

# Leasing in a New Economy

Much like the stock market and the dot-com dynasty, the used car market has seen its share of rough seas, in turn making waves in the corporate leasing industry.



By Dennis Cavagnaro

**I**t's no secret that after 9/11 the economy — in the United States and the world — dipped and some industries were affected more than others — the “three T’s” to be exact: travel, tourism, and transportation.

To boost the sales of new cars and trucks, manufacturers began to offer zero percent

down and zero percent financing. Consequently, many consumers turned in their used cars for new cars which, in turn, caused a glut on the used-car market.

With so many used cars on the market, lessors were hard-pressed to sell their lease-end cars at auction, to dealers or other used-car buyers, and the depreciation rate

assigned two-three years earlier created budget problems for the lessees. The undepreciated value and actual market value did not balance at all. Companies were stuck paying thousands of dollars on cars they were no longer leasing.

### **The Lessee Learning Curve**

So what have lessees learned from this? They have learned the benefits of allowing someone else to assume the risk of vehicle depreciation. More and more companies are considering closed-end leasing as an option to combat the adverse affects of an uncertain used car market on their corporate lease contracts.

For those who haven't done the research, here's a crash course.

### **How Is Vehicle Depreciation Determined?**

There are far more lessors offering open-end contracts than those offering closed-end. Why?

The answer is risk. The risk of vehicle depreciation can be hard to con-figure, hard work to manage, and in some cases, hard to profit from — unless you are an experienced closed-end lessor with knowledge of the industry, the ability to track the direction of the used car market on a daily basis, and the knowledge of the value of key variables such as mileage, equipment, and options.

### **Make and Model Selection Can Make a Big Difference**

There is also a very significant difference on the kind of car you lease. One \$20,000 car can be similar to another car in price. However, the resale of car A could be much higher than car B.

Naturally, it's in the best interest of the lessor to do two things: 1) offer you a reliable car that satisfies your requests and 2) put the customer in a car with a higher resale value. It's a win-win situation for both the lessor and the lessee.

### **No Magic Formula**

While there is no magical equation to determine vehicle depreciation, there are, however, a variety of factors involved.

Decades ago, it was estimated that a car depreciated in value approximately two percent a month. To make the math work, lessors started basing open-ended leases on 50 months.

If a small business owner is looking for a reliable car, say a \$20,000 car, and they apply it to the two percent/50-month open-end lease equation, everything balances at the end of the 50 months and everyone walks away happy.

### **50 Months Is Not Realistic As an Actual Use Guide**

The reality is few keep a leased car on the road for 50 months. Industry statistics show that most companies follow the 36-month or 80,000-mile rule.

pays — because in an open-end lease the lessor does not absorb the residual risk of the car.

By opting for a 50-month lease with lower monthly payments, the lessee is prolonging the life of the car only to eventually pay for it later when the car is pulled from the road at 36 months.

### **Open-End Lessors Take a New Approach**

Today, two years after 9/11, open-end lessors have a new approach to help reduce negative equity at the end of the lease. Knowing that cars depreciate more rapidly today than ever, the equation has to reflect a 2.5 percent depreciation over 40 months.

It's essentially a cash flow computation — but open-end lessors are selling it as a friendlier option with less risk involved for the lessee. Sounds fair.

But the bottom line is still this: The lessee is responsible for the entire

## **More and more companies are considering closed-end leasing as an option to combat the adverse affects of an uncertain used-car market on their corporate lease contracts.**

Using the two percent/50 month equation, and cutting the lease short at 36 months now leaves the small business owner owing \$5,600 at which point the car may only be worth \$4,000. So assuming the car can be sold at its full value of \$4,000, who pays the \$1,600? The lessee

value of the car and is at the mercy of the used car market as reflected by the residual value of the car at the end of their lease. By opting for a 40-month lease, at a higher depreciation, the lessee is paying a higher monthly payment and will, in the end, break even.

## Residual determination is not for amateurs.



### Residual Incentive Shifts to the Lessor in a Closed-End Lease

With a closed-end lease, determining the residual is a far more sophisticated process — let's take the same scenario as used above.

Say a lessee is interested in leasing a \$20,000 car. The lessor will handle this kind of a lease more delicately for the following reason: The lessor will absorb the risk of the car. Therefore, it is in the best interest of the lessor to lease a quality car, with more options, better performance ratings, higher historic value, reported gas mileage (highway vs. "stop-n-go"), and so forth.

These factors are not necessarily taken into consideration under an open-ended lease because there is less incentive to put the lessee in a car easier to sell at the end of the lease!

### The Closed-End Lessor Is Responsible for the Risk of Depreciation

So why does a closed-end lessor care about performance perks?

Because in the end, the car will likely be valued higher, making disposal easier. The lessor has a large incentive to dispose of the vehicle for a higher return and far more channels to do so: auction, dealership, and so on.

The lessor can also control when the car goes to market, but above all, remember that the incentive to get a higher return is the lessor's because they own the car! The lessee just walks away.

### The Decision Continues to Rest With the Lessee

Regardless of the state of the economy, or the number of leasing companies offering open-end vs. closed-end leases, the decision-making process will continue to be that of the small business owner. There are choices to be made and risks to be determined.

The ultimate question is certainty vs. uncertainty. While some lessees may determine it is better to pay residual costs upfront, say in a closed-

end lease by a slightly higher monthly payment on a higher resale car, then via an open-end lease with a lower monthly payment and a balloon payment in the end.

### Forecasting the Vehicle Residual Should be Left to Professionals

Residual determination is not for amateurs. The calculation of vehicle depreciation is not an exact science. In fact it is most often — and most effectively — calculated by experience. An experienced lessor immersed in the automotive industry has both the knowledge and the resources required to tailor a leasing agreement.

To keep up with the bottom line, lessees must be proactive, not reactive. A planned calculation today is far better than an unplanned calculation in the end. **BF**

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