HOW TO ESTIMATE THE SAVINGS from Equipment Lease Spend Management

Why is equipment leasing spend worth thinking about?

U.S. companies leased more than $1 trillion in equipment in 2015, according to the Equipment Lease & Finance Foundation. Leased equipment is a huge spend category growing at 8 to 10 percent annually. Fortune 500 companies across a wide variety of industries commonly have an equipment lease spend of $100 million or more. Some spend up to $1 billion annually. Despite its size and ubiquity, leased equipment spend is still poorly managed in most companies. For procurement leaders, poorly managed spend can become a meaningful source of annual savings.

Most companies don't know how many leases they have, which makes it difficult to determine what the potential savings may be. In this article, we explain how to estimate the savings trapped in your equipment leasing spend. It's really a four-step process:

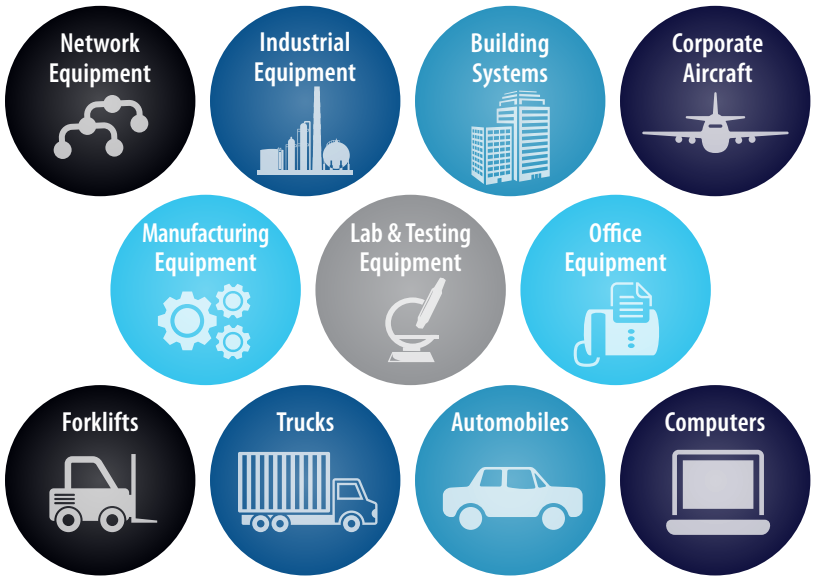
1. Determine how much equipment you lease each year.
2. Estimate how much money you are losing each year.
3. Consider what percentage of the losses you can convert to savings in a year.
4. Decide if the return on investment (ROI) makes it worth fixing.

DETERMINING HOW MUCH EQUIPMENT YOU LEASE

How much you are losing depends on how much you are spending. This is where your hunt begins. The easiest way to find your total annual leased equipment spend and the current state of your corporate equipment leasing process is to ask your corporate controller and treasurer these four questions:

1. What is the total dollar value of the equipment (or original equipment cost) that our firm leased in the last year around the world?
2. Do we have a well-controlled, documented and auditable equipment leasing process?
3. Who is responsible for the economic performance of our equipment lease portfolio?
4. How do we measure our economic performance? Do we have performance metrics?

Types of Equipment Leased



The first question gives you a quantitative starting point for understanding the potential savings opportunity. The second question is a formal way of asking something very simple: How do you know the first number is complete and accurate? The third question identifies the manager who is responsible for equipment leasing in the business and the fourth question tells you how well your company is managing the equipment leasing process. See the table below. If you are a large company with more than $500 million in revenue and get any of the answers in the right column, proceed with your investigation. Otherwise, ignore your equipment lease spend and move on to another savings opportunity!

Are You Losing Money?

	LOSSES LIKELY	LOSSES UNLIKELY
TOTAL SPEND?	Less than $10M	Greater than $10M
AUDITABLE PROCESS?	Yes	No
WHO'S RESPONSIBLE?	Named Executive	No one/don't know
PERFORMANCE METRICS	Yes	No

CLARITY MAY BE HARD TO COME BY

You have to come up with a total spend number you can use as a benchmark for your calculations. But it's not as simple as it sounds. Most companies don't know how many equipment leases they have, nor the value of those leases. To produce its financial reporting, the accounting team makes estimates with available data, which typically means that an accountant at headquarters consolidates spreadsheets sent to him by the business units before a close. In this situation, it is unlikely that there is an auditable process or auditable financials, in which case the data may be incomplete or inaccurate, and the total spend number may be way off the mark.

There is nothing nefarious going on here. In our experience, most large, international companies simply didn't focus on controlling their equipment leasing process beyond the typical accounts payable controls. This is especially true for operating leases because they are treated as monthly operating expenses. Over time, through acquisitions and the normal course of business activity at various locations around the world, the number of equipment leases bloom. As a result, very well-run companies can grossly underestimate their number. For example, a global industrial manufacturer, a Malcolm Baldrige National Quality Award winner, thought it had 2,200 equipment leases when, in fact, it had 7,400 leases. This completeness failure is quite common. When you inquire about it, it may be that your finance executives just don't know what they don't know, which is why this can be tricky.

