Lease or buy?

Short-term and long-term investments each have their benefits and drawbacks.

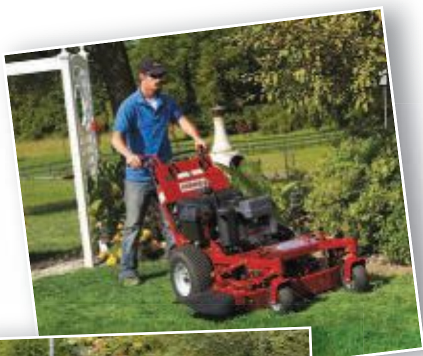
BY CURT HARLER

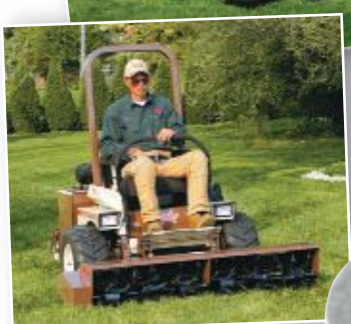
EVEN AS the economy starts to get back on an even keel, there are few landscape contractors with money to throw around. However, they still need to replace and update equipment. During a time when every nickel counts — and cash flow is king — contractors might wonder whether it's better to buy or lease new equipment.

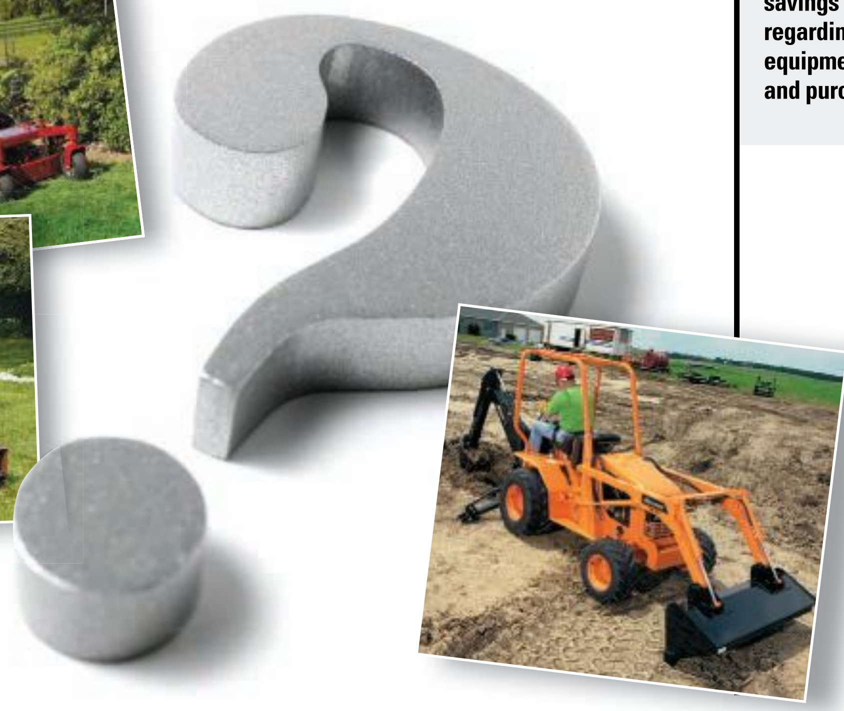
"It's never black and white," says Tom Dowd, manager of lease administration for John Deere Credit in Des Moines, IA. "There are no rules of thumb that can be used to determine whether a lease is applicable."

But there are several things to consider when making the lease versus purchase decision. Before you push the buttons on your calculator, determine whether the equipment you're thinking of leasing carries a high purchase option. The higher a purchase option, the more advantages a lease offers, Dowd says.

To make the decision more complicated, the definition of what a high-purchase option is varies, depending on the evaluated equipment. Determine whether the equipment will be used for short-term, incremental projects or to meet long-term basic needs.







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TAKE AWAY

The best scenario is to finance equipment until you have the cash to pay it off.

