Understanding Asset Leasing Solution

Part-2

Introduction

Asset leasing is an agreement between two parties the lessor (owner of the asset) and the lessee (user of the asset). The lessee enters into an agreement with the lessor to use essential assets such as equipment or vehicles for a specific period in exchange for monthly rentals.

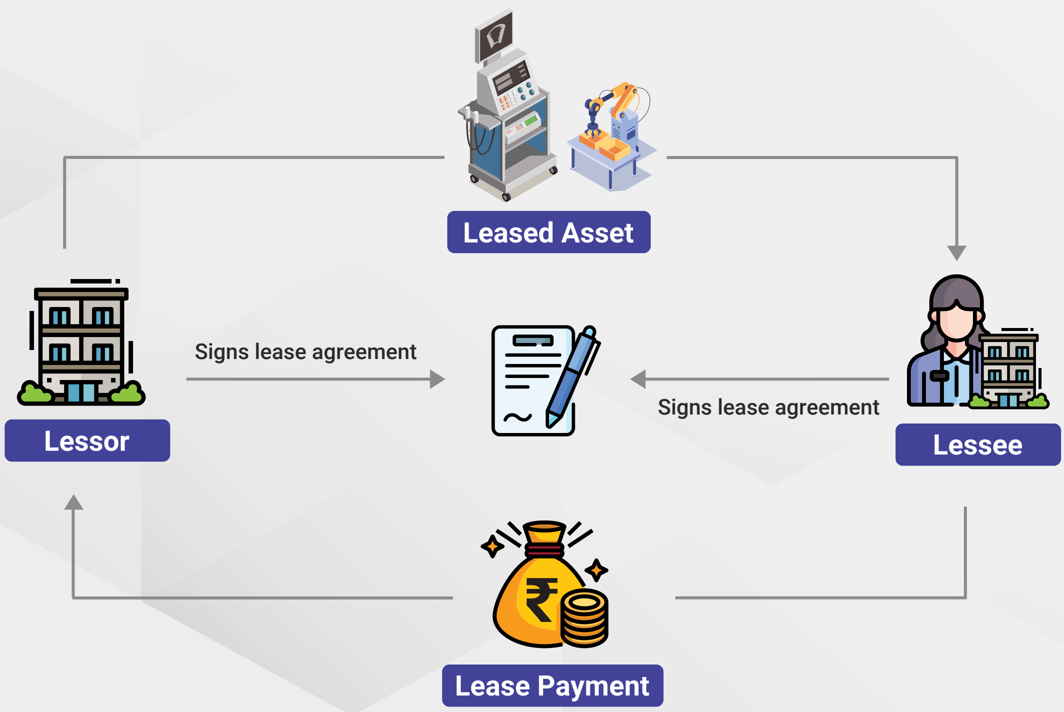
There are three primary models that are adopted in a leasing arrangement based on the convenience and business needs of the parties involved. In this note, we elaborate on these asset leasing models below.

