The Benefits of Leasing: The Small Firm Perspective

By Morris G. Danielson and Jonathan A. Scott

The small business sector includes a large pool of potential clients for the leasing industry. Small businesses (defined by the U.S. Small Business Administration as firms with fewer than 500 employees) produce approximately 50 percent of private GDP in the U.S., and employ 60 percent of the private sector labor force (source: U.S. Small Business Administration Office of Advocacy, www.sba.gov/advoc.) In addition, monthly surveys by the National Federation of Independent Business (NFIB) document substantial capital expenditure activity by these firms.[1] Yet a Dun & Bradstreet study published by the *Journal of Equipment Lease Financing* (2001) reveals that small firms are less likely than larger firms to lease equipment.

Although many small businesses prefer to purchase equipment, others will lease equipment. In this study, we focus on those small businesses that lease equipment. Using data collected by the National Federation of Independent Business (NFIB) in its 2003 *Reinvesting in the Business Survey*, we address two questions. First, how do firms that prefer to lease equipment differ – in terms of age, size, industry, ownership structure, and planning sophistication – from those who typically purchase? Second, what are the benefits of leasing cited most often by firms that prefer to lease equipment?[2]

The results offer a profile of small firms most likely to lease equipment. In particular, small firms most receptive to leasing include the youngest firms, the smallest firms, firms investing in new product lines, and those where the owner has an advanced or professional degree. This information can help lease professionals target marketing efforts to those small firms most likely to lease equipment.

The results also identify two challenges the leasing industry faces in the small business sector. First, some small businesses lease equipment to transfer project risk to the lessor. Second, small businesses most receptive to leasing can have difficulty qualifying for credit because they are

Table 1

SAMPLE DESCRIPTION

Distribution of Responses to the NFIB Survey

	Observations	Total (%)
Industry		
Service	155	20
Construction	194	24
Retail/wholesale	378	48
Other	65	8
Employees		
1-3	360	45
4-10	286	36
10+	145	18
Business age (years)		
< 11	356	45
11-20	213	27
21+	217	27
Don't know/no answer	7	1
Ownership structure		
Proprietorship (inc. subchapter S)	383	49
Partnership (inc. LLC)	152	19
Corporation	248	31
Don't know/no answer	9	1
Owner age (years)		
< 45	275	35
45-54	244	31
55+	256	32
Don't know/no answer	17	2
Owner education		
Less than college degree	415	52
College degree	260	33
Advanced/professional degree	105	13
Don't know/no answer	12	2
Real sales growth (2 year)		
10+ %	373	47
+/- 10%	200	25
Fell 10+%	187	24
Don't know/no answer	32	4
Sample totals	792	100

Source: Data for the "All IPOs" category is adapted from Jay Ritter, "Some Factoids About the 2004 IPO Market" (working paper, University of Florida, Gainesville, February 2005).

How do firms that prefer to lease equipment differ from those that typically purchase? For firms that choose to lease, what benefits do they cite? Here is a profile of small firms that are most likely to lease.

Because many small firms do not have audited financial statements, the difference between the accounting treatment of capital and operating leases is not important to many of these firms.

often the youngest and smallest firms. Thus, our study highlights both the opportunities and challenges the small business sector offers the leasing industry.

SAMPLE AND DATA

The data for this study were collected for the NFIB Research Foundation by the executive interviewing group of the Gallup Organization. The interviews for the survey were conducted between April 3 and May 27, 2003, from a sample of small firms, defined as a business employing at least one individual in addition to the owner(s), but no more than 249. After compiling the results, the interviews yielded a sample of 792 observations. (See Danielson and Scott, 2006, for additional details about the survey.) Table 1 (previous page) lists descriptive statistics for the sample, including information about the firms' industry, number of employees, years in business, ownership structure, owner characteristics, and growth rates.[3]

DESCRIPTION OF LEASING AND PURCHASING FIRMS

The NFIB survey asked firms whether they prefer to lease or purchase equipment. Because many small firms do not have audited financial statements, the difference between the accounting treatment of capital and operating leases is not important to many of these firms. Thus, the survey did not ask participants to distinguish between these two types of lease. Instead, participants were given the choices of "lease – always," "lease – usually," "purchase – usually," and "purchase – always." We combine the leasing categories due to the relatively low number of firms (112) that chose these responses.