Determine how much use you would have for the equipment over the long term.

Talk beforehand with your financial advisors about the potential tax savings (and pitfalls) regarding your equipment leases and purchases.

Making monthly payments on seasonal equipment is helpful, says George Kinkead, president of Minneapolis-based Turfco.

"Instead of having big spikes, leasing can level the cash flow," Kinkead says. "The right answer on lease versus buy is to finance equipment until the point at which you have the cash to pay it off."

Each situation must be analyzed as a separate event.

"Leasing seems to make most sense when a landscaper is awarded a short-term contract and needs additional equipment to complete the job, but isn't certain there's a need for the equipment beyond the term of the contract," Dowd says. "Purchasing seems to make most sense when the customer plans to use the equipment for a long time."

ARE THINGS DIFFERENT IN TODAY'S ECONOMY?

Old-timers often claim that today's economy is different than anything they've ever seen. But that doesn't mean the lease-versus-buy rules change. The advantages of leasing don't change as the economic situation changes, says Tom Dowd, manager of lease administration for John Deere Credit in Des Moines, IA. However, the magnitude of the benefits from the advantages does change.

For example, the time when leasing seems to be most active is right before an economic downturn.

"This is because the leasing advantage of matching incremental equipment needs with current jobs has a much bigger benefit if the economy is slowing," Dowd says.

Because the likelihood of having a need for the equipment is less if the economy has slowed, a contractor can count on being able to return the equipment at the end of the lease term, and won't have to try to remarket a used piece of equipment in a down equipment market.

In a healthy economy, leasing offers another benefit: cash flow, which conserves the bank's line of credit for other uses. The advantage of leasing is the same, Dowd says. However, the economic situation changes the benefit.

One successful strategy is to use the lease terms to spread the payments over a couple years, then buy the equipment and continue to use it.

Kinkead cautions against thinking about landscape equipment leasing on the same terms as a car lease, however.

"Capital, durable equipment, like renovation equipment, typically will last more than two or three years," he says. "It's a cash-flow question. Especially for a smaller operator, it's probably better not to write a check for the full cost of equipment. It's better to buy as the business grows and pay for equipment out of cash flow."

For low-hour users who take care of their machinery, it pays to keep the equipment after the lease ends.

"Any time you lease equipment, you need to know what you'll do with it at the end of the lease," Kinkead says.

Additionally, you (and your accountants) should know how you'll generate the revenue to buy a piece of equipment, and how much you're willing to pay in interest for the privilege of keeping the machine.

On the plus side, leasing allows a business to upgrade its equipment frequently. If nothing else, having new, modern, shiny equipment helps create a prestigious image. And on the more practical side, new equipment eliminates down time and lowers maintenance costs.

Benefits of leasing

A lease generally requires less cash up front and has lower payments than traditional financing. The cash flow advantage is created because of the establishment of a purchase option at the end of the lease, Dowd says.

Initially, a contractor isn't paying for the purchase option. At the end of the lease, the customer makes a decision to purchase or return the equipment. Higher purchase options create a better cash flow advantage for a lease, Dowd says.

A contractor will often have what Dowd calls "incremental equipment needs" when he or she is awarded a short-term contract.

"A lease offers a landscaper a way to acquire additional equipment to perform the contracted work, and match the term and cost of the additional equipment with income generated from the new contract," he says.

Kinkead agrees leasing allows a contractor to bid on jobs or offer new services. Then, once the contractor has a feel for who will buy the services, he or she can lease equipment to match the need.

"I recommend having a sense of where you're going with your business so you don't get into equipment if you don't have the jobs to cover the cost," Kinkead says.

It's recommended to sell the jobs first, and then lease equipment in sufficient size and quantity to cover the contracts you have in hand.

