Reduce Costs Through Eight Smart Equipment Leasing Practices

Matt Robbins, Vice President, and Eric A. Jordahl, Managing Director, Kaufman, Hall & Associates, Inc.

Kaufman Hall greatly appreciates the assistance of John Kirk, Managing Director, and Jonathan Nykvist, Senior Director, Lease Portfolio Recovery Services LLC (Newton, Mass.), in the development and review of this article.

As one of the two primary sources of external institutional capital, equipment leasing is a critically important financing activity that is widely used across the not-for-profit healthcare market. When done well, leasing can produce attractively priced financing with the opportunity to secure one or more of the incremental benefits described in Sidebar 1. When done ineffectively, the net result frequently is a materially different—i.e., higher—cost of funds versus what was expected during the initial lease-versus-buy finance decision.

A range of factors can adversely impact net lease performance, including the following:

- Equipment leasing often occurs outside of the organization’s established capital allocation and financing processes. This differentiated approach also frequently results in leases being incurred without a robust comparative analysis of this option’s full costs (or potential costs) relative to other sources of capital.
- Understanding and managing the financial performance of equipment leasing requires specialized expertise, which organizations may not have acquired yet.
- Fragmented and ineffective management of leases at the end of lease terms is both common and the source of perhaps the greatest financial risk. Ineffective end-of-lease management can result in additional rent payments and expensive buyouts or damage charges. Such activities increase the net cost of funding and expose the organization to a realized all-in cost of capital that is higher, and potentially significantly higher, than expected.

An effectively managed equipment leasing function—that pays equal attention to upfront incurrence and back-end management—can reduce risk exposure and help organizations achieve the originally expected cost of lease funds. Eight smart leasing practices will help hospitals of all sizes take advantage of these opportunities. The practices fall into three categories: cataloging current leases and their costs, drilling down to fix particularly problematic and high-risk leases, and building a better leasing platform.

Sidebar 1. Why Do Hospitals Lease Equipment?

- Offers opportunity to secure an attractive base funding rate in an easy and cost-effective manner
- Executed in the private leasing markets with no upfront or ongoing disclosure or rating requirements
- May provide “off-balance sheet” accounting treatment (currently), which can help preserve working capital and debt capacity
- Shifts technology obsolescence risk and disposition of equipment to third parties
- Assists in physician-alignment initiatives
- Can be executed quickly and can provide a foundation for future operational flexibility
- Provides alternative to longer-term financing structures that may not be viable or practical

Source: Kaufman, Hall & Associates, Inc.

1. Develop and Maintain a Comprehensive Lease Catalog

All hospitals and health systems need to gain a firm grasp of their lease obligations organization-wide, and of the leasing language, conditions, and processes that create financial risks that result in significant expense. Consequently, the first best practice is for the Finance staff to simply catalog and evaluate the current lease portfolio and all related incurrence and management policies and procedures. This work may be challenging because leasing might occur in disparate areas of the organization, perhaps reflecting the fact that leasing often is treated as an operating decision, not a financial one. In larger health systems with facilities in multiple markets, leasing activity typically is delegated to local market staff, with little involvement or oversight from the parent company’s Finance staff.

Since many lessors sell their interest in lease payments to banks and other organizations, the accounts payable file may not provide an accurate list of the lessors or leases. Supporting schedules for the organization’s existing financial disclosures can be a helpful starting point in identifying and profiling lease agreements.

To properly scope the size and potential financial risk of all leases held by the organization, the comprehensive catalog
should include data on the monthly lease payments, stated rent terms, renewal terms, notice requirements, counterparty(ies), original costs of the underlying equipment, and other specifics.

2. Measure Lease Performance and Evaluate Rationale for Current Lease Activity

Close review of all existing lease agreements, including master leases, is recommended in order to understand their costs and potential financial risks. Careful measurement of the economic performance of existing leases will identify the extent of current overspending and can help to start reveal potential savings and risk-reduction opportunities.

Calculation of all-in costs since lease inception, organized by lessor, is recommended. This includes a quantification of cost factors related to pre-lease retained deposits and interim rents, lease extensions, renewals, and other end-of-lease costs. This can be labor-intensive work that requires specialized legal and financial knowledge. It may be effective and efficient for organizations to engage an independent firm with expertise in “lease portfolio evaluation.”

Working with the results of the comprehensive lease catalog, Finance staff should evaluate how and why leasing is used across the organization, and whether leasing activity is fulfilling its stated goals. Going forward, a “postmortem” on equipment leases at their conclusion—comparing expected cost of leasing with the actual outcome—is recommended.

3. Drill Down on Risky Leases

Although financing rates for leases may appear competitive to alternative financing options, poorly managed lease programs may generate realized all-in costs of equipment lease funding that are 10 to 20 percent or more than expected. A close look at particularly problematic leases will be helpful.

