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THE INIC INSTITUTE

FINANCIAL COURSES THAT MAKE SENSE



How to Understand Asset Finance in One Day

COURSE FOUR - 8 MODULES

Message from the author

Why Learn About Leasing?

- By Dominic Lambrinos

There are over 2 million small to medium sized businesses in Australia with many not understanding the most cash efficient means of purchasing a physical asset for their operations.

Physical assets will include equipment, machinery, IT hardware and software and even a store fit out.

It is important to structure these affairs properly because they represent a significant amount of a business' upfront capital costs.

Furthermore, home loan mortgage brokers will have seen upfront and trail commissions dwindle over the past several years, and adapting to the resources available and offering a larger range of products can be paramount to the longevity of the mortgage business.

This course is provided to show you how to gain access to provide leasing in addition to your current suite of products, particularly if you already have a database of clients who run their own businesses.

You will receive both practical and technical skills as well as access to a support community in order to service clients' finance needs, as well as to produce a stream of upfront income in addition to your current income.

Leasing commissions as an upfront are significantly greater than the upfront receivable from mortgage finance transactions as well as being quicker to process.

The author is the founder the largest business finance brokerage practice dealing in 22 products with access to over 50 private and bank lenders and 32 years experience in professional business services in Australia.

The material contained in this course embodies much of the practical experience and technical competence attained in developing leasing as a profitable working income stream.

Please note that this course relates to leasing finance facilities solely for commercial purposes. If your clients desire leasing finance for personal purposes then the *National Consumer Credit Protection Act 2009* imposes additional requirements.



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Module 1

Course Summary

The purpose of this course is to provide mortgage brokers with a package of information and advanced skills and tools in order to establish leasing as an additional profitable working income stream.

The objective is:

1. To introduce a range of new leasing products into your business offerings.
2. To better understand the intricacies of each constituent product and confidently package one or more of these together to satisfy a client's needs.
3. To understand how you would structure your fee schedule across the different leasing products.

In the real world, a client may approach you and say something to the effect of, "I need to purchase a truck so I can make more deliveries in order to meet increasing customer demand."

Unfortunately, however, there are multiple leasing arrangements this client can implement and without a deep understanding of each option (and without understanding the language in the fine print!) this client's requirements may not be properly satisfied.

For example, common issues arise when clients only focus on monthly repayments and do not completely understand the issue of ownership of the asset.

Not only will this course introduce you to leasing and even show you how to attract clients, but it will also teach you the skills necessary in order to profitably and efficiently meet business dilemmas such as the one alluded to above.

The intention of this course is to equip you with a novel and valuable set of skills and leasing products that you can offer your clients in addition to home loans, and is designed to ultimately differentiate you from your competitors so that you can enjoy a competitive sustainable advantage.

With the development of these skills it is intended that you will increase revenues via new incomes derived from these services. Further, you would benefit from improved client retention, increased referrals and the ability to earn a higher level of ongoing fees.

INTENDED PARTICIPANTS

This course has been designed for those who hold a Diploma in Financial Services (Finance/Mortgage Broking) although new entrants may also benefit as they develop the skills to deliver these services.

Participants will likely be mortgage brokers who wish to increase their product offerings and provide a more holistic service to their clients.

The course focuses on both the practical application and technical skills required to introduce leasing, and its constituent products, as an additional stream of income.



CPD HOURS

Industry bodies apply their own individual criteria for the awarding of continuing professional development (CPD) hours.

At present this course provides for 6 hours CPD for the Finance Brokers Association of Australia.



Module 2

Concepts of Leasing

2.1 What Constitutes a Business?

- ❖ People can make money through two different means; they can work for a company and receive a salary, or they can operate their own business.
- ❖ Consequently, a business is an activity or enterprise that exists to make a profit.
- ❖ A business can make a profit by buying and selling goods, manufacturing goods for sale or it can be entirely service-based.
- ❖ This is clearly quite broad, so a business can be something obvious such as Google or a single professional IT consultant.

2.2 Types of Businesses

There are several different types of business structures, but in Australia the main structures are:

Sole trader	This is the most common form for a small business. It suits a small/ single operation such as a tradesman, small accountant or solicitor, and even the typical small corner store. Generally sole traders do not employ many employees, if any at all.
Company	<p>A company is a separate legal entity, used by people in business to delineate their business activities from themselves.</p> <p>You can have a small company such as a family company where the directors and owners are the husband and wife, all the way to a public company where there is an independent board of directors and many shareholders, whose shares are traded on a stock exchange.</p>
Partnership	A partnership is when two or more people or companies agree to work in business together and share the profits in accordance with agreed percentages.
Joint venture	Joint ventures are like a partnership, but are usually used for a specific activity that has a limited life like a property development or an oil exploration platform.