On the other hand, if your controller says that your firm does have an auditable equipment leasing process, and affirms that the company can withstand an accounting audit and a Sarbanes-Oxley Act (SOX) audit, then there is a high likelihood that the total spend number the controller gives you is a solid number that you can work with.

IT PAYS TO BE SKEPTICAL

Having a solid number from a well-controlled process does not necessarily correlate to a well-managed process and high-performance portfolio, which is why we include the other two litmus tests. In large companies, the leasing process is often fragmented, disjointed and orphaned. It's orphaned because there is no overall manager for the life cycle of the leased equipment. While the treasurer is traditionally responsible for leasing in large companies, treasury only gets involved up front—in lease vs. buy analysis and vetting counter-parties on larger domestic transactions. Treasury rarely takes ownership of the economic performance of the portfolio across the leasing life cycle and often doesn't have the resources to track what's happening internationally. Instead, it limits its involvement to the comfort zone: financing decision-making and domestic capital markets partner selection. So, whether it's treasury or someone else, just because someone was designated with the responsibility for leasing in a company does not mean that he or she is measuring the performance of each lease, nor managing the portfolio as a whole. That's why it's insightful to ask for performance metrics. The bottom line here is that it pays to be a bit skeptical, dig below the surface and see what you learn. Again, for procurement leaders, reversing poor spend management can bring happy returns.

THE TWO KEY SOURCES OF SPEND MISMANAGEMENT

Companies with significant leased equipment spend lose money in a whole variety of ways we identify in detailed business process assessments we perform. However, for our back-of-the-envelope purposes here, you need only to focus on the two most significant factors in equipment lease spend mismanagement: the lack of unbundling and competition, and poor end-of-term return performance. The outcome of these management weaknesses is that companies overpay for leases. Our objective here is to determine how much your firm is overpaying.

LACK OF UNBUNDLING AND COMPETITION

Most companies with procurement organizations source their capital equipment fairly well. But most also fail to engage strategic sourcing professionals and their best practices on the financing (or lease) portion of the transaction. Financing is a completely distinct procurement—or should be. Unbundling these two buys is a classic strategy that is too often overlooked. The lessor supply market can, and should, be brought to bear by your sourcing and procurement professionals—if you let them.

The supply market of lessors is distinct from the supply market for equipment. It is all too easy just to accept lease terms provided by the captive finance arm of the equipment manufacturer. But these captives, independents and banks can readily finance multi-vendor packages, and also prefer larger transactions. Buyers should bid the lease competitively in the global market of providers.

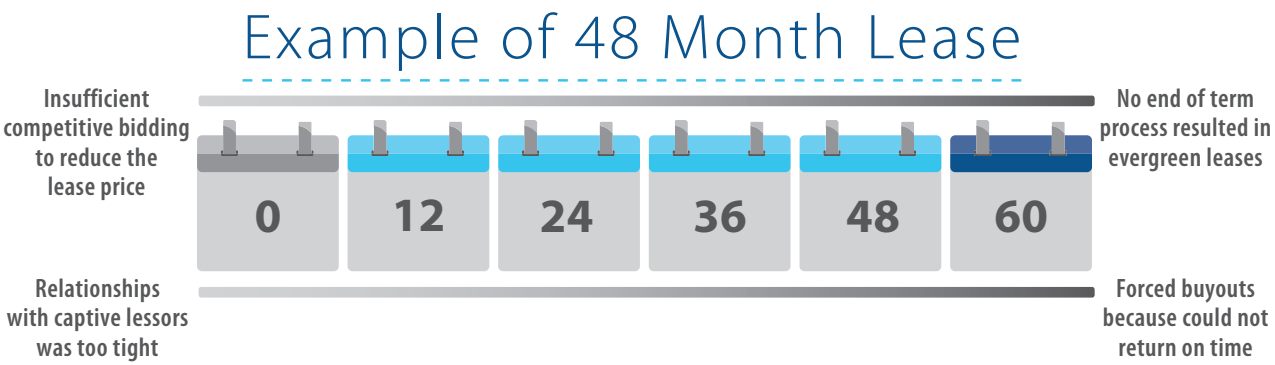
In a fair market value (FMV) lease, savings are driven not only by a lower interest rate, but also a larger equity investment by the lessor. The easiest way to measure the savings is by comparing the present value (PV) of the lease payments of all the bids. As with most competitive sourcing techniques, even a simple sealed bid technique can yield consistent savings of 7 percent. (We know this from having completed thousands of transactions over the years.) These are highly quantifiable, negotiated savings that you can take to your CFO.

POOR END-OF-TERM PERFORMANCE

In procurement terms, leases are multi-year contracts with a very important financial decision at the end of the term. At the end of a lease, lessees must decide if they want to renew, buy out and/or return the leased equipment. On one lease, you may have a partial renewal, partial buyout and partial return—it all depends on the circumstances and the needs of your users. Most companies lease with the intention of returning the equipment at the end of the initial term.

