

# COMMON QUESTIONS REGARDING LEASE-PURCHASE FINANCING

Lease-purchase financing is becoming an increasingly important element in the financial management strategies of local governments. Nationwide, the annual dollar volume of lease-purchase obligations has grown from \$700 million in 1980 to an estimated \$8 billion in 2000. As it has grown, the lease-purchase market has also evolved to address a variety of funding needs and institutional constraints. To assist public officials and staff to understand the state of lease-purchase financing, these are some fundamental questions that are most frequently raised on this subject.

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## *1. What is Lease-Purchase Financing?*

Lease-purchase financing is one means by which a municipality or a public agency can acquire real or personal property. It involves the purchase of an asset through periodic lease payments, which have principal and interest components. Lease-purchase financing is an alternative to purchasing an asset with cash, acquiring its use for a period of time through a true lease or issuing bonds.

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## *2. How does Lease-Purchase Financing Differ from True Leasing?*

To a governmental lessee, the difference between lease-purchase financing and true leasing is who owns or will own the asset. In a lease-purchase, the lessee acquires an ownership interest in the asset, obtaining title to the asset at the end of the lease term. In a true lease, the lessee acquires only the right to use the asset for a period of time, but no ownership of the asset. The term of a true lease is usually much shorter than the useful life of the asset, while a term of a lease-purchase generally approximates its useful life. The term length differs because of what happens at the end of the term. With a true lease, the municipality typically relinquishes the asset but may purchase it at a price that reflects its residual or market value. With a lease-purchase, the municipality retains the asset.

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## *3. How does Lease-Purchase Financing Differ from Bond Financing?*

A bond financing is an exercise of a governmental entity's authority to incur debt. Unlike a bond issuance, in most states a lease-purchase financing is not considered to be debt for state law purposes and voter approvals are not necessary to authorize the transaction. The underlying security for the two types of obligations is also different. With bond financing, the borrower pledges a designated revenue source, such as property taxes or user charges, and obligates itself to raise revenues to the extent necessary to pay debt service. Usually there is no such obligation supporting a lease-purchase agreement. The governmental entity agrees only to budget and appropriate payments from available

revenues each year.

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#### 4. *What Types of Assets Can be Acquired Through Lease-Purchase Financing?*

Lease-purchase financing can be used to finance almost any real type of personal property that the public agency has the authority to acquire. Among the most-often leased property:

Computers	Office equipment
Buses	Permanent buildings
Fire fighting equipment and vehicles	Portable buildings
Heavy equipment and machinery	Road maintenance vehicles
Light aircraft and helicopters	Solid waste disposal equipment
Medical equipment	Telecommunication systems

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#### 5. *What Factors Should be Considered in Deciding When to Lease-Purchase?*

The primary financial objective of any asset acquisition decision is to obtain the use of the asset for the lowest possible total cost, as measured over the period the asset is to be used. Of course, other considerations are important, and may determine which options are available or appropriate in a particular jurisdiction or situation. Factors that should be considered include:

- a. Availability of cash at time of procurement
- b. Competing demands on capital resources
- c. Essentiality of the asset to the basic functions of the agency
- d. Useful life of the asset
- e. Desirability of matching costs and benefits over time
- f. Ability to improve bargaining positions with vendors
- g. Political attitudes toward debt financing

There are relatively few instances where all four options - paying cash, true leasing, lease-purchase financing and the issuance of bonds - are available and appropriate. Each is particularly suited for different types of assets. Cash is appropriate for low-cost items, those with short useful lives or assets which do not serve essential governmental functions. True leasing is useful for assets that tend to become technologically obsolete in a short time (one to three years), those that serve a function of limited duration, or that require regular service or maintenance. Historically, lease-purchase financing works best for assets with a useful life of three to seven years, that serve an essential governmental function and carry an initial cost that would consume a disproportionate amount of available cash. The issuance of bonds usually is reserved for the most costly capital expenditures, typically assets with a useful life of at least ten years, and a source of revenues that can be pledged to pay debt service.

When the costs of two or more available options differ, they should be compared in terms of all of their associated costs. In addition to payments for the asset itself, these include down payments, transaction costs, legal fees, operating and maintenance expenses, ongoing administrative costs and service fees. There are various methods for comparing the costs of different asset acquisition strategies, such as present value analysis and equivalent annual worth analysis. Present value analysis is most useful for comparing alternatives with the same term length or comparing lease-purchasing to paying cash. Equivalent annual worth analysis is most useful for comparing alternatives with different term length, such as true leasing and lease-purchasing. These are not the only methods for evaluating asset acquisition strategies, but any analytical approach must incorporate the time value of money to yield a

meaningful result.

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#### ***6. How are Lease-Purchase Obligations Structured?***

The obligation of the municipality to make periodic lease payments is the cornerstone of the lease-purchase transaction. In California, this obligation may be cast in two different ways. The resultant structures are known as "covenant" leases and "annual appropriation" leases. A related instrument is the installment sale obligation.

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#### ***7. How are Lease Obligations Funded?***

Once it has been decided that lease-purchase financing is the least expensive or the most appropriate means to acquire one or more capital assets, a funding strategy must be implemented to use this financing tool most effectively. There are essentially four funding sources from which municipalities can obtain lease-purchase financing.

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#### ***8. How do Transaction Costs Affect the Cost of Borrowing?***

In deciding which strategy will provide funding at the lowest cost, both the stated interest rate and the transaction costs must be taken into account. Adding transaction costs to a financing increases the ultimate cost above that indicated by the stated interest rate.

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#### ***9. What are the Essential Components of a Successful Lease-Purchase Financing Program?***

Lease-purchase financing should be regarded as one element of an overall financial management strategy. A well-designed program can help balance capital expenditures over time, and, if the Effective Interest Cost is below the investment rate earned on fund balances, it can actually extend limited capital resources. There are several key steps to designing and implementing a lease-purchase program. The most important of these are:

- a. Establish the legal authority to lease-purchase and the limits to this authority.
- b. Determine which capital expenditures are appropriate for lease-purchase financing.
- c. Decide whether to finance each acquisition separately, or to undertake a single financing to fund all of the lease purchasing for a fiscal year.
- d. Monitor all transaction costs.
- e. Understand the transaction terms.

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#### ***10. What are the Basic Elements for Concluding a Lease-Purchase Financing?***

- a. Reaching agreement on acceptable lease rate of interest (annual percentage rate), payment frequency, repayment term and method of funding.
- b. Obtaining authorization by Lessee's governing body including adoption of resolution.
- c. Obtaining legal review of lease documents by Lessee's counsel and issuance of legal opinion.
- d. Executing and delivering to Lessor the Lease documentation, legal opinion and insurance certificates.

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