Reduce Equipment Costs Through Leases
By Dan Sholem, equipment finance consulting

As many higher educational institutions are faced with limited resources and higher performance demands, it's a no brainer to increase equipment usage or return on assets (ROA) and reduce equipment cost through horizontal integration of decision making.

Using resources more efficiently is often the responsibility of university purchasing departments. The mere existence of a purchasing department gives management the sense that the university is achieving the best price for any piece of equipment, supplies, commodity, hardware or service. The existence of a purchasing department should provide all constituencies confidence that funds are well spent and that every dime is squeezed out of the budget.

For purchasing departments to achieve the next marginal improvement in capital efficiency, however, they must integrate their decision-making practices, procedures and processes along with those of the university's finance department, academic departments and facilities management departments that use and operate equipment.

Increased integration of vertical decision making increases ROA. For example, there are 100 aging desktop computers at a state university's medical campus. For the last six months, the four-year-old units have required more and more maintenance hours, software patches and memory upgrades, all translating into money being put into old equipment. The medical school's IT director submits a purchase request to replace the computers. In a good year, with sufficient budget space, the purchase is approved, the purchasing department negotiates a reasonable price, and the equipment is installed.

Or is it? What could be wrong in this scenario?

- How long and how many maintenance dollars did it take to finally prompt a decision to purchase new computers? If the IT team integrated decision making on a proactive basis with the department head and informed him that three years is the likely lifespan in which patching old gear is a no-win game, money could have been saved.
- It costs money to dispose of old equipment. Meeting sustainable standards in disposing old computer equipment requires an integrated maintenance action.
- Conducting a legal review of lease documents from the lessor is essential, and including legal representation in the vertical integration permits the university to know what constraints must be considered prior to starting the process. Discovering this too late is a waste of time and money.
- Was the same mistake being repeated by purchasing equipment university leaders are 95% certain will only be used for three years? Have lease options been considered?

Considering an operating lease

Traditionally, a lease was considered any type of finance arrangement in which the lessee or user takes possession of the equipment at the end of the finance period. Today, the Financial Accounting Standards Board (FASB) defines an operating lease as an arrangement in which:

- The present value of the payments is less than 90% of the equipment cost.

- The length of the lease runs for less than 75% of the equipment's useful life.
- The lease does not provide a discounted purchase option at the end of lease.
- The lessor maintains ownership of the equipment.

The operating lease allows the lessee to expense any periodic lease payments and allows the lessor to take any depreciation benefits associated with the lease. Today, several gray areas have developed in lease pricing scenarios and end-of-lease options. Suffice to say, if a lessor is willing to take on the ownership risk associated with the possibility of having the equipment returned at the end of the lease, and these terms are reflected in a lease agreement, using the operating lease for equipment you are 95% certain of only using for three years—such as the desktop computer equipment—saves at least 10.1% of the 100% price negotiated by the purchasing department.

A bright mind in the finance department may object to using an operating lease because:

- The university is not a taxpayer and cannot use the additional expense from operating lease payments to reduce net income.
- The university borrows money at very low rates, typically through tax-exempt bonds.
- When calculating the all-in interest rate using the operating lease payments plus an end-of-lease fair market value buyout, the inherent interest rate is higher than the tax-exempt rate the department could have used.

By talking with all departments and administrators involved, everyone would have concluded they don't want to own the equipment for more than three years. The finance vertical team would have been able to identify a competitive equipment lessor with the appetite to assume the ownership risk of a returned piece of equipment and provide operating lease financing that, essentially, requires the university to pay only 89.9% of the equipment cost and return those computers at the end of the three-year term.

This process requires dynamic decision making—the finance department must consult the end users on where, when and how much the equipment will be used so return conditions and other operating lease terms can be optimally negotiated to match usage requirements. The players must have periodic, if not continual, dialogue to manage accordingly. Certainly, as individual employees come and go, a database of terms and conditions applying to various equipment must be maintained to secure institutional memory.

Considering tax-exempt equipment

According to the Dorm Authority State of New York (DASNY), the public authority is charged with "providing financing and construction services to nonprofit higher education and healthcare institutions, certain state agencies and nonprofit organizations specified by law."

In 2008, DASNY claimed $220 million in low-cost loans using a tax-exempt equipment leasing program that enabled 24 hospitals and higher education institutions to acquire critical high-tech equipment. Tax-exempt bonds prove to be a vital option. The low cost of funds is below the public-market rate, which saves money in comparable situations.

But, how is each lessee using the equipment? Is the institution saving a few basis points on their lines of credit but paying for equipment value that is not needed? Public universities enjoy low-cost funding through tax-exempt bond offerings. The trend

is to use this low-cost debt no matter the equipment, the expected equipment use in relation to the equipment's long-term value and what cash is available for outright purchase.

Why borrow money at about 2% to fund 200 patient-monitoring devices and own the equipment after three years when it will be obsolete and you will have an inventory of outdated gear and hospital staff requesting additional funds? Why borrow and create a debt obligation plus end-of-term ownership risk when a lessor may offer true operating leases and assume that ownership risk?

