WHITE PAPER: SPIREON - BUYING VS. LEASING WEBINAR

Lease or Buy?

WHY THE CHOICE IS LESS ABOUT FINANCE AND MORE ABOUT ECONOMICS

It's an age-old question with no defined answer: should I buy or lease? From a financial perspective, there are pros and cons for each. But economists say there's more than cash flow and depreciation to consider.

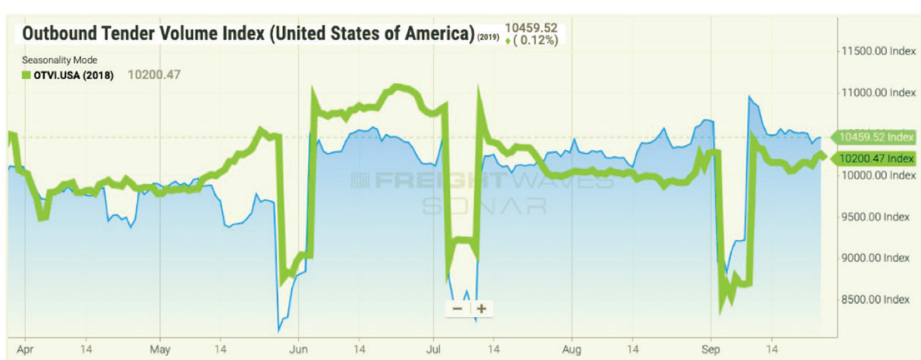
Let's take a look at some economic indicators to understand why Dean Croke of FreightWaves says rising and falling shipping volumes – and how your fleet's operating costs rise and fall with them – can be a deciding factor.

FINANCIAL DOWNTURN

High operating ratios have resulted in a significant impact to the trucking industry in recent months, resulting in poor performance and even bankruptcies in some cases.

Let's compare the 2019 trucking market relative to 2018. Blue represents the volume of freight in 2019, while the green represents the volume of freight for the same time period in 2018. The peaks and valleys are unmistakable and correlate from year to year.

Trucking and Intermodal Volumes



Truckload volumes up 2.54% y/y | Intermodal containers down 4.5% y/y | Trailers on flatcar down 19.3% y/y

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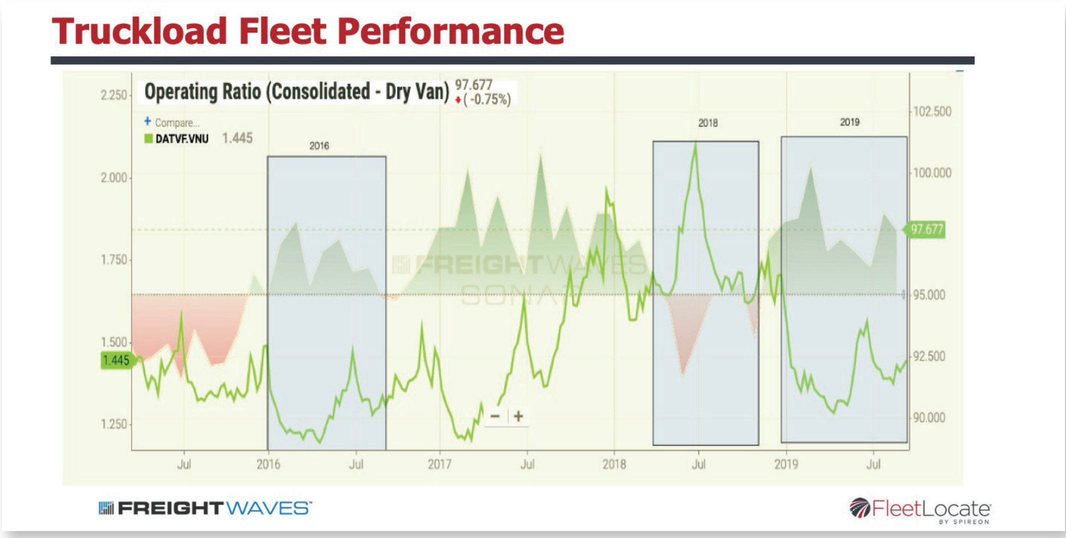
On to the truckload fleet performance where we see the Operating Ratio from our Truckload Carrier Indexes, which represents about 70,000 trucks and a couple of hundred fleets. This five-year window showcases the 95% Operating Ratio with the green representing an above 95% ratio and red representing below 95%.