For example, with a piece of equipment that initially costs $10 million, the “regular-term” rent, on a discounted basis, usually will be below the $10 million amount (depending on the actual term). Regular term rent typically is the only part of the lease arrangement that is measured by lessees in a lease-versus-buy decision or accounted for by auditors. Focusing only on the regular-term rent often makes leasing look like a very attractive financing alternative.

However, retainable deposits due at lease signing and interim rents paid before the leased equipment is fully installed add to front-end costs and can total $1 to $2 million in this example. At lease expiration, extension rents for equipment that is beyond its expiration date, but not yet returned or purchased, and buyout charges (for purchases) or damage charges (for returns) can add as much as $5 to $10 million to all-in costs in this example. Added together, these potential total cash flows of $16 to $22 million make leasing look far less attractive.

Poorly structured contracts, lack of performance monitoring during or after lease term, and insufficient planning and direction at lease end are common and can drive significant excess costs (Figure 1).

4. Focus Particularly on Leases Past or Nearing End-of-Term Date

Operating leases are typically structured as non-cancelable contracts between lessors and lessees. During the regular term of the lease, as long as both parties abide by the terms of the lease, there is limited potential for additional costs to the lessee beyond deposits and interim rent, as described earlier.

As the lease agreement nears the end of its regular term, however, lessees can be exposed to significant financial risk and added costs. Adverse lease-contract terms are a source of risk. Such terms include end-of-lease notice provisions or return requirements. If not managed well, these terms delay lease termination and generate extension rents. The absence of a clear back-end process or a disorganized or poorly executed one by the lessee is an additional source of risk, which also results in delayed lease termination, and ultimately a potentially significant and completely avoidable cost increase.

An effective end-of-lease process requires the coordination of Clinical, Procurement (or Supply Chain), and Finance decision makers to determine the following:

- If the leased asset still is required for patient care
- If the leased asset still is “best in class” and the desired asset
- If the best course of action is to return the asset to the lessor, purchase the asset, or restructure the lease

Best-possible leasing outcomes, and often tangible savings, can be achieved through rigorous, continued monitoring of lease term dates, clear delineation of the appropriate decisions and actions prior to the termination dates, and identification of those responsible for such decisions and actions.

For example, one multihospital health system had an equipment lease portfolio that included more than 300 different equipment leases with more than 100 different lessors. Through the cataloging process described earlier, the organization realized that approximately half of its leases were either past their original lease term or fast approaching it. Some leases had been in extension for more than four years. With these leases, the health system was continuing to make monthly payments to rent equipment that in many cases was long past its economic life. Deferring the decision to purchase or return the equipment resulted in significant incremental cost.
Sidebar 2. Drilling Down to Achieve Savings from Problematic Lease Arrangements

One particular lease agreement, involving approximately $7 million of infusion pumps, was costing the health system an additional $150,000 each month in extension rent. With the help of a third party, the health system determined that it had already paid more than $10 million to the lessor for these infusion pumps. The system asked the lessor for a quote to purchase the pumps outright. The lessor offered to sell the title to the infusion pumps for an additional six months of rent (approx. $800,000). Through negotiations, this cost was lowered to three months of rent, saving the health system $400,000, and avoiding significant future extension rent payments. Similar processes with other lessors now are underway. The organization also is implementing new master lease agreements that limit or remove high-risk language related to automatic rent extensions and problematic returns of leased assets and other key items.

Source: Kaufman, Hall & Associates, Inc. and Lease Portfolio Recovery Services LLC

Sidebar 2 provides an additional example of how savings can be achieved.

5. Understand the Accounting and Credit Implications of Leases

The accounting and credit rating-related issues of leases can have a significant impact on the cost of an organization’s leasing program, so an understanding of basic principles is critical. Operating leases are considered economically similar to renting the use of an asset. The cost of a lease that is classified as an operating lease is included only on the income statement in the current period, with no corresponding balance-sheet entry. Under U.S. Generally Accepted Accounting Principles, a lease arrangement can be classified as an operating lease for financial reporting purposes if it meets all four of the following criteria:

- The discounted value of the contractual lease payments, at an appropriate discount rate, is less than 90 percent of the leased asset’s fair value
- The lessee does not have the option to purchase the asset at the end of the lease term for a bargain purchase price
- The title to the leased asset does not automatically transfer to the lessee at the end of the lease term
- The initial lease term is not more than 75 percent of the economic life of the leased asset

Failure of a lease arrangement to meet any one of these criteria will result in it being treated as a capital lease for financial reporting purposes. A capital lease is considered economically similar to borrowing money to purchase an asset, and will result in corresponding asset and liability entries on the balance sheet, as well as recognition of the cost of borrowing and depreciation on the income statement. Operating leases can make an organization appear less indebted than if the same obligations were accounted for as capital leases.

Despite this accounting distinction, the rating agencies scrutinize an organization’s use of operating leases and other comprehensive debt obligations to determine their impact on overall credit quality. According to the agencies, leasing activity—regardless of its current accounting treatment—is just another form of external financing that has a claim on an organization’s existing liquidity and future cash flows.

