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# AGRIBUSINESS MANAGEMENT

## **PURCHASE OR LEASE: A MANAGER'S CHOICE**

Several years ago the dairy processing sector of the agribusiness industry found itself in the midst of a technological adjustment. Many firms were shifting from the use of glass bottles to paper milk containers. The shift required a substantial change in the plant equipment used to fill, package, and transport the product. Few firms could afford to purchase the equipment associated with this new technology. Both the equipment manufacturers and the dairies soon realized that a lease between the makers and users of the machines would facilitate their adoption by the industry. The net result was a considerable saving for the dairies, greater convenience for milk consumers, and an expanded market for the manufacturers of the equipment.

Rapidly advancing technology has affected other agribusiness firms in recent years. Rarely will you find an agriculturally-related business operating today as it did ten years ago. All phases of agribusiness; processing, storing, packaging, distribution, marketing and supply, are now using facilities and equipment not even in existence ten years ago. Look at the facilities and equipment owned by your firm. They probably are the end result of some technological improvement in the areas of metallurgy, chemistry, physics, mathematics or related basic science. Regardless of its origin, all modern plant equipment has one thing in common -- it is very expensive and its purchase probably represents a significant capital expenditure by your firm.

Why did you purchase the new facility or piece of equipment? Obviously you had determined that your firm would benefit from its use. But why did you *buy* it? Did you consider the possibility of *leasing* the item instead? Perhaps you should have.

This paper is designed to describe several forms of leasing, discuss the pros and cons of these leasing arrangements, and illustrate how an agribusiness manager might approach his choice of an outright purchase vs. the leasing of plant facilities and equipment.

### **Its Beginning and Importance**

Leasing is not new, nor was it invented by the modern car-rental companies. Perhaps my first recollection of a leasing arrangement is linked to my grandfather. He reminisced about his activities as a young man when he would walk into town every Saturday evening to lease a horse and carriage so that he might pursue his marital interests in a more fashionable manner. Obviously, the equipment-leasing business has grown substantially since the days of the horse and carriage. Today it is possible to lease anything from a hippie (a San Francisco entrepreneur has experienced considerable success in this area) to a train (an Illinois-based railroad was the first to lease an entire train to shippers of agricultural products). U.S. companies increasingly are content to let others own the tools of their varied trades. A small army of lessors -- including insurance companies, equipment manufacturers, private investors, and

financial institutions -- have appeared on the scene in recent years.

There are no reliable figures on the extent to which leasing is being used to substitute for outright purchase. However, the National Industrial Conference Board has reported that between 1958 and 1963, 34 percent of a sample of 220 firms increased the extent to which they held plant equipment on lease, whereas only 10 percent decreased their holdings on lease. During the same period, only 15 percent of the firms leased no equipment at all. Obviously, equipment and facilities leasing is big business in the U.S. Industry estimates are that there is currently \$5 billion worth of computers on lease to American industry and another \$5 billion worth of manufacturing equipment similarly placed -- triple the volume under lease just three years ago.

### **Where Does Agribusiness Stand?**

How does the agribusiness industry compare with others in its use and acceptance of leasing arrangements? I know of a few agribusiness firms in the Northwest now leasing their computer facilities. However, these firms represent a minority and have not extended the use of leasing to other areas of their business. It is quite likely that sound economic and operational barriers to the expanded use of leasing do exist and restrict the rate of adoption by agribusiness firms, e.g., food processors may require a very select type of plant equipment which lessors are unwilling to handle because of its peculiarities and a limited market. However, I am convinced that other reasons restrict the more rapid adoption by agribusiness managers of the various leasing arrangements. Furthermore, I suspect that one of the major restrictions is the manager's lack of understanding of how a lease works, what its attributes are, and when they might be put to good use. Because many managers

do not understand leasing, they are naturally reluctant to consider it very seriously. Hopefully this discussion will enhance your understanding of a lease and, thereby, improve your ability to choose between it and purchase.

### **Types of Leases**

A lease is not a singular all-encompassing document. Basically, it stipulates the conditions under which a lessee may use facilities and/or equipment owned by another party (lessor) in return for rental payments to that party. There are, however, two major types of contracts under which a firm may have the use of facilities or equipment not owned by the firm -- the finance lease and the operating lease. Each has its own rationale, its own legal format, and its own set of economic components.