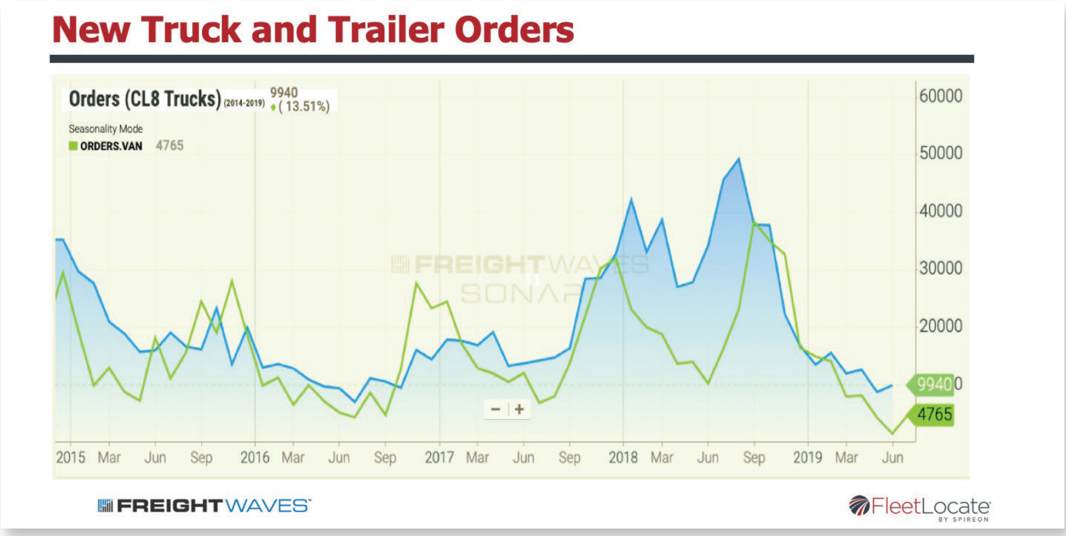
The Operating Ratio shows the ratio of expense to net sales which include wages, maintenance, and other costs. The lower the Operating Ratio, the more efficient the company is supposed to be; basically speaking, the operation requires less money to generate revenue. The green line is the DAT rate, and the three shade boxes represent performances for select years in the freight industry.

The first shaded box represents the most recent recession, back in 2016, rates dropped under $1.25 a mile at the Van Rate, and Operating Ratios peaked at around 97%. Following that in 2017, Operating Ratios reached the high 90s. However, in 2018, despite an increase at just over $2 a mile, the Operating Ratio declined. As of early 2019, Operating Ratios reached around 100%, while the Van Rate dropped to $1.25 a mile. The rectangle on the far right is a perfect example of why fleets need to consider the options of leasing or buying.

So, what does this mean for fleets? A lot of fleets are going through tough times, specifically those in debt. Freight rates are increasing, Operating Ratios are rising, and a high number of bankruptcies have been reported.