Trusts	<p>A trust creates a relationship between a person acting as a Trustee who is entrusted to hold property or other assets for the benefit of a group of persons, referred to as the Beneficiaries.</p> <p>The Trustee is the nominal owner of the property and assets and the Beneficiaries are only entitled to hold their interest in the trust. Unlike companies a trust is not a separate legal entity, however some businesses are carried out through trusts.</p> <p>The ultimate say rests with the Settlor who has the authority to appoint and remove Trustees.</p> <p>There are three main types of trusts:</p>
A. Discretionary Trusts	<p>A discretionary trust permits the Trustee to distribute any surplus to beneficiaries at their discretion.</p> <p>This enables families, for example, to establish a business within a trust that allows their family members to act as beneficiaries to the trust without being involved in how the business is operated.</p>
B. Unit Trusts	<p>The Trustee of a unit trust has no discretion and income must be distributed in proportion to the units the beneficiaries hold (this is akin to a company distributing profits to shareholders via a dividend – the more shares you own the higher your dividend income).</p>
C. Hybrid Trusts	<p>Hybrid trusts combine elements of both unit and discretionary trusts into a more complex trust.</p> <p>For example, a hybrid trust can distribute surpluses discretionally, and distribute capital or capital profits in accordance with unit holdings. Overall hybrid trusts are not widely used and, as such, are not widely accepted by lenders.</p>

2.3 What is Leasing?

Many businesses require physical assets (equipment, machinery, etc) in order to carry out their business operations. However, these large physical assets tend to be quite expensive, and if bought outright create a serious cash flow problem.

Therefore, a business has two options; it can use current or additional equity to purchase the asset, or it can implement a leasing facility where they borrow the required funds/equipment and then repay this amount over a fixed term (plus interest for the privilege).

Assets such as equipment usually exist in a business for a number of years, and accordingly there is an economic benefit to be derived from the asset over a long period of time.

It makes much more sense to finance large assets so that the costs of carrying those assets are allocated over the economic life of that asset.

There is a strong business principle called the 'Matching Principle,' which says that a business should allocate its cash outflows as closely as possible to its income inflows.

In other words, it is not efficient to purchase an asset outright today for, say, \$100,000 when the income from that asset will be derived over the next 5 years.

Leasing finance is available from three main sources. Firstly, a business can engage a major or second tier bank. Secondly, a business can utilise the non-bank lending sector. Finally, leasing funds are also available from private investors.

2.4 Types of Leasing Finance

There are five main classes of leasing arrangements, and these are:

1. **Financial Lease (Hire Purchase and Chattel Mortgage)**
2. **Operating Lease**
3. **Sale and Leaseback**
4. **Novated Lease**
5. **Direct Lease**

This course will deal with the first three categories because these lend themselves most easily to the services of a business finance broker.

2.5 Why Need Leasing?

Every business can segment its outflows into fixed and variable costs. As their name suggests, variable costs vary with the level of output so as a business increases its output it will consequently experience a higher level of variable costs. This makes sense because it should cost more to produce more.

Fixed costs are another story; before you even have your morning coffee and regardless of your revenue you will already be obligated to make these payments, such as rent, salaries, utilities, etc.

Leasing is simply a means to lighten this burden so that rather than having to make a single enormous payment a business can make a series of smaller repayments.

Think about buying your own deliver truck; would you rather pay \$40,000 cash up front or obtain leasing so that you can pay \$800 per month for five years (calculated with an arbitrary but reasonable rate of 7.5% p.a. with no residual value), and thereby allocating the value of the truck against the monthly income the truck makes over the 5 years?

Clearly a large single payment would create a significant degree of strain on a business' cash flow and working capital, so leasing can be used to mitigate this.

**Leasing can relax
fixed cost pressures.**



2.6 Example

Organic Energy manufactures and sells organic superfoods.

Organic Energy needs to purchase another industrial juicer to meet increasing demand from its customer segment that starts everyday with an organic superfood juice.

Furthermore, in order to ensure that nothing goes to waste Organic Energy wishes to purchase another large refrigerator to store product before it is sold.

Organic Energy is adamant that both of these purchases are necessary to facilitate growth in the business, but the problem is the juicer costs \$100,000 and the refrigerator costs \$200,000 and Organic Energy only has \$80,000 cash in the bank.

Cash at bank	\$80,000
Juicer	\$100,000
Refrigerator	\$200,000
Shortfall	-\$220,000

Once Organic Energy submits a professional quote for each piece of equipment, a lender approves leasing facilities for both the juicer and the refrigerator where Organic Energy must pay \$1,850 per month for the juicer and \$3,700 per month for the refrigerator¹.

Fortunately Organic Energy is currently generating \$20,000 per month in gross profit (which is expected to grow further as they produce more output with this new equipment), and so is comfortably able to afford these facilities with enough left over to meet their other expenses (especially with the \$80,000 cash buffer they were able to maintain in the bank).

Gross profit/month	\$20,000
Juicer cost/month	\$1,850
Refrigerator cost/month	\$3,700
Gross surplus/month	\$14,450

Initially it seemed almost impossible to acquire this equipment, however a leasing facility enabled Organic Energy to capitalise on this growth opportunity immediately.

¹ Each facility is approximated using an interest rate of 10% p.a. over 5 years with a 20% residual amount.

In many cases, the opportunity cost of waiting until a business can afford to purchase equipment outright can surpass the actual costs of the leasing facility. This concept is tabulated in the below.

Equipment	Monthly Repayment (\$)	Total over 5 Year Life (\$)	Residual (\$)	Total Outgoings (\$)
Juicer	1,850	111,000	20,000	131,000
Refrigerator	3,700	222,000	40,000	262,000
				393,000
Total costs without leasing				300,000
Cost of leasing over 5 years				93,000

INTERESTING NOTE

If this equipment generates in excess of \$93,000 over the 5-year period, then the leasing facility essentially pays for itself.

Further, suppose Organic Energy were able to generate an extra \$10,000 per month with this new equipment. Then the opportunity cost of not implementing a leasing facility would be...

\$10,000 – \$4,450² = \$5,550 per month.

That is, they would be missing out on making an extra \$5,550 per month net of all leasing charges.

² Total monthly leasing charge = \$1,850 + \$3,700 = \$4,450.