Overall Results and Industry Effects

Table 2 reports on leasing and purchasing preferences for all observations, and by industry. The majority of the firms selected "purchase – always," with 63% (494) of the sample in this category. "Purchase – usually" was the second most frequent response, selected by 22% (175) of the sample. Only 14% (112) of the firms selected either "lease – always" or "lease – usually."

Table 2 shows that leasing activity is strongly related to industry. Although 20% of "all firms" are in service industries, only 13% of the leasing firms are in these industries. This difference is statistically significant at the 10% level. Thus firms in service industries are less likely than other firms to lease equipment. In contrast, retail/wholesale firms are more likely than other firms to lease equipment. Fifty-seven percent of the leasing firms are retail/wholesale firms, but only 47% of "all firms" are in these industries. This difference is significant at the 5% level. These results confirm those in the above-mentioned Dun & Bradstreet study, where the

Table 2

DESCRIPTION OF LEASING AND NONLEASING FIRMS

	All firms	Lease	Purchase – usually	Purchase – always
Total observations	781	112	175	494
Distribution percentages by industry				
Service	20	13–	18	22
Manufacturing/construction	25	21	20	27
Retail/wholesale	47	57++	51	44
Other/don't know	8	9	11	7
Total	100%	100%	100%	100%

In each row, we compare the values listed in the "lease," "purchase – usually," and "purchase – always" columns to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

Table 3

DESCRIPTION OF LEASING AND NONLEASING FIRMS – FIRM CHARACTERISTICS

	All firms	Lease	Purchase – usually	Purchase – always
Distribution percentages by				
Number of employees				
1-3	46	52	37– –	47
4-10	36	30	37	37
10+	18	18	26++	16
Total	100%	100%	100%	100%
Firm age (years)				
<11	45	53+	46	44
10-20	27	16– –	29	28
20+	28	31	25	28
Total	100%	100%	100%	100%
Ownership structure				
Proprietorship (inc. subchapter S)	49	58+	46	48
Partnership (inc. LLC)	31	25	35	32
Corporation	20	17	19	20
Total	100%	100%	100%	100%

In each row, we compare the values listed in the "lease," "purchase – usually," and "purchase – always" columns to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

Table 4

DESCRIPTION OF LEASING AND NONLEASING FIRMS – OWNER CHARACTERISTICS

	All firms	Ability to use latest equipment	Improve cash flow	Tax benefits
Distribution percentages by				
Number of employees				
1-3	46	52	37– –	47
4-10	36	30	37	37
10+	18	18	26++	16
Total	100%	100%	100%	100%
Firm age (years)				
<11	45	53+	46	44
10-20	27	16– –	29	28
20+	28	31	25	28
Total	100%	100%	100%	100%
Ownership structure				
Proprietorship (inc. subchapter S)	49	58+	46	48
Partnership (inc. LLC)	31	25	35	32
Corporation	20	17	19	20
Total	100%	100%	100%	100%

In each row, we compare the values listed in the "lease," "purchase – usually," and "purchase – always" columns to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

Leasing activity is strongly related to owner education. Owners without a college degree are less likely to lease, whereas owners with a college or advanced degree are more likely to lease.

service industry was shown to have a lesser propensity to lease and retail/wholesale firms a greater one.

Size, Age and Ownership Structure

Table 3 (previous page) looks at the relation between lease/ purchase preferences and three firm characteristics: number of employees, firm age, and ownership structure. Table 3 reveals that leasing activity is more frequent in young firms (10 years or less) and proprietorships. In particular, 53% of the firms that prefer to lease have been in business less than 11 years, whereas only 45% of "all firms" are in this category. Similarly, 58% of the firms that prefer to lease are proprietorships, but only 49% of "all firms" are proprietorships.[4] Each of these differences is significant at the 10% level. In addition, Table 3 shows that the smallest firms (3 or fewer employees) are slightly more likely to lease equipment than other firms.