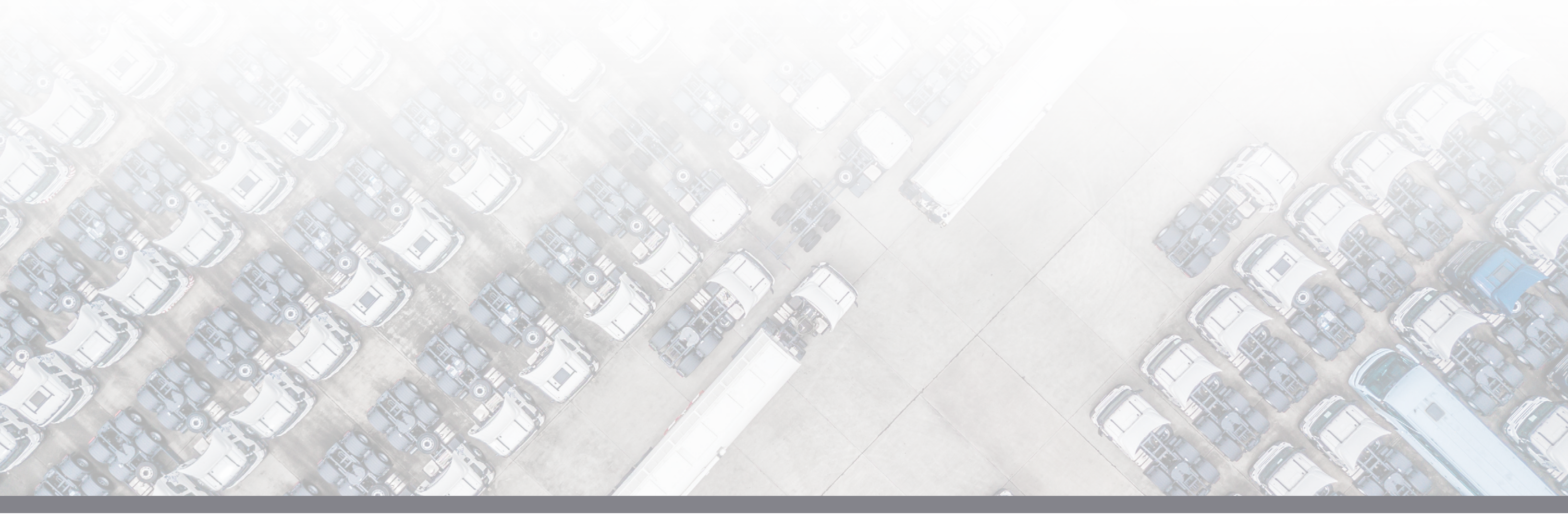
ORDERING FOR TRUCKS AND TRAILERS

When shipping volume is high, new orders for trucks and trailers spike. The following chart analyzes truck and trailer orders. The huge rise in 2018 saw record increases in shipping volume, which led to an increase in carrier equipment ordered. The increase in demand also increased rates, which then led to more orders.

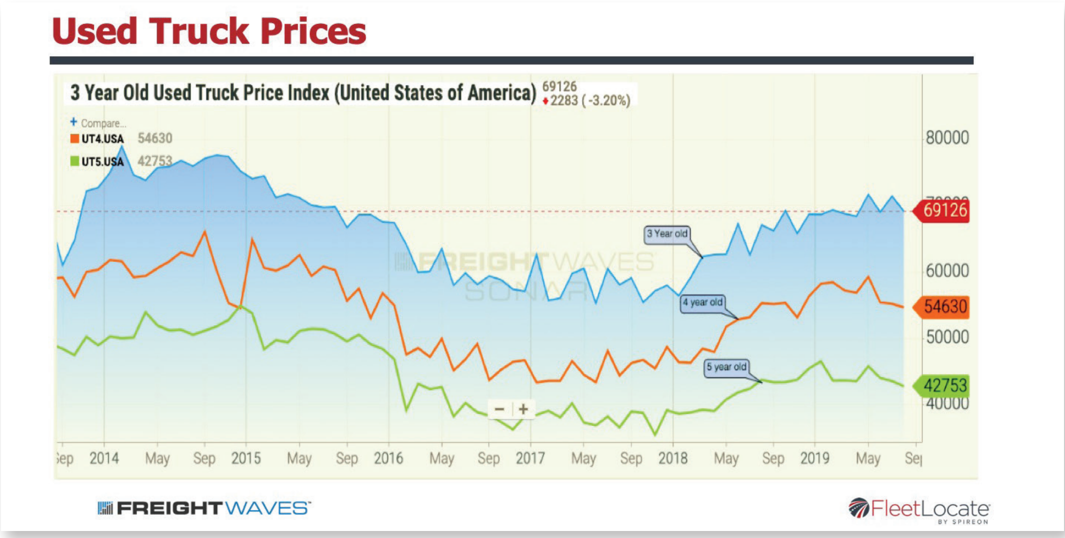


Unfortunately, going into 2020, the issue we have now is that many fleets have an excess capacity of trucks and trailers, which explains the trend toward higher ratios and lower rates.

This time last year, truck orders were higher with initial net orders showing 11,000 compared to 53,000 in the prior year. Truck replacements each year equals to around 220,000 a year, which is about 19,000 orders a month. With that said, thus far we're about half that. As a result, based on last year, the industry has put a lot of trucks into the business. What folks are calling the payback period in which too many trucks were ordered in recent years, and now a surplus, has put a decline in truck orders.