*The Finance Lease:* Commercial banks, equipment-leasing companies, and some pension funds are common vendors of the finance lease. As the terms indicate, the finance lease is a rather special form of financing. Instead of a firm being burdened with raising the money for the acquisition of a capital item, the lessor purchases the item, permits the lessee to use it, and is repaid by the lessee through monthly or annual rental fees.

Generally speaking, under the terms of a finance lease, the lessee assumes the cost of service, maintenance, bookkeeping, etc., over the duration of the lease, regardless if it is for six months or sixty. And, unless the lessee has an option to purchase, the leased item goes back to the lessor when the lease expires. The lessor hopes to recoup his entire investment in the leased item, including his purchase cost and some profit, during the term of the lease.

Various types of financial institutions such as insurance companies and consumer finance houses must carry heavy reserves against their commitments. Hence they have the problems of finding investment opportunities by which such reserves may be held in the form of earning properties instead of sterile cash. A finance lease provides these firms with such an opportunity. Many of these firms join with the makers and users of equipment to set up a joint venture subsidiary to buy equipment and lease it to agribusiness firms (the users) thus limiting the risks for all parties and changing the maker's or lessee's contribution from a working capital item to an investment item. Needless to say, there are numerous legal variations to this general theme. The basic economic component of this type of lease is that it shifts the burden of capital accumulation from the lessee (an agribusiness firm with a capital shortage) to the lessor (an insurance company with a capital surplus).

*The Operating Lease:* A second major type of lease is called the operating lease. Computer leasing firms commonly operate with this type of lease. Its distinguishing factor is its intent to shift the risks of obsolescence from the user of the equipment to the lessor. Naturally, the lessee pays handsomely for this protection. Operating leases are generally for shorter periods of time than the finance lease -- some run on a month-to-month basis so the lessee is relatively free to shift to newer equipment as soon as it is available.

Under these arrangements, the lessor rarely has time to recover his investment on a single lease. Instead, he attempts to lease the same equipment to other firms, hoping that the manufacturer of the leased item doesn't bring out a radically improved and more efficient version before the lease has repaid all investments and rendered an acceptable

profit. Under the terms of this type of lease, the lessor usually remains responsible for equipment maintenance and repair.

### **The Parties to a Lease**

As already indicated, every lease involves two parties -- the lessor and the lessee. Those two parties may not always represent similar interests, however. For example, the lease may be between a maker of equipment and a user. This arrangement gives the lessor a large degree of control over the way in which equipment and facilities are used and the rendering of technical and maintenance service. It also accelerates greatly the lessor's capital requirement because he must not only finance the manufacturing process, but also a heavy investment in equipment on lease.

Many types of facilities and equipment in the agribusiness industry are tremendously expensive relative to the period of time during which they are used and the financial resources available to the average agribusiness firm. Because such equipment is needed only in one stage of the average job, its use by a single firm is not continuous but irregularly intermittent. Both factors (i.e., short period of usage and limited financial resources) may be overcome to some degree if one firm buys one machine while its neighbor buys another type and they lease to each other. The result is one user leasing to another user. This arrangement has obvious limitations, particularly amongst competing firms. However, some equipment (e.g., trucks, dollies, skids, conveyors, etc.) is useful to many different (and non-competing) firms and therefore retains attractive leasing possibilities.

Of course the scheme described above is somewhat cumbersome and depends on cooperation between firms. The result has been the emergence of firms that buy

equipment from the makers to lease to the users. These arrangements are particularly common in the auto and truck-rental businesses.

It has been shown, therefore, that the parties to a lease differ. They may be 1) maker-user, 2) user-user, or 3) leasing company-user.