Asset Leasing Models

1. Direct Lease.
2. Sale and Leaseback.
3. Lease Rental Discounting.

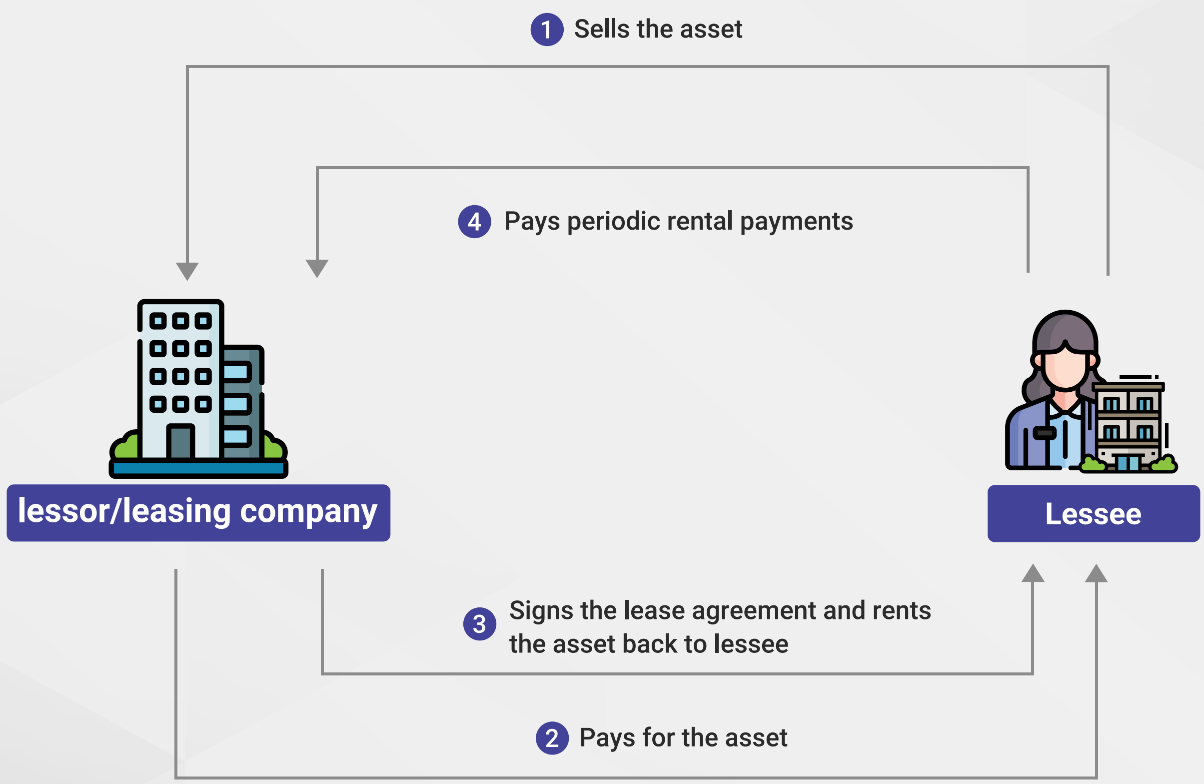
Direct Lease

In this model, the lessor makes direct payment to the Original Equipment Manufacturer/Vendor for the purchase of the asset and then rents it to the lessee. The lessee pays the lease rentals to the lessor during the lease term allowing it to use the asset without owning it. The lease tenure depends on the nature of the asset and lasts for a period which is shorter than the asset's economic life. At the end of the lease term, the lessee may have the option to return the asset to the lessor providing it the financial flexibility by keeping the asset and its related liability off the balance sheet.



Sale and Leaseback

In this model, there are two parties to the agreement, the lessor (buyer/owner of the asset) and the lessee (seller/end-user of the asset). The lessee either uses an existing asset or purchases a new asset and sells it to the lessor, entering a leaseback arrangement for a specific period. In case of an existing asset, the lessee sells it to the lessor at the written-down value (WDV). The lessee pays lease rental to the lessor during the lease term allowing it to use the asset without owning it. There is no physical movement of the asset, and the leased asset appears in the books of the lessor (the buyer/owner). The lessee benefits by replacing the high-cost debt of owning the asset with low-cost lease liability. The lease tenure depends on the nature of the asset and usually ranges between 5-7 years. At the end of the lease term, the lessee purchases the asset back from the lessor.

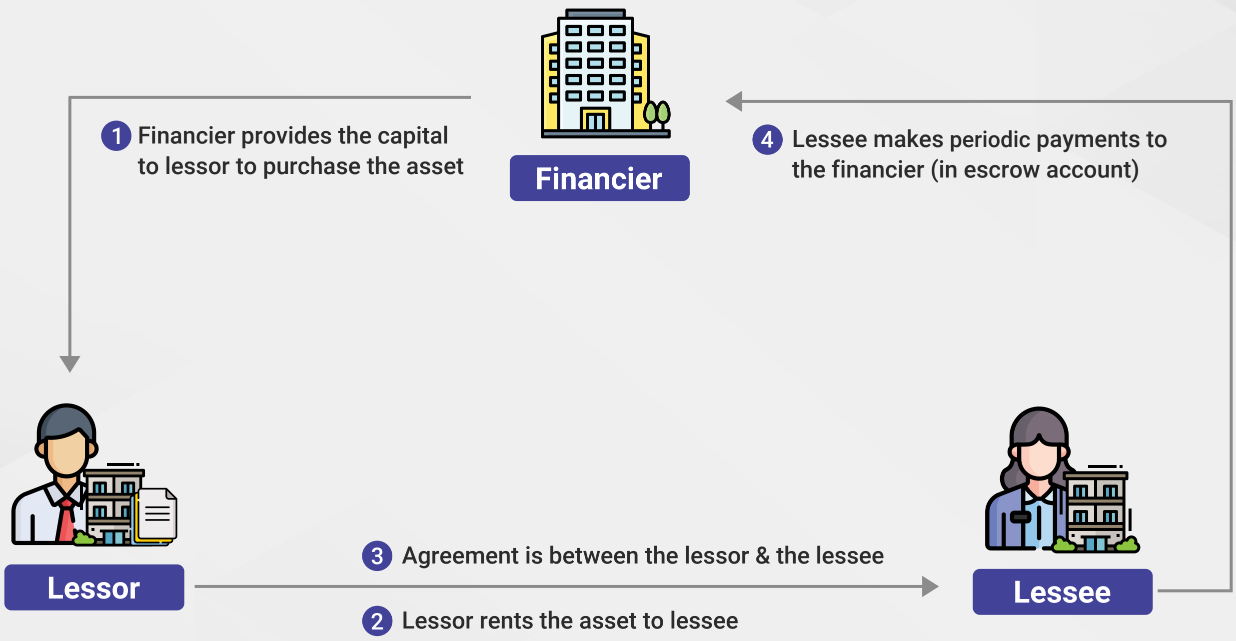


Lease Rental Discounting

Lease Rental Discounting (LRD) is an arrangement in which the lessor or the owner of the asset can obtain a loan from a financial institution by keeping the rent receivables from the asset as a collateral. LRD allows asset owners to unlock the value of future rental income to manage immediate financial needs. The structure of an LRD transaction can vary depending on specific circumstances. In this note, we discuss two cases that we might encounter within this model.