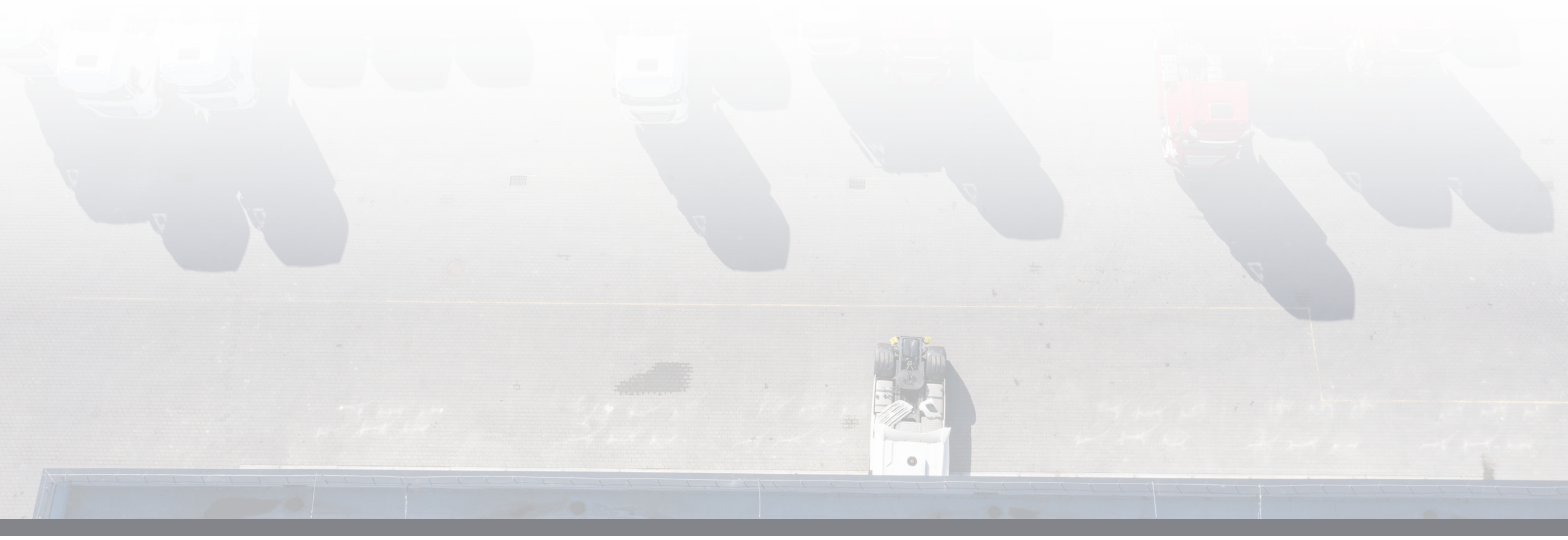


Data from ACT Research shows used truck prices for three, four, and five-year-old used truck prices. Last year used truck prices increased from about 10% as fleets added more capacities. The graph shows that four- and five-year-old trucks have a lower resale value, as would be expected, but have been declining much faster than usual compared to three-year-old trucks.



As for three-year-old trucks, it seems to stay at an even pace since August. The slight increase for used trucks, mainly around May and June, should be noted because of the bankruptcies around that time. It has likely affected the number of trucks entering the market from a supply standpoint, which in turn has impacted the lower prices. There were certainly some ups and downs through the years, but the data shows the price of used trucks is trending down.

Fleets are still adding capacity at this current time, with consumer spending still robust. Looking into 2020, it is uncertain what the future looks like, but currently, it seems more truck prices will decline in value as more supply hits the market.



THE APPETIZER: BUYING VS LEASING

According to Croke, when looking at the buy vs lease decision, it's important to consider the macroeconomic market. A lot of shippers in the market are not sure what to do when it comes to investing, building inventory levels, and shipping freights.

Advantages of Both

Both buying and leasing have their advantages. Here we list the main advantages of both.

