Case 6

Lease a Lot

Round Table Rental Yards provides construction equipment, trailers, crutches, etc., on short-term rentals. Historically, Art, the owner, has purchased the items that he rents out, but his business has been expanding so rapidly that he is considering both straight leases and lease-purchase arrangements. He has decided to use the procurement of a new bulldozer with a list price of $290,000 as a test case.

If he purchases the bulldozer outright, then he must also decide whether he should plan on overhauling it or selling it after 3 years. This overhaul will cost about $150,000, but it should double the useful life of the bulldozer. However, the bulldozer's value on the used market would drop from $180,000 after Year 3 to $135,000 after Year 6. Its annual operation and maintenance costs will start at $25,000 and increase by $7500 each year. This increase is due to increased use more than to increased age, so it is not affected by the overhaul.

The manufacturer has a subsidiary that specializes in financing through leases and lease-purchases. In both cases, the subsidiary uses a term of 5 years with no option to extend it further. Art believes that other contract periods could be negotiated, but for this initial analysis he believes that their standard term is representative of the other possibilities. For the standard lease, the annual payment is $45,000. For the lease-purchase, the annual payment increases by $42,000. Although lease contracts can be written either way, for this lease Art would be responsible for the overhaul cost at Year 3.

Art will insure the bulldozer for theft, catastrophic damage, and liability. This policy will cost him $9500 each year. He will spend about 5% of the rental income transporting it to and from job sites. On the plus side, he expects it to bring in $175,000 the first year. Rental income should increase by $30,000 each year until it hits a maximum utilization of $300,000 per year.

If secured loans are available for 9%, which financing plan do you recommend?

Option

Art's business can depreciate the bulldozer under a 5-year modified accelerated cost recovery system (MACRS depreciation schedule, with a combined state and federal tax rate of 41%. Do tax considerations change your recommendation?