### **Know Your Terms**

The terms of lease vary widely. Before negotiating a lease, an agribusiness manager must understand the basic terminology and its variations. The period or duration of rental, for example, may vary from an hour, a day, a month, or longer, depending on the type of the item being leased and the lessee's pattern of usage. The duration of a lease of structural facilities or major plant equipment with continual usage is apt to be indefinite, with a right of termination by either party after proper notice. Rental fees are usually based on a unit of time or a unit of use. In rare cases, however, both time and use are combined in the form of a constant time unit fee plus a use unit fee. If the lessor undertakes to maintain the equipment in useable condition, he will normally reserve the right of access to it for this purpose. He will also retain a right of recapture in case of default of rental payment or misuse of the item.

Other terms which are generally understood and accepted by leasing companies, but may not be familiar to managers are:

*Full-Service Lease:* A lease where the lessor provides everything but the human operator of the equipment.

*Short Term Lease:* A lease very similar to the full-service lease except that the duration rarely exceeds a week.

*Trip Lease:* A lease originally conceived for truck rentals but generally stipulates in detail the exact degree of usage of the rented item by the lessee. Any departure from the specified use voids the lease.

### **Some Legal Aspects**

When negotiating a lease, there is no substitute for good legal advice. Every manager should consult his firm's lawyer during the time the lease is being composed. Only a good lawyer can convert your firm's needs into a proper legal document. Wise legal counsel early in your negotiations is likely to prevent many confused and unhappy moments later.

As potential lessees, all managers should be aware of certain legal generalities. For example, each of the following is illegal or of doubtful legality:

- a) It is illegal for a lessor to charge you (as a user of equipment, not all of which is supplied by the lessor) a higher rental fee than that charged another lessee of an identical item (but who may be obtaining all his equipment from this lessor). In other words, a lessor of a full line of plant equipment must charge a constant rental fee of all lessees of a given item regardless of whether the full line of items is being rented or not.
- b) It is illegal for the lessor to base the rental fee for a machine on the user's entire output of the article on which the machine can be used; the rental can apply only to that part of the lessee's total output on which the machine was actually used.
- c) The lessor cannot specify that the contract is invalid if the user rents

other equipment from a competing lessor.

- d) The lessor cannot legally specify in the contract that the lessee must buy from him certain supplies or materials sold by the lessor and used in connection with the operation of the equipment. Nor can he (the lessor) charge a higher rental to nonusers of the materials he makes.
- e) It is of doubtful legality to lease equipment without also offering it for sale. This requirement is less certain than those above and probably does not apply to such arrangements as the car and truck rental leases.

With the exception of e) above, all the legal restrictions listed prohibit the monopolist lessor from pressuring the lessee into purchasing or leasing other items offered by that lessor. Unfortunately, however, this pressure may appear in other forms. For example, it is probably not illegal for the lessor to find it more difficult to provide maximum maintenance service on machines that are used to process materials obtained from sources other than the lessor. In unfortunate cases like these, the quality of service rendered by the lessor may speak louder than the words of the contract.

### **The Pros and Cons**

For the moment let's assume you are aware of the various types of leases and the different combinations of lease parties. Let's also assume that you are familiar with variations in the terms of lease and have access to good legal counsel. Finally, let's assume that as the manager of an agribusiness firm you are faced with the need of a major piece of plant equipment. Will you purchase this equipment or lease it? What factors must you consider in making

your choice of actions? What is the net advantage or disadvantage to the equipment user of renting instead of buying? Some of the gain and loss factors are peculiar to individual business situations; others are more general. The following discussion is concerned only with the latter.

*Financial:* As you might expect, many factors involved in the user's decision to purchase or lease are financial in nature. For example, the opportunity to lease equipment reduces the user's capital requirements. This appears as a clear advantage to a firm wishing to expand or diversify its business, but lacking the capital to buy the necessary equipment or facilities.

Looking at the situation from an opposite perspective, a well-financed firm may find it desirable to lease some of its equipment instead of buying it if the firm has available or can find alternative, more profitable uses for the capital thus released. Of course, an accurate appraisal of relative opportunity costs becomes very important in this decision area.

By leasing certain equipment necessary to its business, a firm may diminish the dispersion of its managerial abilities over those activities which are only incidental to the main business.