The Advantages of Both

Lease	Buy
• Focus on core competencies	• Retention strategy (lease purchase)
• Operating Costs ○ purchasing power ○ cost of administration ○ predictable R&M costs	• Tax advantages (accelerated depreciation)
• Insulate from the cyclicality in the secondary market	• Flexibility to make equipment changes
• Co-terminus - make the lease align with the end of a revenue contract	• Build equity
• Better use of working capital	• Lower operating costs
• Take advantage of the latest technology	

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Leasing Advantages

One of the big advantages of the leasing side is a strong focus on efficiency. Since many truck companies are focused on running the business, leasing lessens the burden of maintaining and managing their assets.

As for operating costs, purchasing power is very important. Many small fleets lack purchasing power and need fewer trucks or trailers. Unlike larger fleets that have better pricing power, by leasing, smaller fleets can work out more flexible around options for their vehicles.

As for the cost of administration, businesses don't have to worry about the hassle of maintaining the fleet, or handling warranties and repairs. Leasing also keeps costs more predictable, which is a good thing. It gives the business a better handle on what your operating costs would be compared to when you're on the buying side and paying for everything.

Other leasing advantages include isolation from the up-and-down used truck market, aligning the lease with the end of revenue contract, also called co-terminus, better use of working capital, and keeping your fleets up to date with the latest technology.

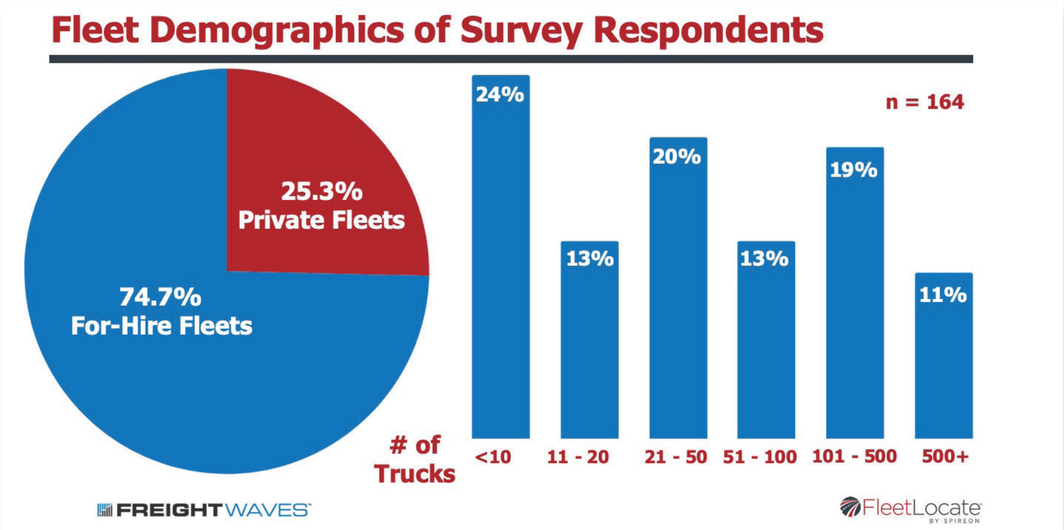
Buying Advantages

Onto the buying side of things, it's a great feeling to own your equipment. Retention strategy or in this case the lease-purchase program works in a way in which fleets, especially the larger ones, buy trucks and then lease them out to drivers. This retention strategy works well in bringing in drivers into the industry, and then eventually the driver buys their own truck.

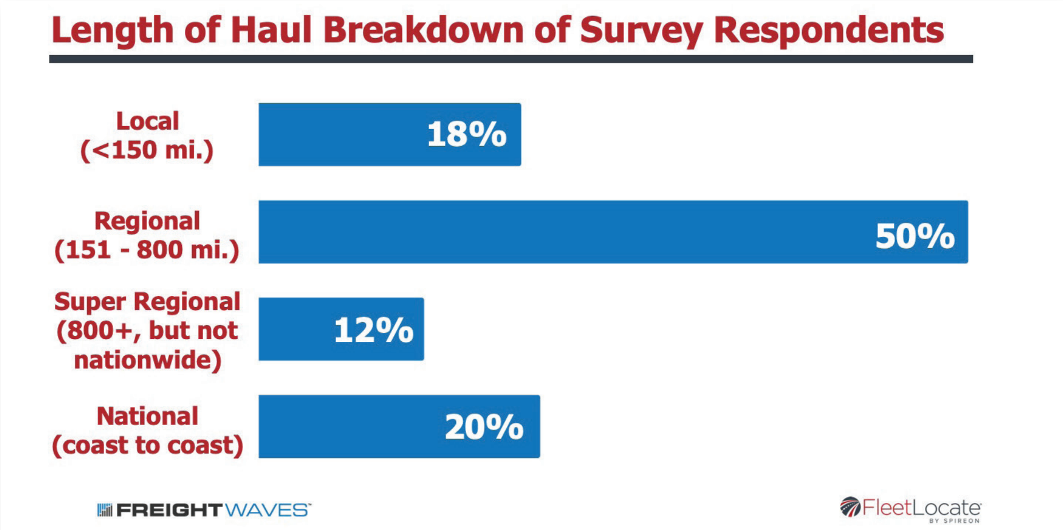
Flexibility is an advantage that is often overlooked. Owning the truck or trailer gives you flexibility in terms of being able to make changes to the asset. By owning your assets, you're able to lower your operating costs since you have total control over your inventory and can build equity. Lastly, there are tax advantages due to accelerated depreciation.