Owner Characteristics

Table 4 (previous page) examines whether the firms' leasing and purchasing preferences depend on owner age and owner education. Leasing activity is slightly more common in the youngest group of owners (under 45 years old). Forty-three percent of the firms that prefer to lease have owners younger than 45, whereas 36% of "all firms" have an owner this young.

Leasing activity is strongly related to owner education. Owners without a college degree are less likely to lease, whereas owners with a college or advanced degree are more likely to lease. At first glance, this result might be comforting to the leasing industry, because it suggests owners with the ability to weigh the costs and benefits of leasing are more likely to lease equipment. However, Table 1 shows that over 50% of the small business owners in this sample do not have a college education. Thus one of the challenges facing the leasing industry in the small business sector may be educating potential customers about the costs and benefits of leasing equipment.

Investment and Planning Activities

Table 5 compares the firms' leasing and purchasing preferences to various measures of a

Table 5

DESCRIPTION OF LEASING AND NONLEASING FIRMS – FIRM CHARACTERISTICS

	All firms	Lease	Purchase – usually	Purchase – always
Distribution percentages by 2--year real sales growth				
10+%	49	44	51	49
+/- 10%	26	27	29	25
Fell 10+%	25	29	20	26
Total	100%	100%	100%	100%
Purpose of investments made in the last 12 months				
Replacement/maintenance	46	44	43	47
Extension of product line	21	15–	23	22
Investment in new line	23	30+	24	20
Other/don't know	10	11	10	11
Total	100%	100%	100%	100%
Business planning tools				
Use written business plan	31	35	32	30
Make cash flow projections	69	71	75	67
Calculate tax implications of investments	18	22	17	17

In each row, we compare the values listed in the "lease," "purchase – usually," and "purchase – always" columns to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

firm's investment and planning activities. The percentage of firms that prefer to lease decreases slightly (relative to "all firms") as the growth rate increases. For example, 49% of "all firms" have sales growth rates in excess of 10%, but only 44% of the firms that prefer to lease are in this category.

The firms' leasing preferences display a stronger relation to the type of investment the firm typically makes. Although 21% of "all firms" report extension of existing product lines as their most important type of investment, only 15% of the leasing firms are in this category. In contrast, 30% of the leasing firms recently invested in a new product line, whereas only 23% of "all firms" made this type of investment.

These results suggest that the lease/purchase decision depends, in part, on the risk of an investment. If a firm is extending an existing product line, the firm may view the investment to be less risky, and therefore may be more willing to make a long-term commitment by purchasing the required equipment. In contrast, if the firm is entering a new product line, where the success of the investment might be uncertain, the firm may lease the required equipment as a means by which to transfer risk to the lender.

Firms preferring to lease equipment use more sophisticated planning tools than other firms, as they are slightly more likely to use written business plans, make cash flow projections, and calculate the tax implications of investments. For example, 35% of the leasing firms use written business plans, but only 31% of "all firms" use this planning tool. Because these planning activities can help business owners understand the costs and benefits of leasing, firms that engage in such activities should be more likely to lease equipment.

SUMMARY: WHICH SMALL FIRMS PREFER TO LEASE?

We provide additional analysis (including multivariate tests) of small firm leasing preferences in our report "The Leasing Decisions of Small Businesses" (published by the Equipment Leasing and Finance Foundation, 2006). The results of these additional tests reinforce the conclusions drawn from Tables 2 through 5. In particular, firms reporting a preference for leasing include:

- Industry – Firms in the retail/wholesale industry (Table 2).
- Number of Employees – Firms with 3 or fewer employees (Table 3).
- Firm Age – Firms in business 10 or fewer years (Table 3).
- Ownership Structure – Firms organized as proprietorships (Table 3).
- Owner Age – Firms with owners younger than 45 (Table 4).
- Owner Education – Business owners with a college or advanced degree (Table 4).
- Purpose of Investments – Firms investing in new product lines (Table 5).