By leasing instead of buying, the user exchanges a debt-servicing charge for an operating expense in his cost structure. For example, the entire rental fee can be charged off as an expense in computing profits on which income tax must be paid. If the item were purchased, the cost of debt service would consist of depreciation on the amount paid plus interest (actual if it were purchased with borrowed funds or imputed if funds already in the business were used). Depreciation and interest actually paid are

reportable as expenses, but imputed interest is not. Hence, the user with limited funds seems to gain a clear advantage by leasing. However, this is subject to one limitation: if the actual useful life of the equipment is longer than the depreciation period allowed by the Internal Revenue Service, then the owner-user (as opposed to renter-user) may be free of depreciation charges and enjoy supplemental profits from its use during this excess period (while the renter-user pays the same rental fee during the machine's entire useful life).

*Risks:* By leasing his facilities or equipment, the lessee avoids the risk of its physical damage and of loss in its value due to technological obsolescence, mechanical failure, or loss of market for the product handled by the leased item. The renter-user seems to avoid these risks. One must recognize, however, that the rental fee he pays will generally cover the lessor's estimates of these risks. So in reality, the lesser merely exchanges an uncertain risk for a predictable annual cost. Leasing, therefore, can be thought of as a form of insurance against various forms of uncertainty.

*Service:* When an equipment manufacturer sells and is paid for an item, he has received the total income ever to be generated by that item. If the manufacturer later chooses to render technical and maintenance service, he does so with the hope of maintaining customer goodwill and improving the chances that a replacement will be purchased from him some time in the future. However, if the manufacturer leases the product, his motivation for good service is more immediate and continuing for under normal terms of lease he cannot expect a rental income from an item which is not operating properly.

*The Psychological Factor:* The instinct of ownership is very strong and, for many American businessmen, probably constitutes a considerable deterrent to leasing. This factor is probably more prominent in the area of consumer goods than among managers of agricultural businesses. However, some managers undoubtedly gain some degree of satisfaction from ownership and while this factor should not enter into the balancing out of purchase vs. lease possibilities, it no doubt has some influence on the manager's final choice.

### Summary

The decision to purchase or lease facilities or equipment is a manager's choice. Because of its importance to the short-and long-run profitability of the firm, the manager must not take this decision lightly. While the benefits of outright purchase are generally recognized by the agribusiness manager, those associated with leasing can be more fully realized by the manager's full understanding of 1) various types of leases, 2) the parties to a lease, 3) the terms of lease, and 4) the legal aspects of leasing.

Finally there do exist certain factors which favor leasing over purchase. Probably the most important of these factors are:

- a) *When Use Is Occasional* -- a firm which has a less-than-constant need for a piece of equipment may compute with some exactitude the economics of leasing vs. purchase\*. The costs of rental and ownership can

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\* R. F. Vancil. "Lease or Borrow -- New Method of Analysis." Harvard Business Review, Sept. & Oct. 1961.

Jown R. Charrin. "A Lease-or-Purchase Decision Model for the XYZ Corporation." Management Services, Sept. & Oct. 1969.

be estimated fairly accurately and a balance drawn. In making such a decision, the agribusiness manager should be careful to include hidden factors such as imputed interest on money invested, tax advantages, opportunity costs, and the discounting of future rental payments.

- b) *When Capital Expenditure Is Large* -- whenever the purchase price of a piece of equipment represents a substantial amount of capital, the prospective user should give serious consideration to opportunity costs. He should compare the return expected from the purchase and use of the machine with the return promised by the most profitable alternative use to which the capital may be put. Excessive opportunity costs tend to enhance the attractiveness of leasing.
- c) *When Service Is Very Important* -- some equipment requires unusually expert and careful repair and maintenance. Some lease

arrangements put the burden on the lessor to see that the leased item is kept in good operating condition. Generally speaking, as the importance of service increases, so does the attractiveness of a lease to a prospective lessee.

- d) *When Materials and Special Equipment Are Interdependent* -- it sometimes occurs that new materials appear which the agribusiness firms are unable to use without leasing a machine designed to handle them. Such was the case noted in this paper's introduction where the use of paper milk containers required the lease of special equipment by the agribusiness firm.

In the final analysis of purchase vs. lease, the choice is yours to make. Be sure you have all the facts before making your selection; errors are often expensive and unforgiving.



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