease**
Capital allowances claimed by borrower Repayment £169,016 Pre-tax internal rate of return 6%	Capital allowances claimed by lessor Repayment £164,999 Pre-tax internal rate of return 5.09%	Capital allowances claimed by lessor Repayment £129,902

Financial assumptions: 1. £1,000,000 (excluding VAT) item of plant. **2.** Fixed rate (5.25%) base cost of funds. **3.** Annual repayments in advance. **4.** Seven-year term. **5.** (A&B only) Margin of 75bp + base cost. **6.** (A&B only) Short-funding leasing treatment. **7.** December drawdown.