These characteristics do not appear to profile ideal lease candidates. For example, firms in business 10 or fewer years and firms with young owners (less than 45 years old) might have difficulty qualifying for standard credit terms. However, the credit risk of a small firm might be mitigated if the business owner has an advanced degree, as do many of the firms expressing a preference for leasing.

Firms with negative growth rates and firms investing in new product lines might be not ideal lease candidates either. Firms with negative growth rates may be having financial difficulties, making them poor credit risks. And, firms investing in new product lines might prefer leasing as a means to shift risk to the lender. This finding corroborates the 2000 Equipment Leasing Association survey, "The Start-Up Strategy: Lease to Succeed," wherein executives from high-tech startup firms acknowledge that leasing allows them to shift risk to the lessor.

In summary, many small firms are interested in

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leasing equipment, creating an opportunity for the industry. However, lease providers must be aware that the demand for leasing could be concentrated in the portion of the small firm market that poses the greatest underwriting challenges.

REASONS THAT FIRMS PREFER TO LEASE

We now focus on those firms who prefer to lease equipment. If a respondent said that the firm prefers to "lease – always" or "lease – usually," the survey asked a follow-up question: "What is the one most important advantage of leasing over purchasing?" The respondents chose from a list that included "ability to use latest equipment," "improve cash flow," "tax benefits," "better service from seller," and "other." In this section, we compare these responses to the set of firm characteristics used in Tables 2 through 5.

Overall Results and Industry Effects

Table 6 reports the reasons firms prefer to lease, by industry. The table identifies "improve cash flow" as the most common reason firms choose to lease equipment (38%, or 42 respondents), followed by "ability to use latest equipment" (28%, 31 respondents), and "tax benefits" (25%, 28 respondents). Because "better service from seller" (4%) was selected by a small number of firms, we combined these responses with "other" in Table 6 and exclude them from the remaining tables. In Table 6, and the other "Reasons Firms Prefer Leasing" tables, the "all firms" column refers to the 112 firms that prefer to lease equipment.[5]

Table 6 reveals that "improve cash flow" is the most commonly cited reason that small firms prefer to lease equipment. This benefit of leasing is especially important in the following subsets of firms:

- Industry – Firms in the service industry (Table 6)
- Number of employees – Firms with four or more employees (Table 7)
- Owner education – Business owners without a college or advanced degree (Table 8)

"Ability to use latest equipment" is the second most common reason to lease equipment in the NFIB survey, and "tax benefits" is third. Each of these reasons to lease equipment is important to firms with three or fewer employees (Table 7). Thus, lease providers might highlight different benefits of leasing when marketing products to different segments (based on firm size) of the small business sector.

In the retail/wholesale industry (which Table 2 shows is the industry with the most leasing

Table 6

REASONS FIRMS PREFER LEASING

	All firms	Ability to use latest equipment	Improve cash flow	Tax benefits	Other
Total observations	112	31	42	28	11
Distribution percentages by industry					
Service	14	3– –	29++	8	9
Manufacturing/construction	21	13	28	21	9
Retail/wholesale	57	71	33– –	71	73
Other/don't know	8	13	10	0	9
Total	100%	100%	100%	100%	100%

In each row, we compare the values listed in the "lease," "purchase – usually," and "purchase – always" columns to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

Table 7

REASONS FIRMS PREFER LEASING – FIRM CHARACTERISTICS

	All firms	Ability to use latest equipment	Improve cash flow	Tax benefits
Distribution percentages by				
Number of employees				
1-3	51	77++	31– –	68+
4-10	30	10– –	48++	18
10+	19	13	21	14
Total	100%	100%	100%	100%
Firm age (years)				
<11	53	61	60	48
10-20	16	19	7	19
20+	31	20	33	33
Total	100%	100%	100%	100%
Ownership structure				
Proprietorship (inc. subchapter S)	58	59	62	57
Partnership (inc. LLC)	25	27	21	18
Corporation	17	14	17	25
Total	100%	100%	100%	100%