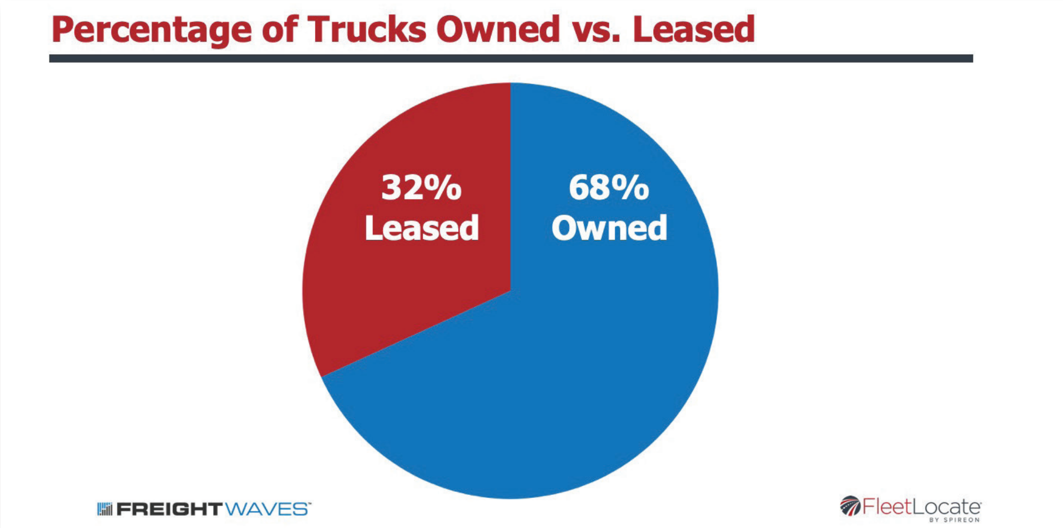
THE BATTLE BEGINS: BUY VS LEASE

Now, let's set the scene on which is better for your fleet. This next survey showcases 164 fleets, asking them a range of questions regarding the pros and cons of leasing versus buying. The graph shows a survey of the 164 fleets, whether they were for-hire fleets or private fleets. The numbers at the bottom represent the number of trucks each fleet has.

