Why isn't Lease Pricing Simple?

By Ian Burchell

Why isn't lease pricing simple? After all, we know that the lessor requires a certain yield, so surely the question is simply: what is the rent whose present value is equal to the lessor's initial investment? This calculation can be easily done on a calculator, so why are there seminars to explain this, and complex software to calculate it?

Well, for one thing the lessor's cash flow does not only consist of the purchase outflow and the rental inflow; there are often other flows. One such flow, tax, can be far from simple. Although at the end of the lease the total taxable income is usually the same as the total of the cash flows, in each year during the lease they can be very different. This timing difference between cash and tax is not just due to simple accruing; it can be more complex. For example, a purchase is a day one cash outflow, but for UK tax purposes it can be represented as a series of declining capital allowances that go on forever. Furthermore, the accounting calculation sometimes directly affects the tax calculation (and thus the cash flow calculation). An example of this is the taxation of negative accounting depreciation in the UK, where an accounting concept affects the timing of the tax recognition of the rentals.

Even the measurement of the lessor's return is not simple. Instead of just using one rate, two are used: one for when the lessor has funds invested in the lease; and a lower deposit rate during phases when the lessor has had its investment repaid. Sometimes lessors also target the Net Present Value of their cash flows. After all, although the yield may be large, if it's on a tiny investment, or for a short time then the absolute return can be negligible. Other jurisdictions may employ different pricing measures, such as the tax loan method used in France, or the loss ratios used in Japan.

Then there are the concepts of the lessee's return (for example, average rent, PV of rent, implicit rate) and lease optimization. Lease optimization involves finding the best lease parameters to make it as attractive as possible to the lessee (subject to achieving the lessor's return). Altering the term of the lease or the shape of the rent profile can improve the lessee's economics, as can changing the amount of external debt, the debt repayment profile, and changing the dates of Early Buyout Options. It is important to know how the lessee is evaluating the lease, as the lease with the lowest present value of rents may not be the lease with the lowest implicit rate or other lessee measure.

Clearly lease pricing is not as simple as it first seems, and computer software is essential to price leases correctly. All of the ideas in lease pricing are very simple and easily taught. However, it is the combination of these ideas that means lease pricing isn't simple.

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