DISCUSSION WITH THE AUTHOR



Module 3

The Leasing Details

3.1 Repayments Sensitivity

When it comes to leasing there are a few issues that will impact the amount of monthly repayments, and these are:

i. The Interest Rate

This is the most obvious factor influencing the amount of the monthly repayment.

A higher interest rate attracts a higher monthly repayment, and a lower interest rate results in a lower monthly repayment.

ii. The Term

When there is a fixed amount to repay, squeezing these repayments into a short amount of time to clear the arrangement quickly versus spreading the repayments out over a longer time will obviously affect the constant repayment amount.

In other words, if the lease is for \$100,000, a term of 3 years will result in a higher monthly repayment than an arrangement with a term of 10 years (where the \$100,000 principle to be repaid is allocated over a far longer time horizon).

iii. The Residual

The residual amount is simply the value assigned to the asset at the end of the arrangement's term. That is, an arrangement could be structured so that the client still owes this residual amount to the lender at the end of the term.

For example, a leasing arrangement for a truck valued at \$100,000 could be structured with a 20% residual value. This means that the monthly repayments would be calculated on an amount of \$80,000 and the remaining \$20,000 would be payable to the lender as a lump sum at the end of the arrangement's term.

Clearly arrangements with a higher residual value would attract lower monthly repayments because as the end lump sum gets larger the monthly repayments are calculated on a lesser amount. That is, residual amounts and monthly repayments have an inverse relationship.

A residual amount of 10% means monthly repayments are calculated on 90% of the asset's value (and 10% is payable as a lump sum at the end), whereas a residual amount of 30% means monthly repayments are only calculated on 70% of the asset's value (with 30% payable as a lump sum at the end).

Example:

The below table illustrates the effect of term and residual amount on the level of monthly repayments. The repayment amounts are approximated using an asset value of \$100,000 and an interest rate of 10% p.a.

Residual	Term			
	12 months	36 months	60 months	Lump Sum at end
10%	7,930	2,963	1,979	10,000
20%	7,140	2,725	1,851	20,000
30%	6,351	2,488	1,723	30,000

3.2 Repayments Allocation

Most of the time, each monthly repayment will be made up of a principle amount and an interest amount.

The principle allocation goes towards paying down the initial loan amount, so if the asset value is \$100,000 and the residual is 20% then this principle allocation goes towards paying down the \$80,000 loan amount.

Keep in mind that this principle amount represents the value of the asset, so if the borrower never wants to own the asset and instead simply wishes to rent it (as in an Operating Lease), then there will be no principle amount and the repayment will be purely interest-based.

The interest allocation is an extra payment amount that is charged for the privilege/convenience of using the leasing arrangement. It can be thought of as a rental charge.

As the monthly repayment amount remains constant, the allocations that go towards the principle and interest components are dynamic.

At the beginning of the loan most of the repayment will constitute an interest charge and only a small amount will go towards paying down the principle.

However, as time goes by more and more of the principle amount will be repaid and therefore the interest is being charged on a lesser and lesser principle amount.

Consequently, by the end of the loan most of the repayment will go towards paying off the principle amount and only a small allocation is given to the interest charge.

The below table highlights the interest (light green) and principle (dark green) allocations on a 12 month leasing facility with an asset value of \$100,000 and a monthly repayment of \$100 (approximate values), so you can see how the relationship between principle and interest amounts changes over the term of the facility.

Repayment = \$100						
Month	Opening Balance	Interest	Principal	Closing Balance	Cumulative Interest Paid	Interest Still To Pay
1	1,000.00	30.77	69.23	930.77	30.77	169.23
2	930.77	28.21	71.79	858.98	58.98	141.02
3	858.98	25.64	74.36	784.62	84.62	115.38
4	784.62	23.08	76.92	707.70	107.70	92.30
5	707.70	20.51	79.49	628.21	128.21	71.79
6	628.21	17.95	82.05	546.16	146.16	53.84
7	546.16	15.38	84.62	461.54	161.54	38.46
8	461.54	12.82	87.18	374.36	174.36	25.64
9	374.36	10.26	89.74	284.62	184.62	15.38
10	284.62	7.69	92.31	192.31	192.31	7.69
11	192.31	5.13	94.87	97.44	197.44	2.56
12	97.44	2.56	97.44	0.00	200.00	0.00



Components of Leasing Finance

All leasing revolves around the simple principle of implementing an arrangement whereby a business can make monthly payments in order to use certain assets rather than purchasing these assets outright for their full cost price.

However, there are differences amongst the leasing arrangements available.

Please note that all of the tax implications discussed in these pages are only applicable if expenses are incurred in the process of generating taxable income.



“I’m forming a committee to create a task force to choose a team leader to assemble a board to hire the best people to determine the fastest way to deal with the problem.”

i. Financial Lease

A Financial Lease is a non-cancellable arrangement that lasts for a relatively longer term; usually the full economic life of the asset (i.e. until the asset's resale value is diminished), where the security for the arrangement is the asset being leased.

Under a Financial Lease, all of the risks of ownership are transferred to the client along with all burdens relating to maintenance, repairs, insurance, etc.

These risks and burdens fall upon the client regardless of how the title of ownership is arranged; the two main types being under a Hire Purchase or Chattel Mortgage facility.

Hire Purchase

Under a Hire Purchase arrangement, the title of ownership rests with the lender for the duration of the term and once all repayments have been made the asset can be legally bought from the lender for a nominal amount (e.g. \$1).

