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PROCUREMENT STRATEGIES

Benefits of the Lease with Title Transfer Strategy

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INTRODUCTION

When a company develops a procurement strategy for the acquisition of equipment, it seeks a standard process for working with vendors to obtain equipment in a manner agreeable and familiar to both parties. One often overlooked procurement method is the lease with title transfer strategy – a capital lease procurement method that allows a company to lease equipment and obtain ownership upon the final lease payment.

The bones of this strategy do not differ much from other common procurement strategies, such as traditional leasing or financed purchasing. Lease with title transfer is also very similar to leasing with a $1 buy-out option, but excludes the legal obligation to send the lessor $1 to obtain title of the equipment. Despite its similarities to other strategies, a lease with title transfer approach offers multiple benefits that should not be overlooked.

This ISG white paper examines characteristics and benefits of the lease with title transfer strategy, and discusses various scenarios where this strategy can be applied.

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FLEXIBILITY IN FINANCING TERMS

Both the purchasing and leasing approaches to asset acquisition typically offer the opportunity to negotiate various pricing terms. The purchase approach provides a company with an opportunity to negotiate payment terms, potential discounts and the payment type. Purchasing also gives a company the opportunity to negotiate package deals related to the various components of a transaction. Larger transactions are usually easier to negotiate, since they involve an opportunity to bundle certain portions of the transaction at a discounted price.

Through the development of lease rate factors, leasing also allows a company to negotiate the same variables as if the equipment were being purchased. The company negotiates with the lessor to develop lease rate factors that result in an acquisition cost that is less than or equal to a desired net present value. This approach to negotiating lease rate factors that satisfy a NPV threshold can also be used with the lease with title transfer model. For example, if a company only wants to use the lease with title transfer model if the net present value equates to 105% or less of the original equipment cost (indicating a 5% premium), it can negotiate the lease rate factor with the lessor to ensure it equates to the desired NPV.

Keep in mind that a lessor will not be able to provide the same pricing on a lease with title transfer transaction as they would on a traditional lease, since they will be foregoing the potential profits from re-sale or secondary leasing. If a consumer was leasing a computer for 36 months and the lease payments equated to roughly 75% of the net present value of the equipment, the consumer should expect to pay a slight premium for a lease with title transfer transaction because the lessor will want to realize the foregone residual value. The premium will typically cover a substantial portion of residual value the lessor is foregoing by agreeing to the lease with title transfer transactions.

Compared to purchasing, the lease with title transfer method provides a "smoother" cash flow when acquiring equipment.

MINIMIZING CASH OUTLAY

One of the biggest disadvantages to purchasing as a procurement method is that it requires a large initial cash outlay. Leasing on the other hand, requires little or no down payment up-front in order to obtain the equipment. This means that a company can retain its cash and perform other business functions with it.

Compared to purchasing, the lease with title transfer method provides a “smoother” cash flow when acquiring equipment, as the price of the equipment is spread out over a term specified in the lease contract, rather than paid up front as it would be with purchasing.

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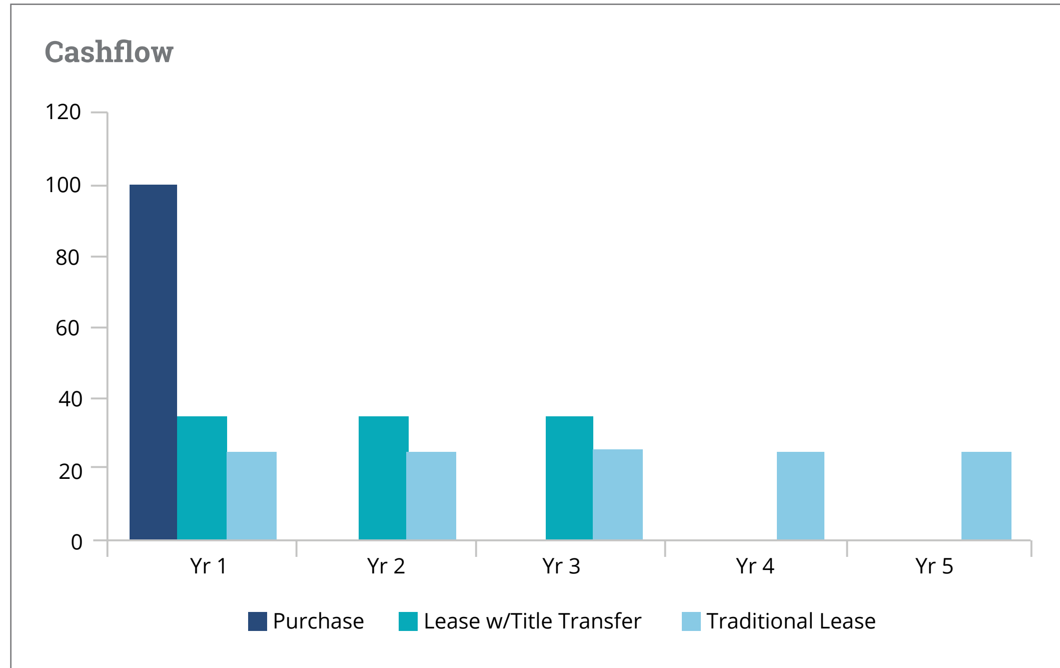