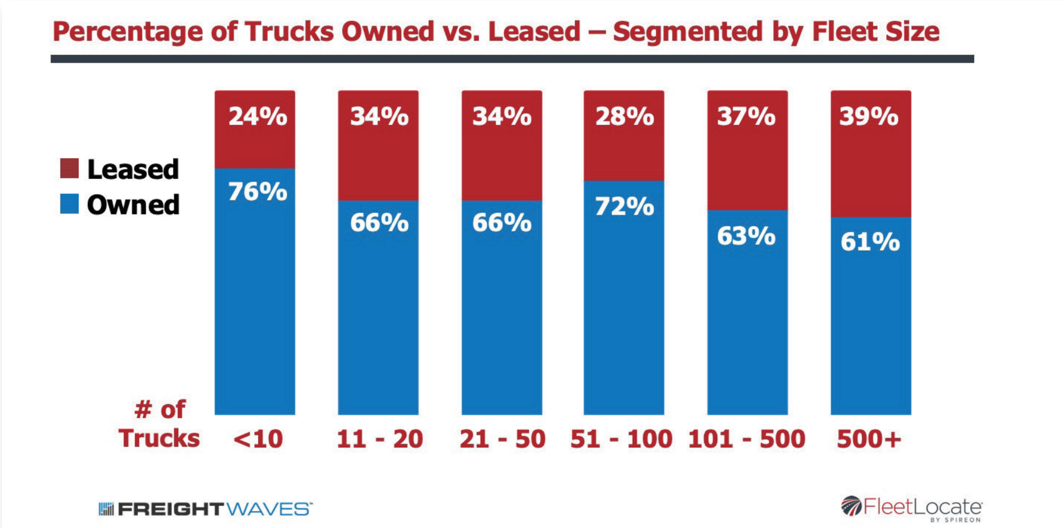


Next, we break down the length between hauls for the fleets. Why this is important is because the distance traveled determines a lot about the type of equipment you might buy or lease. As you can see many of the fleets are regional, ranging from 151 to 800 miles.





From the graph, many fleets seem to buy their trucks compared to leasing them. As you'll see in the next graph, many fleets utilize both leasing and buying depending on how big their fleet is.



Depending on the size of the fleet, you can see carriers with more trucks tend to lease much more than smaller fleets. Why? According to Croke, as fleets get larger, the percentage owning trucks decrease, which likely has something to do with the lease-to-own purchase programs that large fleets employ to encourage drivers to buy their own truck, as mentioned earlier.

Primary Benefits of Owning vs. Leasing Trucks

Owning		Leasing	
62%	Accelerating depreciation to minimize taxable income	Access to maintenance network	49%
50%	Lower total cost of operation	Ability to use the newest technology and equipment	45%
43%	Deducting interest expenses	Ability to increase/decrease truck fleet size to adjust to demand	43%
20%	Lower total maintenance expenses	Ability to expense monthly payments	39%
15%	Lower insurance premiums	Smaller monthly payments	34%

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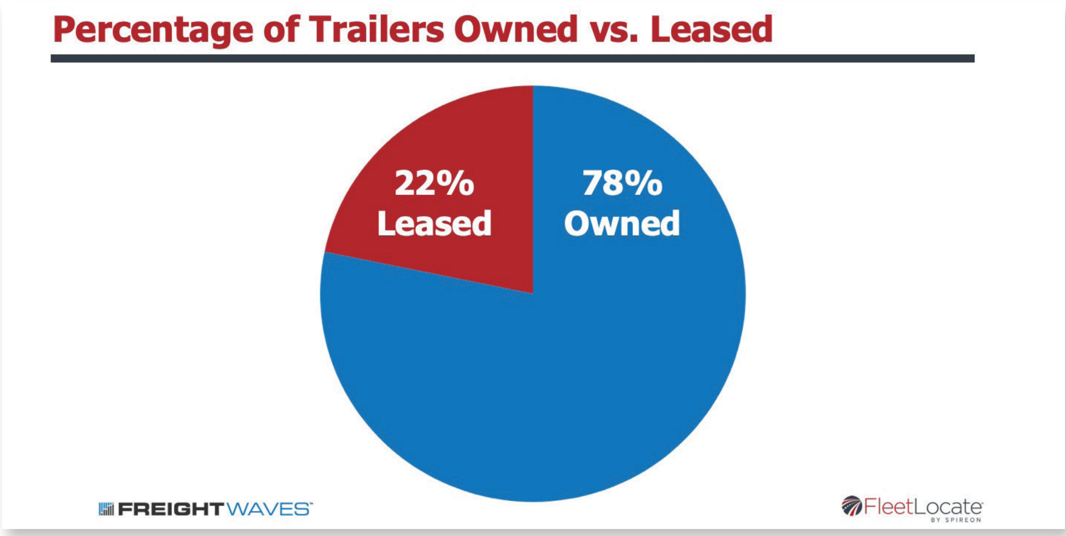
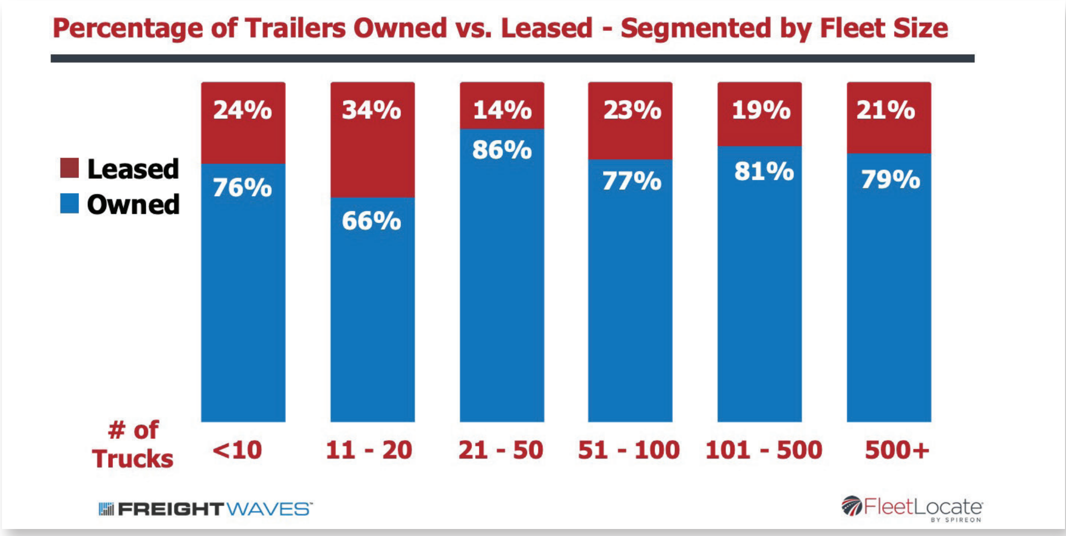
The results for trailers for the same fleets that were surveyed for trucks are pretty similar. You'll notice ownership is a bit higher for trailers compared to trucks. Also note that the percentage of owned and leased trailers in terms of the number owned varies much more compared to that of trucks, as seen in the second graph below.