As for tax implications, under a Hire Purchase arrangement the borrower can claim depreciation, running costs and interest paid against their business revenue.

When it comes to GST payments, the borrower can claim one-eleventh of all repayment components (principle and interest).

That is, if the term is 5 years and the monthly repayment is \$2,500 then the total amount paid will be \$150,000. The client can claim a GST expense of \$13,636³ in their next Business Activity (BAS) statement.

³ $150,000/11 = 13,636$.

Chattel Mortgage

Under a Chattel Mortgage arrangement, the title of ownership is immediately passed to the borrower and the lender takes a mortgage over the chattel (e.g. the truck).

However, the monthly repayments under a Chattel Mortgage do not contain GST (and therefore are lower than the comparable Hire Purchase repayments).

Consequently, when it comes to GST under a Chattel Mortgage the borrower can only claim one-eleventh of the purchase price of the asset (not the total repayments amount as under a Hire Purchase).

That is, if the asset was purchased for \$110,000 then the client can claim a GST expense of \$10,000⁴ in their next BAS statement.

⁴ $110,000/11 = 10,000$.

ii. Operating Lease

An Operating Lease lasts for a relatively shorter term and certain features of the contract can actually be renegotiated throughout the term of the arrangement, with the security once again being the asset leased.

However, with an Operating Lease the title of ownership always stays with the lender so that the borrower never actually owns the asset.

Therefore, this asset will not appear on the borrower's Balance Sheet, which may be preferable because it will produce higher operational and return-on-asset figures for the borrower.

However, the borrower only has a limited right of use over the asset yet is still responsible for all issues relating to upkeep and maintenance.

Think of this like renting a hotel room; you only pay to use the room for a fixed amount of time but you never actually own it.

In saying this, the borrower does have the right to purchase the asset for fair market value at the end of the term or return the asset to the lender.

The tax implications of an Operating Lease can be favourable because the entire monthly charge and associated maintenance/upkeep expenses are tax deductible for income tax purposes.

When it comes to GST, the client can claim one-eleventh of the monthly charge so if the monthly charge is \$2,200 the client can claim a GST of \$200⁵ for that month. In any BAS statement the client can therefore claim a GST amount of \$600⁶.

⁵ $2,200 / 11 = 200$

⁶ $200 * 3 = 600$ as BAS statements are quarterly (every 3 months)

"All leasing revolves around the simple principle of implementing an arrangement whereby a business can make monthly payments in order use certain assets rather than purchasing these assets outright for their full cost price".

iii. Sale and Leaseback

This arrangement is feasible when the client owns valuable assets that are unencumbered (with no debt) or if the value assigned to them by a professional valuer exceeds the associated level of debt.

With a Sale and Leaseback, the client actually sells the assigned asset to the lender who then leases it back to the client. In other words, the client is trading the receipt of a lump sum (equal to the value of the asset) for a monthly obligation to make lease repayments back to the lender.

It is important to note, however, that this exchange does not take place physically but instead solely on paper. That is, the location of the asset does not change.

Clearly this is a way for the client to become raise funds from selling their asset (to the lender), which they still need to use so they agree to pay monthly rental charges (back to the lender) so that they can continue using the asset.

The security for a Sale and Leaseback is the asset being leased.

The Leaseback arrangement can quite easily be structured as either a Financial Lease or an Operating Lease.

3.4 Example – Sale and Leaseback

Let us continue our earlier example involving Organic Energy.

Business is going well and the new equipment is bringing in a significant amount of new business, which management is very happy about.

However, they seem to have erroneously forecasted their expenses budget and did not take into account the additional administration and logistics expenses that they are incurring as a result of their higher level of output.

As it turns out, they actually paid for their first industrial refrigerator outright, which constitutes a significant asset currently sitting in their Balance Sheet.

A Sale and Leaseback is proposed as a means of exchanging the value tied up in the refrigerator for cold hard cash.

A valuer is organised to come in and assigns a value of \$120,000 to the slightly older second-hand refrigerator.

The lender approves the facility and pays Organic Energy \$120,000 for the refrigerator, and then leases the refrigerator back to Organic Energy for a monthly charge of \$2,500 over 5 years⁷.

Fortunately the extra monthly expense of \$2,500 is covered by monthly revenue and the immediate inflow of \$120,000 can be used to pay these unexpected expenses so that Organic Energy can focus on the front-line management and growth of the business rather than on the cash flow pressures.

⁷ This charge is approximated using a value of \$120,000, a term of 5 years, a residual value of 10% and an interest charge of 12%pa.

iv. Direct Lease

A Direct Lease can sometimes be appropriate with assets that have a lesser value whereby the borrower leases the asset directly from the manufacturer without the intervention of any financial lender.

When the manufacturer is selling assets with a higher value they may desire the added security of a financial lender and prefer to structure the lease in one of the aforementioned arrangements.

Direct Leases will not be elaborated on in any further detail because they clearly do not warrant the involvement of a business finance broker.

v. Novated Lease

A Novated Lease is simply a way of salary packaging a vehicle into a remuneration scheme. In other words, three parties enter into a facility; the employer, the employee and the leasing company.

The employee agrees to be responsible for repayments so that the lender is happy, and then the employer agrees to make these repayments on behalf of the employee and then deduct them from the employee's pre-tax income.

If the employee ceases to work for this employer at any time during the term of the facility, complete onus for these repayments falls on this employee.

This type of facility could result in significant income tax savings for the employee, as well as GST savings on both the purchase price of the vehicle as well as the associated running costs.



Module 5

What does a typical problem look like in Leasing?