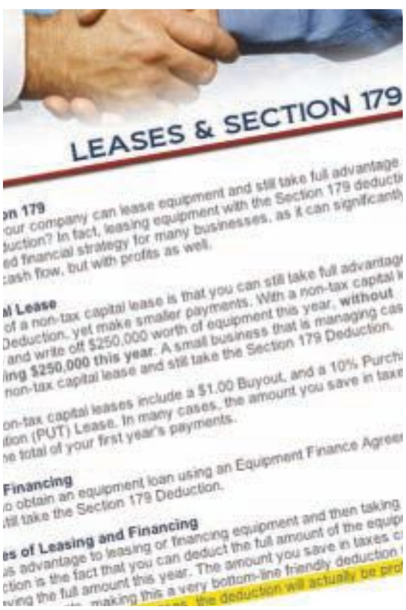
Leasing makes sense for seasonal equipment, too. Aeration, for example, is a job typically done in the spring and fall. While you may need an aerator for both seasons, it's likely that you won't generate sufficient revenue to pay for it until late in the year. Lease payments spread out the cost.

Income tax benefits

Another strategy involves off-balance sheet financing, which are leases structured as true leases that don't pass title to a contractor.

Work with your accountant to keep current with tax rules on financing.

"The landscaper currently doesn't need



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TOM DOWD, manager, lease administration, John Deere Credit to record an asset or liability on his financial statements for a lease," Dowd says.

Talk to your accountant for up-to-date information about this strategy. The Financial Accounting Standard Board (FASB) is in the process of making changes to the rules about off-balance sheet financing. Presently, a lease can be structured so a contractor doesn't show the asset on the balance sheet. Monthly payments are made like any other expense.

The FASB will likely rewrite the rules by 2011 to change off-balance sheet financing. It's expected that the changes will be retroactive — which means contractors will have to take future lease payments, capitalize the payment stream and show that as a liability. If the lessor expects to buy the equipment at the end of the lease term, that purchase option will have to be capitalized.

There are other tax implications: True leases allow 100% of the lease payment to be deducted for income tax purposes.

"If a landscaper has maximized his Section 179 deductions on his income tax return, a lease structured with a large payment up front may offer a way for the landscaper to get a bigger deduction on his income tax return," Dowd says.

Again, consult a tax advisor to determine whether a specific lease offers a higher deduction.

Leasing pitfalls

While there are many advantages to leasing, you can incur a higher total cost if you decide to purchase and own the equipment. For example, renovation equipment and sod cutters are more likely candidates for leasing than mowers. You probably know how many hours will be put on a mower, and when your business grows to require another mower, it can be purchased. By contrast, renovation equipment use is sporadic, and adding another truck to the fleet probably doesn't require purchasing or leasing another sod cutter. One can be shared.

> **"DON'T GET INTO EQUIPMENT** IF YOU DON'T HAVE THE JOBS TO COVER THE COST."
>
> **GEORGE KINKEAD**, president, Turfco

A contractor who thinks a lease avoids maintenance costs is in for a surprise, however. It's best to treat leased equipment as though you'll own it forever.

If you decide to exercise your purchase option at the end of the lease, the lease typically will result in a higher overall cost to purchase the equipment, Dowd says, adding that leasing isn't a less costly way to purchase equipment.

"If a customer knows he's going to purchase the equipment, a lease isn't likely the best means to facilitate the purchase," he says.

Additionally, all leases have requirements about the same condition and miles or hours allowed on the equipment when it's returned. This includes everything from pickup trucks to zero-turn mowers.

If the equipment is returned at the end of the lease and doesn't meet these requirements, there are abuse or excess use charges assessed to the customer, Dowd says. If the equipment is going to be used an excessive number of hours or in a harsh environment, a lease isn't likely the best option.

Money-saving strategies

Dowd says he has seen customers who have maximized their Section 179 deductions for leased equipment for one year, then purchased the equipment at the end of the lease, using the section 179 deduction in the next year. This way, a contractor gains use of the equipment in the current year — and maximizes his or her deductions for tax purposes.

Dowd also has seen customers lease equipment when they've been awarded short-term contracts, and then return the equipment at the end of the contract term. LM

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