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Can Operating Leases Be Strategic?

Operating leases can cut capital commitments, boost strategic flexibility, and help a company manage capacity utilization during an economic downturn

Gregory V. Milano

Some CFOs and treasurers shun operating leases. They claim that such leases are dilute earnings before interest, tax, depreciation and amortization (EBITDA). Such finance executives claim that they merely represent expensive financing that other companies employ to artificially push assets off their balance sheets.

Further, they correctly point out that rating agencies and banks see through this off-balance-sheet financing by recognizing the capital obligation associated with minimum lease commitments.

Nevertheless, operating leases can smooth the way to a more efficient use of capital and provide greater operating flexibility in many businesses. In an uncertain business world, operating leases enable a company to commit to only a portion of the life of an asset. If they're managed properly, they also allow companies to dial the capital they employ up and down to mitigate risk at the bottom of a cycle.

What's more, many successful companies have a strategy for constantly refreshing their assets with newer versions. That can help companies maintain reliability and improve customer experience and perception.

Indeed, leases create an automatic prompt for companies to consider upgrades on every renewal. That can be a very important consideration when leasing retail space, automobiles, trucks, aircraft, and other assets.

To be sure, employing operating leases more aggressively tends to reduce EBITDA. That's clear in an industry like retail, where the use of operating leases is substantial. We separated the 84 largest retailers into high and low lease groups based on the size of their latest annual rent payment as a percentage of net property and plant and equipment.

For 2009 and 2010, the median EBITDA of the high lease group was 43% lower than it would be before rent (also known as earnings before interest, taxes, depreciation, amortization, and restructuring or rent costs, or EBITDAR). That's a 20% larger reduction in EBITDA than the 23% median decline of the low lease group.

However, this hit to EBITDA is largely offset by how these companies are valued. For the high-lease group, the median ratio of enterprise value (market capitalization plus net debt) to EBITDA was 7.4x over the period. That is about 20% higher than the median of 6.1x for the low lease group.

So although EBITDA tends to be lower for companies that more actively employ leases, the market seems to normalize much of this in valuation.

Lease Strategy

There are several important considerations in developing an effective operating-lease strategy. But first, you need to forget about the distinction between "on balance sheet" and "off balance sheet." Indeed, accounting rules are likely to change soon, and all leases with multi-year commitments will be put on the balance sheet.

Before and after such a change to generally accepted accounting principles may occur, your focus should be on comparing the capital commitment of a lease to buying the asset. Signing a multi-year lease with minimum required payments is scarcely different structurally from borrowing money to buy the asset and committing to payments of interest and principal. The lease is merely of a shorter duration.

To improve the comparability of companies that lease with those that buy, Standard & Poor's adjusts a company's debt to include the debt-equivalent of its lease contracts by calculating the present value of their lease commitments. That is a useful general approach for companies to employ.

For example, consider a company that leases assets with a 30- year life and an underlying value of $10 million for five years at a rate of 10% of the original underlying asset value per year. Assuming the company has a marginal cost of debt of about 6%, the present value of the five-year lease commitment is $4.2 million at the outset.

That is about 42% of the purchase commitment. And this amount declines over the life of the lease as the remaining commitment gets shorter.

This is strategically significant. The company could buy more than twice as many assets for the same capital commitment by committing to a shorter period of use than the full life of the asset. For some companies such moves can help drive a growth strategy.

When confronted with this math in the 1990s, a client in London told me "if that's how you will determine my capital base, I will sign one-year leases with 24 one-year-renewal options" rather than the standard 25-year leases that prevailed at the time in London retail.

Of course, if he could convince a lessor to agree to such an arrangement, the strategic flexibility of having full use of a store with the right but not the obligation to walk away every year would provide strategic flexibility and risk protection in down times. Imagine never having unused or underperforming capacity!

To make the best use of the strategic flexibility and the value of the flexibility leases create, you need to structure a portfolio of leases to expire gradually over time rather than all at once. For example, if 20% of the assets under five-year leases come up for renewal each year, there's an ongoing opportunity to reduce capital by not replacing expiring leases when unexpected tough times arrive. That's more effective than selling assets in tough times, since the resale values often decline then as well.

Most operating leases last more than one year. But they can often be structured so that the company must only commit to a portion of the asset life, which is why the capital commitment is lower. The implied interest rate embedded in leases often seems high compared to borrowing rates, but this is simply the cost of the strategic flexibility leases provide.

Like most things in life, leases can be a problem if taken to an extreme. The annual fixed charges are often higher for leases than for owned assets. Companies thus must be careful to limit the proportion of their assets under lease to ensure that during good times and bad there isn't too much financial risk. Traditional debt and the implied debt equivalents of leases must be considered together in determining the right financial policies.

In determining how far to push a lease strategy, be sure to prepare robust scenario analyses to test the downside and see how the leases help or hinder the situation when an unexpected crisis hits.

Are leases right for your company? Consider the types of assets, the uniqueness, and specialization of those assets and the frequency with which you may want to replace or upgrade them. Then think about this in the context of the lease rates, durations and covenants available to determine if leases would be likely to provide significant strategic and financial benefits. Many companies are likely to find they should be leasing somewhat more than they do now.

Gregory V. Milano, a regular CFO columnist, is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.