4.1 Problems in Business

The two main problems with a lease (as is with most forms of finance) are:

- i. **The security**
- ii. **Serviceability**

Certain types of assets are more easily financed, such as cars and certain types of trucks as these assets have a strong secondary market in case the asset has to be repossessed and on-sold by the lender in the secondary market.

Other forms of security assets that do not have a strong secondary market, such as specialised manufacturing equipment, will require the finance to rely more on the net asset position of the borrower and guarantor/s.

The other problem associated with leasing is ensuring there is adequate historical evidence proving that the business has sufficient net income to pay for the lease payments.

In other words, the problem relates to ensuring that the business will make adequate future earnings to service the additional leasing obligations.

A lender will look at the serviceability on a future maintainable earnings basis, which means in layman's terms how much the earnings are before interest, tax, depreciation and amortisation ongoing into the future.

For example, some of the addbacks can be:

	Amount (\$)
Net Revenue	20,000
Addbacks	
Tax	100,000
Depreciation	60,000
Amortisation	30,000
Director's Salaries	200,000
Director's Superannuation	18,000
Extraordinary (unusual) expenses	20,000
Maintainable Earnings	448,000

Therefore even though net revenue was only \$20,000, which would most likely be insufficient to sustain any leasing arrangement, the future maintainable earnings are actually in the vicinity of \$488,000.

4.2 Opportunities to Look For

In a nutshell, any client who is looking to acquire an asset for commercial purposes is a potential customer.

These assets could allow the client to capitalise on a growth opportunity, so an inability to afford such assets will obviously result in the client being concerned for the long-term success of their business.

Consequently, a leasing solution can be easily sold as a means to capture growth opportunities or alleviate them from fixed cost pressures so that they can keep their focus on the front-line management and growth of their business.

There are a few questions you can ask to identify a client's situation and desperation for a leasing solution:

- ❖ What do you want to buy and how will this asset grow your business?
- ❖ How much cash do you have at the bank?
If their assets are less liquid than cash then chances are they will have trouble in funding the acquisition of an asset outright.
- ❖ What are your immediate/short-term payment obligations?
- ❖ What assets do you already own outright?

Keep in mind certain assets are easier to lease than others, but assets available to lease include cars, trucks, plant and machinery, computer equipment, some software, some components of a fitout and specialised vehicles such as limousines or hearses.

Once you determine that a leasing facility is appropriate, the below client situations can help you match an appropriate facility to your clients unique circumstances.

Client Situation	Solution
Does not want to list asset in Balance Sheet	Operating Lease
Wants to own the asset from day 1	Chattel Mortgage
Is happy to wait until the end of the term to own the asset	Hire Purchase



Module 6

Important Elements

Regardless of the type of leasing arrangement, there are important elements and process similarities universal to leasing finance in general. Consequently, the below information is applicable to both Financial (Hire Purchase and Chattel Mortgage) and Operating Leases.

5.1 How Does It Work?

The leasing process is relatively simple in comparison to alternate forms of finance.

Initially a client will approach you and tell you that they require a particular asset, say a truck, to assist with business operations.

They should already have an idea of which truck in particular they desire and so it should not be a difficult task for them to either acquire a professional quote or an invoice from the supplier.

The importance of this document is elaborated on in further detail below, but basically the lender wants to look at the exact asset in question.

This quote/invoice would also contain payment information for the supplier, and so once the asset's value is assessed and agreed upon the lender will directly pay the supplier in full.

Now it is a matter of entering into a specific leasing arrangement with the lender, where monthly repayments will be directly debited from your client's bank account and paid into the lender's bank account.

At the end of the term the arrangement may specify another significant event, for example a Hire Purchase agreement may denote a nominal amount the client must pay in addition to the final monthly repayment in order to receive the title of ownership over the asset.

And that is how it works in a nutshell. The following sections elaborate on each area in more detail.

"Keep in mind certain assets are easier to lease than others, but assets available to lease include cars, trucks, plant and machinery, computer equipment, some software, some components of a fitout and specialised vehicles such as limousines or hearses".

5.2 How Much Does It Cost?

The cost of a leasing facility is very much dependent on the asset class and also details surrounding the client. For example, cars will usually cost somewhere between 5% and 9.5% p.a., but if the client has poor credit history this cost can increase to up to 15% p.a.

Furthermore, as discussed above, increasing the term and residual amounts associated with the arrangement will result in a lower monthly repayment. For cars the usual maximum term is 4 years and maximum residual is 40%.

Trucks generally have lower maximums; 3-year term and 30% residual, because they get used more and therefore depreciate in value over a shorter period of time.

Some machinery will not have any residual so that its value is completely depleted over the term of the arrangement.

Special machinery and fitouts can cost up to 15% p.a. and computers and software can also be financed together and they can range in cost all the way up to 20% p.a.