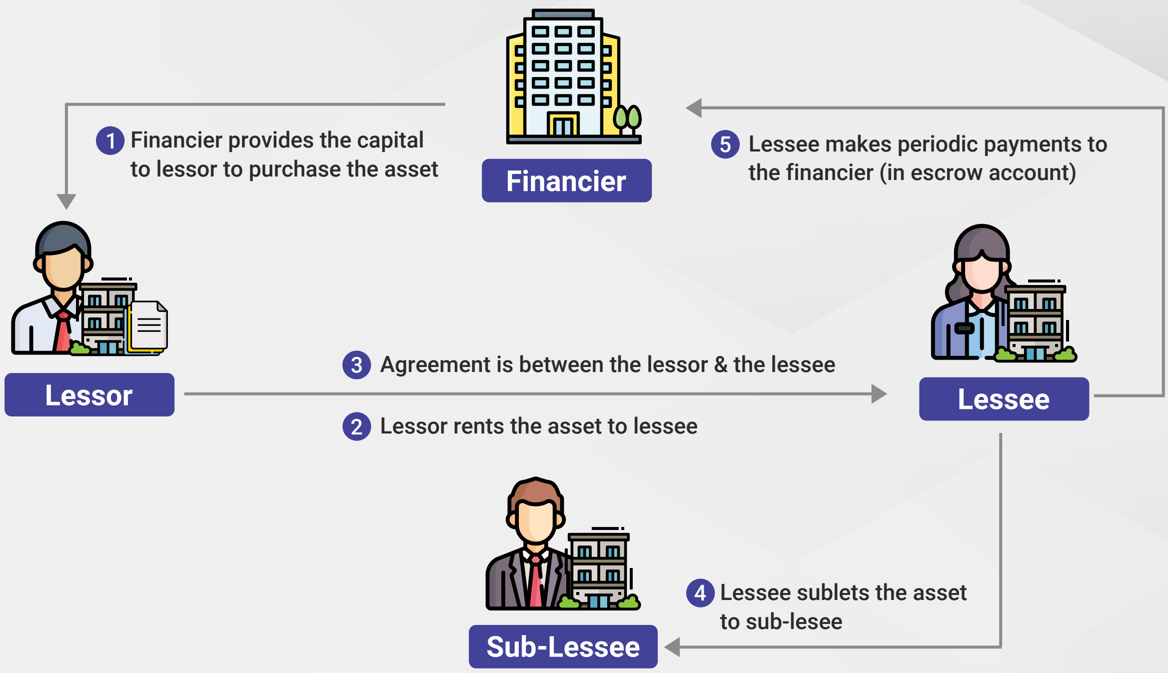
Case 1

There are three parties in the transaction, the financier, the lessor (owner of the asset) and the lessee (end-user of the asset). The financier provides capital to the lessor to purchase the asset/equipment, the lessor then enters a leasing agreement with the lessee in exchange for periodic payments. In this arrangement, while not mandatory, an escrow account may be created among all three parties, wherein the lease rentals due are assigned to the financier, who receives the periodic payments instead of the lessor. The ownership of the asset lies with the lessor and the leased asset appears in the books of the lessor. At the end of lease period, the lessee can choose to return the asset, extend the lease term, or buy the asset from the lessor.



Case 2

There are four parties in this case: the financier, the lessor/owner, the lessee, and the sub-lessee. The leasing arrangement is same as Case 1 with one additional element - sub-lessee. The financier provides capital to the lessor to purchase the asset/equipment, the lessor then enters a leasing agreement with the lessee in exchange for periodic payments. While the lessor rents the asset to the lessee, the lessee further sub-lets the same asset to sub-lessee. The sub-lessee in some special cases acts as a guarantor for the lessee. Similar to the previous case, an escrow account is created between all the four parties wherein the financier receives the periodic rentals. At the end of lease period, the lessee can choose to return the asset, extend the lease term, or buy the asset from the lessor.



While, the above section covers the three asset leasing models, it is important to understand how these are classified in accounting as well.

There are primarily two ways to classify leases in the market: Operating Lease and Financial Lease.

- **Operating Lease:** An operating lease is a type of lease where the ownership of the asset is not transferred to the lessee even after the end of the lease term. Operating leases are for shorter duration and the lessor bears the responsibility of maintaining the asset. This type of lease is beneficial to the borrowers in cases where the asset needs to be replaced frequently.

- **Financial Lease:** A financial lease or a capital lease is a type of lease where the leasing company (lessor) is the owner of the asset for the lease tenure. A finance lease transfers the risk and reward of asset ownership to the lessee. At the end of the lease term, the lessee gets an option to purchase the leased asset.

The choice between these lease types depends on the structure of the agreement and the requirements of the parties involved, ensuring businesses align leasing decisions with their operational and financial strategies.

Conclusion

Asset leasing helps small and medium enterprises in scaling operations by bridging the gap between their growth aspirations and financial constraints. By opting for Direct lease, Sale and Leaseback arrangement or Lease Rental Discounting, enterprises not only get access to required assets but can reallocate their capital to pay their debt, invest in core operations, or growth opportunities.