Not-for-profit rating analysts make credit adjustments for operating lease cash flows, taking into consideration all direct and indirect debt obligations. Moody’s Investors Service converts lease expense to a “debt equivalent” by multiplying the current-year expense by six and recalculating debt-related ratios. Standard & Poor’s calculates a “lease-adjusted debt service coverage” ratio by adding lease expense to maximum annual debt service (MADS) and earnings before interest, tax, depreciation, and amortization (EBITDA).

So although operating leases may be off balance sheet for accounting purposes (at this time), such financing arrangements are increasingly being viewed as on credit.

6. Include Leasing Decisions in the Centralized Capital Allocation and Financing Processes

Putting in place selected best practices to build a better leasing platform will improve leasing performance going forward, thereby enabling the organization to reduce financing costs.

The most important approach to building a better leasing platform is to ensure that all leasing decisions are included in the organization’s capital allocation and financing decision-making and management processes. Inclusion in these processes subjects leasing activity to the same level of transparency and accountability as other capital decisions, thereby mitigating potential financing risks described earlier.

Increasingly, the outside world—including rating agencies—is looking at an organization’s “Comprehensive Debt” load, which includes long-term debt, operating and capital leases, and unfunded pension exposure. There are many reasons to use leasing, but it is important for hospitals and health systems to develop a good methodology for making lease-versus-finance-versus-buy decisions, and for understanding the all-in economics and risks associated with each of these alternatives.

7. Centralize Leasing Management and Develop Specific Leasing Policies and Procedures

Given historical and current accounting rules, operating leases to date largely have not been the direct responsibility of the Finance staff. Yet, management of other balance sheet resources, such as investments and long-term debt, has long been centrally managed by the Finance staff.
One of the most important benefits of this centralization is the development of institutional expertise with complex instruments. As discussed earlier, leasing is a complex activity and modest familiarity with key terms and best practices can have significant financial consequences. To effectively manage an organization’s overall lease portfolio, leasing activity and management also should be centralized at this level. At a minimum, securing an organization-wide agreement on specific policies and procedures will raise awareness of the issue and begin the transition toward better-contained leasing costs.

Policies and procedures should cover topics including the following:

- Guiding principles and rationale on the use of leasing as a capital source
- Required analytics for evaluation of leasing’s impact on the income statement, balance sheet, credit strength, and overall financial performance of the organization
- Approval process for lease use through the organization’s capital-allocation process
- Lease documentation, including structure, financial and legal terms, and other contractual factors
- Management of leasing activities for best long-term financial outcome (rather than being focused on annual budgetary targets)
- Detailed responsibilities and mechanisms for lease monitoring and end-of-lease management

Sidebar 3 outlines additional procedures that should be addressed by larger, more complex hospital systems.

### Sidebar 3. Additional Leasing Procedures for Large Health Systems

To ensure that effective lease management is not inhibited by intra-system policies and reporting structures, large health systems additionally should address procedures related to:

- Centralization of all leasing activity, including both equipment and real estate leases, under Finance or Corporate Treasury departments
- Central oversight provided for any approved local leasing activity
- Policies and procedures for ensuring uniformity of lease terms and activities across all markets
- Enterprise-wide strategy for managing overall leasing activity relative to other capital sources
- Management of adjusted balance sheet metrics for total levels of comprehensive debt, including leases, long-term debt, swaps, and pension obligations

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**8. Develop Leasing Experts and Ensure a Thorough Performance Monitoring Program**

An organization’s leasing program will benefit from the development of individuals with leasing expertise, without which it would be impossible to achieve the best practices described here. Experts with financial, legal, and management acumen can help to ensure the development, implementation, and performance monitoring of the highest-quality-possible lease program.

Experts are required at all stages of the leasing process to negotiate and renegotiate lease terms and conditions in order to contain downstream financial risk and the overall cost of capital. The goal is “clean contracts” that limit or remove unfavorable contract terms. Such terms, though often subtle and seemingly innocuous, have the potential to create significant financial risk if not targeted and monitored.

An effective leasing program also will require the clear delineation of responsibilities between the Clinical, Procurement, and Finance teams. Clinical and Procurement teams should focus their efforts on answering the questions, what equipment do we need, and where can we get it? This will allow the Finance staff to focus on conducting robust lease-versus-buy analytics and on identifying the optimal capital source for this planned capital spending.

End-of-lease policies and procedures must be in place. These should require the three teams to reconvene and address the items outlined in Best Practice No. 4.

An organization-wide effort can ensure that leasing program improvements are identified and maintained going forward, but vigilance and C-suite buy-in are required. Use of the eight best practices described here can help all hospitals and health systems lower their financial risk and identify and achieve significant dollar savings.

For more information, please contact Matt Robbins (mrobbins@kaufmanhall.com) and Eric Jordahl (ejordahl@kaufmanhall.com) at 847.441.8780.

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**References**