5.3 Tax Treatment

GST PAYABLE (assuming asset is used solely for business purposes)

	Acquisition of asset	Monthly repayments
Hire Purchase	Yes	No
Operating Lease	No	Yes
Chattel Mortgage	Yes	No

DEDUCTIBLE AGAINST REVENUE (assuming asset is used solely for business purposes)

	Interest payments	Asset depreciation	Rental payments
Hire Purchase	Yes	Yes	-
Operating Lease	-	-	Yes
Chattel Mortgage	Yes	Yes	-

ASSET IN BALANCE SHEET

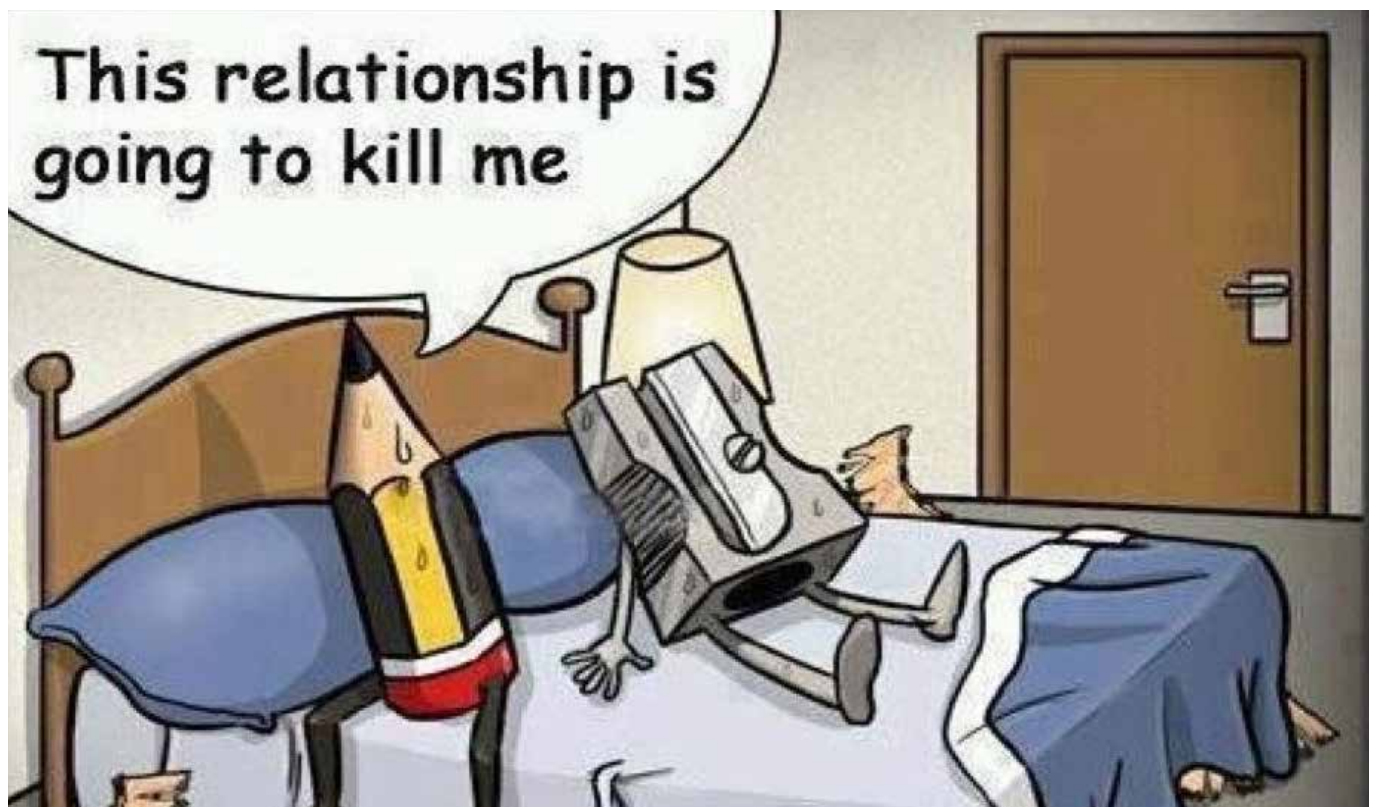
	In Balance Sheet	As an asset	As a liability
Hire Purchase	Yes	No	Yes
Operating Lease	No	-	-
Chattel Mortgage	Yes	Yes	Yes

5.4 The Important Elements

As mentioned in a previous section of this course, the two most important elements of a leasing transaction that a lender will always assess are security and serviceability.

In the discussion of each aspect below, it is important to keep in mind the fundamental rule of finance; the positive correlation between risk and reward.

To apply this rule to leasing, the riskier the lender feels about a transaction the higher the interest rate they will charge for the facility. So the safer you and your client make the lender feel the more favourable the interest rate is for your client.



5.5 Security

In assessing the security for a transaction, the lender will focus on a few main components:

i. Professional Quotation/Supplier's Invoice

This document is important because it basically assures the lender that the asset in question is real and it has a physical dollar value.

In cases where this value is not so clearly determined, the lender will actually organise a professional valuer to value the asset.

In the past lenders have been burnt by fraudsters who have colluded with the supplier and have organised for the lender to pay for an imaginary asset, pocket the lump sum payment and then renege on the repayment obligations.

For this reason lenders will always want to see this piece of paper.

Additionally, this document is important because it will also evidence the functionality of the asset in question so that the lender is confident that this particular asset will satisfy the operational requirements specified by the borrower.

Once again, this is to ensure the legitimacy of the asset and the arrangement as a whole.

ii. Resale Value

Resale value is important to the lender because it gives them an idea of what the asset can be sold for if it needs to be liquidated.

This is essentially a contingency plan.

If the client fails to meet their repayment obligations, then the lender finds some solace in the fact that they can sell the asset for this resale value to recoup some of their losses resulting from the defaulted facility.

iii. Assets and Liabilities Statement

Even in cases where the only security on the facility is the asset being leased, a lender will most likely still wish to see the personal statement of assets and liabilities for the client.

This is because they like to see whether or not there is some 'substance' behind the client and it gives the lender an idea of the borrower's ability to repay the loan through other means.