The chart above illustrates the annual cash flows of three procurement scenarios for equipment with a five-year useful life. The purchasing scenario represents a one-time up-front payment, and the two leasing scenarios represent a three-year lease. Because title of the equipment doesn't transfer to the lessor at the end of the third year with the traditional lease, a new traditional lease needs to begin in year four, meaning there is never a time without payment being owed.

Many rules or restrictions are associated with leasing equipment.

PROVIDES THE OWNERSHIP ADVANTAGES OF A PURCHASE

Many rules or restrictions are associated with leasing equipment. These rules generally prevent the lessee from handling leased equipment in a completely unrestricted manner, which they would be able to had it been purchased. Two of the largest restrictions on leased equipment are not allowing the lessee to move the equipment to a new location during the life of the lease, nor modify the equipment in a way that alters its original state.

The first major restriction mainly affects larger companies with multiple locations. If the equipment is procured by a traditional leasing method, the lessor may forbid the lessee from moving the equipment to a location not specified in the original leasing contract. By using a lease with title transfer method, since title of the equipment will eventually pass to the lessee, lease contract terms that allow the equipment to be moved as pleased can be easily negotiated.

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Utilizing a lease with title transfer method makes it much easier to negotiate the terms of the leasing contract.

The second major restriction applies to nearly all leased equipment. Traditional leasing generally has strict rules that prohibit the lessee from modifying the equipment being leased. For example, an automotive lease contract will state that the lessee is not allowed to perform any modifications to the vehicle. If any modifications are allowed, the lessor will most likely require that the lessee return the car back to its original state before the lease expires, or pay a penalty fee. Here again, utilizing a lease with title transfer method makes it much easier to negotiate the terms of the leasing contract, so that these restrictions do not prevent the lessee from handling the equipment as freely as they would had it been purchased.

UTILIZE ASSETS FOR LIFE

The lease term for leased equipment is generally shorter than the useful life of the equipment. This is because the lessor structures the original lease with the plan to realize some degree of residual value on the back end of the lease, whether through re-sale or secondary short-term leasing contracts. A new car, for example, can often only be leased for terms of 24 or 36 months, so that when the original lease expires and the car is returned, the dealership can then sell it on a secondary market (as a used car) or issue a second short-term lease contract to another consumer.

When an original lease expires, the consumer can send the equipment back to the lessor, undergo a costly lease extension, or accept a costly buy-out quote. A lease with title transfer transaction allows the consumer to obtain title of the equipment upon expiration of the original lease, then have the freedom to keep the equipment for the remainder of its useful life, or until a refresh is desired. The time that the equipment is kept without any payments being owed is when the savings are realized.

For example, if Company ABC needs a dozen high-capacity servers to support the development of a new location, it can obtain the servers through a 36-month lease, despite the servers having a 60-month useful life. At the end of the lease, if the company still needs the servers, it can send them back and refresh with new equipment or undergo a costly lease extension/buy-out, which would eliminate the financial advantage the 36-month lease initially provided. Had the company elected to utilize the lease with title transfer strategy, it could avoid any additional payments and have the freedom to use the equipment for its entire 60-month useful life.

Leasing equipment allows a company to utilize an asset for a specified period of time at a price that is typically less than the purchase price.

ELIMINATE COSTLY LEASE EXTENSIONS OR UNFAVORABLE BUY-OUTS

Leasing equipment allows a company to utilize an asset for a specified period of time at a price that is typically less than the purchase price. By essentially renting the equipment, a lease facilitates a periodic refresh of the equipment, allowing a company to consistently update its processes and systems to operate on the most current technology at a much cheaper price than purchasing. However, leasing is only advantageous if a company efficiently manages its leased assets.