Let's blur those vertical decision-making lines through implementation of a continual review of economic and technological issues concerning leased equipment usage. Technology and economic issues work together in drafting an optimal solution.

Johns Hopkins University School of Medicine in Baltimore analyzed computer use—including desktops, laptops and patient-monitoring devices—throughout its facilities. The university concluded it had been wasting funds by using tax-exempt bonds or paying cash for the full price of the equipment rather than using operating leases to finance and pay for less than 90% of the equipment cost. The school also concluded that to use this leasing structure, a disciplined equipment tracking and lease notification system must be in place, or additional costs would be incurred.

For example, a university may lease computer servers for three years to match the length of a research project and a related funding grant. One year into the lease, the researchers may ask for additional, faster computing power with memory upgrades that have recently become available from the manufacturer. With communication between decision-making verticals, a lease extension with upgrades could be negotiated with the lessor and implemented prior to the original lease termination date. Certainly, it is possible to keep the lease payments at the same level by extending the lease term beyond the expiration date.

Other examples of midterm solutions achievable through integrated decision making are: early equipment returns, economic reengineering of lease structures, midterm lease extensions, equipment remarketing assistance and logistics support. These are all matched through early, ongoing evaluation and will add value to the initial lease transaction.

Operating lease vs. lease

Until you integrate the decision makers, it is surprising to see how semantics can cause problems. Too often in financial arenas, "lease" is used to define finance mechanisms used to acquire equipment. Most often, the term is defined locally by the ingrained pattern of equipment acquisition so a single finance structure is defined as a lease throughout the entire university system.

Because of the infrequent use of the operating lease structure, a lease becomes problematic due to the nature of budgeting. While a department may make periodic lease payments from an operating budget, the lease structure provides for ownership at the end of the term because the lessor has no residual interest remaining in the equipment. These structures are often end-of-lease $1 buyouts. In corporate and higher educational arenas, this semantic game is used to acquire equipment using a departmental operating budget under misleading terms.

By focusing on asset allocation rather than asset use, institutions limit their ability to actually do more, despite the current budget size. The goal should be using the equipment, not owning it, and certainly not budgeting for it. Due to the extreme verticality

of decision making, budget and asset ownership becomes more important than operations and use.

Implementing a continual review of economic and technological issues concerning leased equipment usage is not mutually exclusive. Whether in the higher education or corporate setting, matching these is the key to a successful proactive approach.

Each lending or leasing entity has its own appetite for risk. Whatever the firms mandate, each lessor develops and brings a specific appetite for risk. While financial risk is typically not a significant concern for colleges and universities acquiring equipment, a specific nuance when doing business with any not-for-profit and especially state operated institutions is in place. That nuance is the appropriations clause in master lease agreements (MLA) in which public universities permit the lessee to return the equipment and stop making lease payments if funds are not appropriated by the institution.

Most public institutions use an annual budgeting process. If that budget does not include funds to pay a lease for medical imaging equipment, for example, the institution can stop payment and return the equipment no matter how many months remain on the lease. This goes against the grain of equipment finance standards in which the lease typically has a hell-or-high-water clause holding the lessee responsible for the lease payments in any event. This additional risk—while proven not to be statistically material—is a fiduciary risk a lessor's credit committee must consider prior to entering the public higher education equipment finance market.

Keeping track with RFID

Knowing where and how much assets are, when and how each unit is being used (and possibly who is using the asset) and tracking maintenance requirements are fundamental to managing equipment and equipment cost.

Most institutions have an asset identification strategy that uses simple, standard serial number plates on the bottom of each asset. Simple tagging provides a base level of security and manual inventory opportunities. Radio frequency identification technology (RFID) takes asset management to a modern level. RFID tags the size of a small fingernail can be affixed to assets as they are deployed.

These tags are entered into a database that can be customized to coordinate with financial, inventory, operational or other software used in any particular working environment. With this database, lease terms and maintenance provisions outlined in a MLA are easily monitored, changes in use are identified prior to a periodic mark, and budgets are met, maybe even reduced.

With RFID tags, labor-intensive annual inventories become a thing of the past because real-time inventories are performed by using hand-held readers or permanent readers mounted in strategic locations. Theft is reduced, maintenance is improved, usage awareness is increased, and the amount of equipment required is reduced as systematic identification is cemented in the management process.

Surplus equipment is an ownership risk, and RFID technology can be used to track it. But maintaining, storing, securing and selling surplus assets all cost money. By recognizing these potential costs during the acquisition decision-making process, a university will be in a position of strength when determining and negotiating the optimal funding mechanism. If the equipment is likely to become surplus prior to the end of its

marketable life, arranging a true operating lease—in which the lessor assumes ownership risk—makes logical sense.

Twenty-first century higher educational institutions find many academic disciplines interacting with one another. Engineering students take finance classes, and fine-arts students study biology. The students refine their understanding of their core disciplines by using concepts from others. That is where breakthroughs in knowledge happen.

Managing the equipment acquisition process in an optimal fashion requires the same pattern. Risk managers, supply chain experts, finance staff, purchasing managers and operational management Six Sigma gurus should cross-coordinate their efforts to achieve breakthrough performance levels.

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