Finally, this statement will also give the lender an idea of the client's history of saving and accumulating wealth, which is especially important when the client is providing a personal guarantee.

5.6 Serviceability

In assessing the serviceability of the borrower, the lender will focus on a few main components:

i. Financial Statements

The Financial Statements are important in this assessment because they highlight significant aspects such as the client's gross and net profits, the allocation of their revenue and their current level of expenses relative to the revenue.

If the ratio of expenses to revenue is unreasonably high then it may be unfeasible to add another leasing facility expense, however in assessing the serviceability in greater detail the lender will also need to calculate the client's future maintainable earnings.

ii. Future Maintainable Earnings

Future maintainable earnings, as alluded to above, are essentially a calculation of the financial accounts to identify the real amount of cash available to service a leasing obligation.

For example, a director can always pay herself slightly less to meet these obligations. Expenses such as depreciation and amortisation are not actually realised each year so the amounts of money 'spent' on these items would also be available to pay for a leasing facility.

Consequently, these types of expenses need to be added back to net profit in order for the lender to get a real idea of the level of cash on hand.

The example above identifies some of these addbacks to be taxation, depreciation, amortisation and director's salaries and superannuation.



"Something's clicking. I want you to find out what, and click the holy hell out of it."

iii. ATO Snapshot (Portal)

The client's accountant will always be able to acquire an ATO Portal snapshot that will simply list whether or not the client has any outstanding taxation liabilities.

Lenders would obviously prefer to see that all taxes are current and BAS statements are lodged, but if the client is behind on their taxes it will often suffice if they have an arrangement in place with the ATO to repay this outstanding amount.

This is important because if a client is behind on their taxation requirements and they do not have a repayment arrangement in place with the ATO, then the lender will assume that the client is making no effort to meet this liability obligation.

The moral of the story is that if the client were making no effort to meet their ATO payments, why would they make an effort to meet their leasing repayment?.

Once again, it is important to note that these aspects are not only important to the lender but also to the borrower. It is in the borrower's best interest to conduct the facility with as little risk as possible because this will directly translate in a lower interest charge.

All of the above elements are a means for the lender to evaluate the level of risk inherent in the leasing arrangement.



“I’m forming a committee to create a task force to choose a team leader to assemble a board to hire the best people to determine the fastest way to deal with the problem.”



Module 7

Other Alternatives To Raise Funds

The following products are raised for general information and a thorough understanding of these products is outside the scope of this course.

6.1 Cash Flow Finance

Cash Flow Finance is a viable and usually accessible solution to meet shortcomings in working capital and the problems associated with mismatched timing of cash inflows and outflows.

Cash Flow Finance can produce a significant stream of upfront and trail income for business finance brokers, and if you are interested in learning more about this there is a Cash Flow Finance course available by the same author.

However, in a nutshell Cash Flow Finance does not generally require property as security and instead can rely upon:

- ❖ The receivables ledger
- ❖ Individual invoices
- ❖ Purchase orders
- ❖ Inventory

These finance solutions are typically less expensive options than leasing arrangements, however the exact cost of finance differs amongst the constituent products that fall under the umbrella of Cash Flow Finance, including:

- ❖ Debtors Factoring
- ❖ Trade Finance
- ❖ Invoice Discounting
- ❖ Inventory Finance

"These finance solutions are typically less expensive options than leasing arrangements, however the exact cost of finance differs amongst the constituent products that fall under the umbrella of Cash Flow Finance".

6.2 Merchant Cash Advance

This type of finance is particularly applicable to the retail industry, as this is an advance paid against future credit card and EFTPOS receipts.

The repayment of the debt is paid as a fixed percentage against future credit card and EFTPOS receipts and is paid automatically back to the lender each time payments are settled by your client's bank.

Whilst many lenders in this area will say that they do not charge an interest rate but rather a percentage of your client's future sales, the blended interest rate normally works out to be around 25% per annum plus. The amount able to be borrowed on such a facility is usually up to \$150,000.

6.3 Small Business Loans

These loans are becoming more popular for businesses that have a good credit rating, have been in business for more than one year, are registered for GST and have an annual turnover of over \$100,000.

These facilities are generally used to purchase inventory, pay suppliers, pay creditors and the ATO, pay wages, etc.

There cannot be any personal element in the use of the funds under this type of facility.

The term of these loans is usually for around 6 months and the costs start at 15% per annum but generally average at 23% per annum.

6.4 Low Doc Loans for Leasing

Low doc loans are another type of debt finance available to clients who do not wish to go through the considerable paperwork associated with a finance facility; hence the name low doc (documentation) loans.

Clearly these types of loans are more opaque in nature (information is not so transparent) and therefore they carry a greater degree of risk for the lender.

To prevent interest rates from becoming unreasonably high due to this increased risk factor, these loans typically require property in the borrower's Assets and Liabilities Statement as this is an easy and tangible means for the lender to mitigate a significant amount of risk.

These loans also carry additional conditions such as a truck must be of a certain size, or a car must be of a certain value, etc.



Module 8

How To Sell Leasing

7.1 The Process

The flow chart below provides a general helicopter view of the entire leasing finance process. Keep in mind, however, that every client is different and challenges associated with this work are often client-specific. This means that each client engagement may have its own intricacies that could slightly alter the process from what is provided below.

Stage 1



Stage 2



Stage 3



7.2 Early Stages

The first thing to happen is to receive an enquiry from a client.

As mentioned earlier, however, the problem is the client will only know that they need a certain amount of money for a particular reason. Most likely, they will have no idea which leasing arrangements are available or which ones are even applicable to their unique business situation.

