



Interest Rates: How They Affect Leases

Introduction

Leasing is a very attractive financing alternative when making a new equipment acquisition. Currently, there is a lot of uncertainty with respect to economic conditions. Using a lease as an alternative to cash purchase or bank financing can have a tremendous positive impact on present and future cash flows and tax liabilities. Lease rates are now at their lowest than they have been for the last eighteen months. Low rates, economic conditions, and lease benefits are all great reasons to consider leasing as a finance alternative.

Current Economic News

There has been a lot of news about the economy lately. Are we currently in a recession? Is the economy slowing down, or not? Many economists can't quite agree on the outlook for the U.S. Economy. Some say that we need to tighten our belts and brace for an all out slide. Others claim that we need to ride out current market fluctuations. However, there is a general consensus that economic growth will slow considerably this year. The Federal Reserve has made drastic cuts in the Federal Funds Rate to help stimulate the economy, and the U.S. Congress has created an economic stimulus plan that has been approved by President Bush. But, what is the net effect of all this and how does it determine what businesses will pay for acquiring equipment?

Interest Rates

There is a common misconception that when the Federal Reserve lowers "interest rates" that all rates are affected. When the Federal Reserve raises or lowers "rates" it is acting on one interest rate – the Federal Funds Rate. This is the rate that banks charge each other for overnight, or short-term, loans. Banks use these loans to meet federal obligations to maintain certain levels of reserves.

Other interest rates that grab our attention include *prime rate*, *mortgage rate*, *lease rate*, etc. The prime rate is a term applied in many countries to a reference interest rate used by banks and is normally associated with the rate at which banks lend money to their most favored customers. The Wall Street Journal defines the prime rate as "the base rate on corporate loans posted by at least 75% of the nation's 30 largest banks." The prime rate is used as an index for business and consumer loans.

One of the biggest misconceptions is that mortgage rates are set by the Federal Reserve. Many borrowers believe that when the Federal Reserve lowers (or raises) interest rates that their home loan will be affected. Many mortgage rates are actually determined on the secondary market. That is, mortgage investors buy bundles of similar loans called mortgage backed securities. These securities are sold to Wall Street, mutual funds, and other financial investors who trade them much the same way as Treasury securities and bonds. It is these financial investors in the secondary market – not the Federal Reserve, or mortgage lenders and brokers – who collectively determine the interest rate of your mortgage loan.

Finally, we come to lease rates. Again the common misconception is that lease interest rates are determined by some controlling central entity or bank. Most lease rates are determined by the yield from Treasury bills. Treasury bills are short-term debt securities issued and backed by the U.S. Treasury. Treasury bills do not pay explicit interest; rather they are initially sold at a discount from their maturity value. An investor who buys a bill at a discount and holds it to maturity will receive as interest the difference between the price paid and its maturity value. The difference between the initial price and maturity value is the yield the investor will receive. Investors will purchase “like term Treasury bills” to fund their leases. That is, if a business wants to lease a phone system, for example, for 3 years, the investor will sell a previously purchased 3-year Treasury bill to another investor to pay for the phone system. The price they sell the Treasury bill has an implied yield. The investor will charge the customer purchasing the phone system a lease rate based on the implied yield plus an applicable margin.

Summary – Where is this all leading?

Economic conditions are currently sluggish and could continue to slow down further. There are many incentives designed to help stimulate growth. The Federal Reserve has drastically lowered the federal funds rate. The prime rate has followed the federal funds rate. The markets that determine mortgage and lease rates change daily. Specifically, the market for Treasury bills is trading mostly up. That is the price for Treasury bills has been rising – investors feel there is a lot less risk in Treasury bills so they buy more of them. The inverse relationship between the price of a Treasury bill and its corresponding yield means that lease rates are currently very attractive.

This means that if a business is considering making an equipment purchase and is looking to finance the acquisition, then leasing is a very attractive option. Lease rates are low. Leasing can help an organization better manage its cash flow situation, and depending on the type of lease, keep the asset off of the balance sheet allowing the company to fully expense the equipment. An alternative is to combine a lease with an eye toward purchase and take advantage of some of the U.S. economic stimulus options, such as an IRS Section 179 Deduction.

About Dynamic Funding, Inc.

Dynamic Funding, Inc. is a Colorado based, service oriented, independent equipment leasing company. Founded in 1996, Dynamic Funding, Inc. is a full service lessor that provides financing for business equipment, software, and services. DFI's customers include commercial, non-profit, and government enterprises. We market our services directly to end customers and also through partnerships with equipment manufacturers, distributors, resellers, software providers, and technology consultants.

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