Large companies are the most common victims of end-of-term spend leakage. In these cases, when you add up all the payments (and calculate their present value), they exceed the cash purchase price significantly—often by 125 percent of what you would pay if you bought the equipment.

The end-of-term decision typically must be made at least 60 days before the lease ends so the lessor can be notified pursuant to the contract terms. All too often this process happens inconsistently, late or not at all. A lack of action at end of term, as with many contracts, can result in an evergreen lease. Failure to track equipment properly, and proactively manage the end-of-term decision and logistics is the most common and costly error made



in this spend category. Lessors know this and bank on it—it's their business model. There are many three-year leases out there on their fifth year.

Large companies are the most common victims of end-of-term spend leakage. In these cases, when you add up all the payments (and calculate their present value), they exceed the cash purchase price significantly—often by 125 percent of what you would pay if you bought the equipment. When this happens, what's the point of doing a lease vs. buy analysis?

Nada. You should have bought it. And therein lies the savings opportunity.

HOW TO ESTIMATE HOW MUCH MONEY YOU ARE LOSING FROM END-OF-TERM LOSSES

Let's again assume you have $100 million of leased equipment spend. To estimate the end-of-term losses your company may be experiencing, you need to conduct the following exercise: Analyze 40 to 60 equipment leases from around the world that were put in place more than three years ago to determine the average initial term of the leases in your portfolio and the average hold period beyond the initial lease term.

For example, a laptop lease may have an initial term of 36 months. If you keep an IT lease for 48 months, then your hold period for that lease is 12 months. In general, we see an average hold period of nine to 12 months beyond original term in companies with 1,000 equipment leases or more.

If you lease $100 million annually over an average initial term of 36 months, you pay roughly $33 million per year in payments. If your average hold period is 48 months—one year beyond the initial term—then you lose $33 million each year. That's the opportunity to generate end-of-term savings in year one.

Here's the formula:

($100,000,000/(36/12))
x (12/12)

$33,000,000
or, expressed generically:

(total spend/(average initial term/12))
x (average hold period/12)

end-of-term savings opportunity in year one

END-OF-TERM SAVINGS DEPEND ON DATA QUALITY AND EXECUTION

The $33 million in savings that comes from improved end-of-term performance requires more effort to capture. You have to do two things in parallel:

- Triage your existing portfolio to remove evergreen leases.
- Define and roll out an end-of-term management process and best practices to protect those leases that are still within their initial term.

Start by capturing all of your lease documents. Then abstract the key data elements into a centralized database, and sort by dollar value and age of the evergreen payments, and triage the largest and oldest evergreen leases first. (There are automated tools that can help you with this.) This gives you the best bang for the buck. Remember the company that thought it had 2,200 leases and ended up having 7,400? Well, after triaging its portfolio, it discovered that its run rate was about 3,500 leases. It eliminated 3,900 evergreen leases and giant savings resulted, but it took time. As a rule of thumb, we found that companies can

eliminate about 10 to 12 percent of their end-of-term savings opportunity in year one. That translates into roughly $3.9 million of savings in year one, which is 12 percent of $33 million. You can generate that same savings on average for the next three to four years until you achieve about a 70 to 80 percent return rate, which seems to be the natural limit for large companies. Once again, you must manage and control the business process, and adopt best practices across the equipment leasing life cycle to make it happen.

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Best-in-class companies:

- Track assets throughout their life cycle to end of term.
- Notify current asset owners prior to the end of term with adequate time for analysis.
- Add work flow for other stakeholders, such as procurement and treasury.
- Provide guidelines for making the end-of-term decision.
- Provide performance scorecards for each stakeholder or group.

To sourcing and procurement professionals, the best practices for managing leased equipment spend are nothing new. They are commonly applied to many other spend categories with unique requirements in the source-to-settle-to-sunset process. However, the application to the leased equipment spend category is rather new.

In most companies, leased equipment is not defined as a category or included in sourcing wave analyses. The equipment is typically purchased by different category owners. Either the category owners, or the budget holders in the field who requested and use the equipment make their own decisions on leasing vs. buying. It is those budget holders and equipment users around the world who must be both enabled and incented in order to manage this spend. You can enable them with process automation. Given the magnitude, the savings should be a sufficient incentive.

HOW TO DECIDE IF IT'S WORTH FIXING

After you do the math, caucus with your colleagues and get their thoughts about the opportunity. Ask them if it is worth studying the process carefully and preparing a detailed business case. If the savings are the same or better than our back-of-the-envelope exercise here, then the ROI of tackling this category is very attractive.

P.S. BONUS SIDE BENEFIT

And there is one major side benefit to fixing the process: Your corporate controller needs the controls and data quality to comply with the new lease accounting standards that were just released. Note to self: Ask controller for moral support and budget contribution when it comes to funding project. SDC

ABOUT THE AUTHORS

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