Therefore, this step requires a significant degree of problem solving in order to tailor a solution to the client's individual circumstances.

You will need to send an initial request for information so that you can undertake a quick analysis to see whether or not any subject deal is viable.

This email would most likely request information such as:

- ❖ 2 most recent years' financial statements (profit and loss statement and balance sheet).
- ❖ Current management accounts.
- ❖ ATO portal snapshot (to see if the client is up to date with their tax liabilities or, if not, if there is an repayment arrangement in place).
- ❖ Professional quotation/invoice for the asset to be leased.

7.3 Documentation Stages

This stage is important because it is all about packaging the client together and submitting to a lender (who is already aware of the deal because you set it in principle with them earlier).

In addition to the important supporting documentation listed above, a lender may require a story about the transaction, the business and the owner, as well as additional ad-hoc documents depending on the client's unique circumstances.

Therefore it is important to continuously liaise between the lender (and/or their representatives) and the client and the client's accountant/lawyer or whoever else may be involved in the process.

As this supporting documentation comes in it is important to analyse each piece of information and identify any possible problems that may arise.

These issues will have to be mitigated or extensively explained as the case is submitted to the lender because if the lender identifies an issue that you have failed to address then they can essentially write off the entire deal and will often refuse to reconsider their decision.

This process can involve significant amounts of information flowing into and out of the office at different times and it is therefore important to stay organised and already have an established filing system.

"You will need to send an initial request for information so that you can undertake a quick analysis to see whether or not any subject deal is viable".



"The last thing you want to do is request information that you have already received but have simply misplaced".

7.4 Final Stages

The final step is important because it is the last opportunity you will get in this case to foster a trustful relationship with the client (and the lender if you have not dealt with them before).

This is where any unanswered questions from the lender will have to be adequately addressed. It is important to stay involved so that if there is any repeat business from this client you receive your fair share of commission.

Once the client signs the relevant documents the deal is essentially closed and awaiting settlement, which is when your commission fees become payable by the lender.

This final step also presents an opportunity to generate further business through client referrals.

A warm lead is always preferable to a cold one, so it may be worthwhile to consider establishing a system to reward clients if they refer successful deals to your business.

If the client is pleased with the level of service you have shown them (which hopefully they will be!) then it may be appropriate to enlighten them to other aspects of your business, for example home loans and/or Cash Flow Finance, etc.



Module 9

Learning Exercise

Module 8: Learning Exercise

1.	These course notes are designed to provide you with an all-encompassing understanding of cash flow finance?		
		<input type="checkbox"/> True	<input type="checkbox"/> False

2.	Choose three types of leasing finance from the following:		
	Chattel Mortgage	<input type="checkbox"/>	Hire Purchase <input type="checkbox"/>
	Second Mortgage	<input type="checkbox"/>	Car Hire <input type="checkbox"/>
	Cash Flow Finance	<input type="checkbox"/>	Operating Lease <input type="checkbox"/>

3.	The three main reasons companies use leasing finance are to:		
	Match asset costs against future revenues	<input type="checkbox"/>	Buy business assets they could not afford otherwise <input type="checkbox"/>
	Pay for outstanding taxes	<input type="checkbox"/>	Pay wages <input type="checkbox"/>
	Release equity in assets they have already bought	<input type="checkbox"/>	Purchase stock <input type="checkbox"/>

4.	What are the three main issues that affect the amount of monthly repayments?		
	Interest Rate	<input type="checkbox"/>	Upfront and balloon payments <input type="checkbox"/>
	The length of the loan	<input type="checkbox"/>	The type of asset it is <input type="checkbox"/>
	How many times you expect to use it in a year	<input type="checkbox"/>	The colour of the asset purchased <input type="checkbox"/>

5.	If your client does not want to list the asset in Balance Sheet, you would use a:		
	Hire Purchase		<input type="checkbox"/>
	Operating Lease		<input type="checkbox"/>
	Chattel Mortgage		<input type="checkbox"/>

6.	If your client does wants to own the asset from day 1, you would use:		
	Hire Purchase		<input type="checkbox"/>
	Operating Lease		<input type="checkbox"/>
	Chattel Mortgage		<input type="checkbox"/>

7.	If your client is happy to wait until the end of the term to own the asset, you would use:			
	Hire Purchase			<input type="checkbox"/>
	Operating Lease			<input type="checkbox"/>
	Chattel Mortgage			<input type="checkbox"/>

8.	What would you look at to understand the security:			
	Suppliers invoice	<input type="checkbox"/>	Useful life	<input type="checkbox"/>
	The length of the loan	<input type="checkbox"/>	Resale Value	<input type="checkbox"/>
	How energy efficient it was	<input type="checkbox"/>	The size of the equipment	<input type="checkbox"/>

9.	Leasing can be used to buy all types of assets:		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

10.	During the course of a lease the interest and principle components of each repayment remains constant:		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

11.	If a client has a bad credit rating, they can still be approved for leasing:		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

12.	It is the client's circumstances and wishes that dictate the type of lease rather than the class of asset.		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

13.	It is important not to lose a client, so getting them to sign an application and privacy statement before you understand their needs is paramount.		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

14.	You should ask your clients for referrals?		
	<input type="checkbox"/> True	<input type="checkbox"/> False	

Congratulations!

You have just completed the 'How to Understand Asset Finance in One Day' course. I hope you now have a much better understanding of how Asset Finance works.

Regards, Dominic.

Dominic Lambrinos