In each row, we compare the value listed in each leasing benefit column to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

Table 8

REASONS FIRMS PREFER LEASING – OWNER CHARACTERISTICS

	All firms	Ability to use latest equipment	Improve cash flow	Tax benefits
Distribution percentages by				
Owner age (years)				
< 45	42	51	49	36
45-54	22	10	24	39++
55+	36	39	27	25
Total	100%	100%	100%	100%
Owner education				
Less than college degree	37	19– –	52+	39
College degree	41	55	36	42
Advanced/prof. degree	22	26	12	19
Total	100%	100%	100%	100%

In each row, we compare the value listed in each leasing benefit column to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

The importance of "tax benefits" increases if these benefits can be calculated readily, as might be the case when a firm is extending a product line.

activity), "ability to use latest equipment" and "tax benefits" are the most important reasons to lease. In contrast, "improve cash flow" is the most important reason to lease equipment in the service industry (which Table 2 identifies as the industry with the least leasing activity). Thus, effective marketing efforts might stress different benefits of leasing when targeting potential customers in different industries.

Size, Age and Ownership Structure

Table 7 (previous page) lists the primary reasons firms prefer leasing, by firm size, age, and ownership structure. The strongest results in this table are for the smallest cohort of firms: three or fewer employees. "Ability to use latest equipment" and "tax benefits" are the most important reasons why firms with three or fewer employees lease equipment, whereas "improve cash flow" is least important.

Owner Characteristics

Table 8 (previous page) summarizes the reasons firms lease equipment by owner age and education. The table shows that "ability to use latest equipment" is the least important reason to lease if a business owner does not have a college education. Only 19% of the firms citing "ability to use latest equipment" have an owner without a college degree, whereas 37% of "all firms" have an owner without a college degree, and this reason increases in importance (relative to "all firms") if the business owner has more formal education.

In contrast, "improve cash flow" is the most important reason to lease for business owners without a college degree, and decreases in importance if the owner has more formal education. Lastly, "tax benefits" are less important to the younger and older business owners but are significantly more important to the middle-age business owners.

Investment and Planning Activities

Table 9 evaluates the associations between the firms' investment and planning activities and the reasons cited for leasing assets. Firms extending existing product lines are 26% of the firms citing "tax benefits" as the primary reason to lease, but are only 15% of "all firms." Thus, the importance of "tax benefits" increases if these benefits can be calculated readily, as might be the case when a firm is extending a product line. Firms investing in new product lines are 39% of the firms citing "ability to use latest equipment" as the primary reason to lease, but are only 31% of "all firms."

Therefore, "ability to use latest equipment" is important if there is uncertainty about future demand, product specifications, or production requirements, as might be the case when a firm is

Table 9

REASONS FIRMS PREFER LEASING – OWNER CHARACTERISTICS

	All firms	Ability to use latest equipment	Improve cash flow	Tax benefits
Distribution percentages by				
Owner age (years)				
< 45	42	51	49	36
45-54	22	10	24	39++
55+	36	39	27	25
Total	100%	100%	100%	100%
Owner education				
Less than college degree	37	19– –	52+	39
College degree	41	55	36	42
Advanced/prof. degree	22	26	12	19
Total	100%	100%	100%	100%

In each row, we compare the value listed in each leasing benefit column to the value listed in the "all firms" column in a binomial Z-test. Items that are significantly different from the "all firms" value are indicated by a ++ or – – (5% level) or a + or – (10% level).

investing in a new product line. In this circumstance, the flexibility offered by lease contracts can be valuable.