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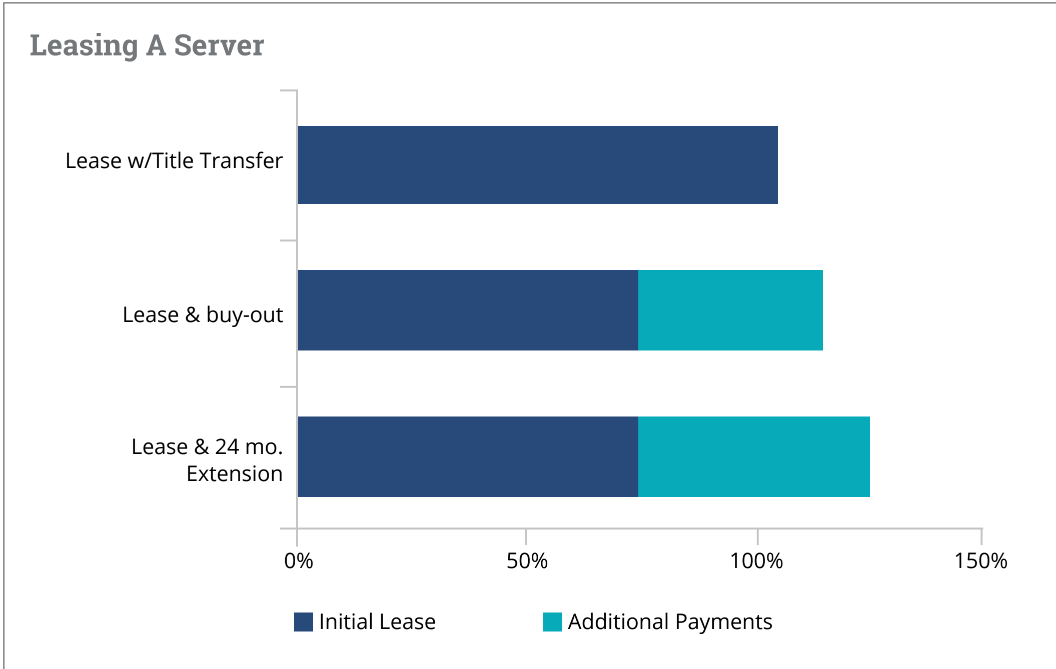
Leasing terms are generally negotiated so that the net present value of the lease payments is less than the original equipment cost. However, if a lease is extended upon its initial term, or late return fees are incurred, the savings from leasing are quickly diminished as the lease is extended. By utilizing a lease with title transfer strategy, a company eliminates the possibility of undergoing costly lease extensions, since title of the equipment immediately transfers to the company upon fulfillment of the final lease payment. Should a company decide to keep the assets it's leasing rather than return them, the lessor will have the freedom to give the company a buy-out quote that is equal to or greater than the amount they could sell that equipment for on a secondary market.



For example, if a company enters into a 36-month traditional lease for a server with a 60-month useful life, the lease payments may equate to roughly 75% of the servers value (25% a year). At the end of the lease, the lessor is not likely to give the consumer a buy-out quote anywhere near the remaining 25%, since the server would sell for considerably more on a secondary market. In this situation, a quote of roughly 40% is more realistic. Additionally, a 24-month lease extension (to bring the server to its 60-month useful life) would cost the company roughly 50% of its original NPV, assuming the monthly payments remain the same at the original 25% a year. Using a lease with title transfer transaction eliminates the possibility of unfavorable buy-out or lease extension quotes.

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ELIMINATE END-OF-LEASE ASSET MANAGEMENT

Traditional leasing as a procurement strategy requires an end-of-lease management system, which is often complex, time consuming, and inefficient. End-of-lease asset management tasks include:

1. Disassembling the leased equipment.
2. Packaging the equipment.
3. Shipping it back to the lessor & tracking the shipment.
4. Updating any asset tracking databases to reflect shipment details and asset status.
5. Potentially develop a refresh plan to replace the equipment that is shipped back.

The most difficult part of managing an end-of-lease asset management system is timing.

The most difficult part of managing an end-of-lease asset management system is timing. The equipment needs to be disassembled and sent back to the lessor before the end of the lease, or else the lessee may incur late fees or back-rent charges. This means accounting for the time to disassemble any equipment and package it, and the time to ship from the working site to the lessor. For example, if Company ABC sends its leased servers back to the lessor one month late, the lessor could charge the company an additional month of rent or a late fee.

A lease with title transfer strategy helps to eliminate nearly the entire end-of-lease management system, since the equipment becomes the lessee's property upon completion of the lease. A lease with title transfer strategy eliminates the need to have a team in place to coordinate the packaging and shipment of the leased assets back to the lessor. A lease with title transfer strategy also eliminates, or at least postpones, the need for a "refresh plan" for equipment coming off of lease. The company will simply have more flexibility in refreshing the equipment.

CONCLUSION

No single procurement strategy is best for all companies, and many different factors should be considered before selecting a procurement strategy, including:

1. Budget restraints.
2. Volume of equipment and leases.
3. Nature of the equipment the company is procuring.
4. The company's ability to manage and refresh equipment on time.

These are just a few of the factors that need to be considered before pursuing any single or combination of procurement strategies. However, if developing a steady refresh cycle, avoiding large initial cash outlays and getting the most out of the equipment are priorities, a lease with title transfer strategy should be considered.

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