Table 9 also shows that firms citing "tax benefits" as the most important reason to lease are more likely than other sample firms to have a written business plan, make cash-flow projections, and calculate the tax implications of investments. However, as shown in Table 5, many sample firms do not engage in these planning activities. Thus, to increase market penetration in the small business sector, lease providers may need to provide potential customers with guidance about how to estimate the tax benefits of leasing.

SUMMARY: WHY DO SMALL FIRMS LEASE EQUIPMENT?

We provide additional analysis (including multivariate tests) of the question, "Why do small firms lease equipment?" in our report "The Leasing Decisions of Small Businesses" (published by the Equipment Leasing and Finance Foundation, 2006). The additional results in that study corroborate, amplify, and extend those already reported in Tables 6 through 9.

Conclusions

The small business sector offers the leasing industry both opportunities and challenges. Because only 14% of small firms report that they prefer to lease equipment, the leasing industry could gain significant new business by increasing market penetration in the small business sector. However, to do this, lease providers must identify small firms most predisposed toward leasing. This study reveals that these firms include the very smallest firms (three or fewer employees), the youngest firms (10 years in business or fewer), and firms investing in new product lines.

These results suggest that many small firms use leasing as a tool to manage risk. Firms where the ultimate success of investments is most uncertain – young firms and those entering new product lines – are willing to lease required equipment, postponing a long-term commitment until the success of the venture is more certain.

Lease providers must also increase small business owner awareness of the benefits of leasing. If a small business calculates the tax implications of investments, it is more likely to lease equipment to capture these benefits. Although leasing is more common among firms where the owner has an advanced or professional degree, firms fitting this profile are a small portion of the small business sector. Thus, increasing market penetration in the small business sector may require the leasing industry to educate small business owners about the benefits of leasing. What are the tax implications of leasing, and what are the cash flow benefits? By helping business owners understand these concepts, small businesses will be better able to identify circumstances where the benefits of leasing outweigh the costs.

Lease providers must also increase small business owner awareness of the benefits of leasing. If a small business calculates the tax implications of investments, it is more likely to lease equipment to capture these benefits.

Endnotes

1. The NFIB conducts random surveys of its members quarterly. In these surveys, 55% to 70% of the responding firms report a median expenditure of at least $20,000 (for the prior six months), while 1% of the owners typically report outlays in excess of $500,000 (in the prior six months). Source: "Small Business Economic Trends," National Federation of Independent Business Research Foundation, Washington, D.C.

2. In a report titled "The Leasing Decisions of Small Businesses" (published by the Equipment Leasing and Finance Foundation, 2006), the authors provide additional information about these two questions. In addition, the full report provides information about why some small firms prefer to purchase, rather than lease, equipment.

3. The NFIB survey included questions about a range of investment topics, including leasing activity, capital budgeting tools, and business planning activities. The sample size in the remaining tables (including both leasing and nonleasing firms) is 781 because some owners did not answer all of the leasing questions.

4. Long and Sopranzetti (2002) find that leasing is less common in proprietorships. Their results may differ from ours because they focus solely on capital leases, whereas our study considers all leasing activity.

5. These results are similar to those in two recent studies. In a *Beverage World* (2003) survey of the

trucking industry, cash flow concerns were the most important reason to lease, followed by the ability to use newer, more fuel efficient vehicles. In a *Cornell Hotel & Restaurant Administration Quarterly* (2001) study of leasing activity in the lodging industry, cash flow advantages and protection from obsolescence were the most important reasons to lease. However, in the *ELA Survey of State Small Business Winners* (2005), the ability to have the latest equipment was the most frequently cited advantage of leasing, and increased cash flow was fifth. The small business winners survey included only 20 firms, compared to 112 firms who prefer leasing in the NFIB survey.

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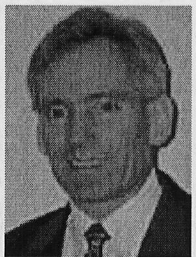

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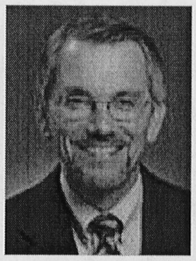

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