Here again, we showcase the benefits that the 164 fleets see in both owning and leasing, this time for trailers.

Primary Benefits of Owning vs. Leasing Trailers

Owning		Leasing	
62%	Lower total cost of operation	Ability to increase/decrease truck fleet size to adjust to demand	51%
55%	Accelerating depreciation to reduce taxable income	Ability to expense monthly payments	36%
40%	Deducting interest expenses	Smaller monthly payments	29%
28%	Lower total maintenance expenses	Access to maintenance network	26%
15%	Lower insurance premiums	Ability to use the newest technology and equipment	25%

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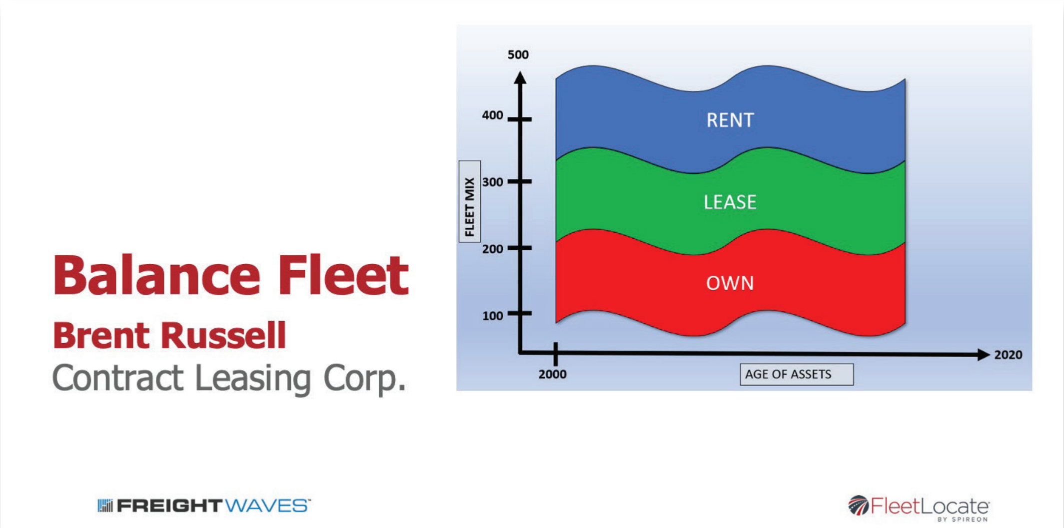
One standard to consider is that there is generally a 3:1 ratio regarding trailer and truck. For every three trailers, there is one power unit, which is the general industry-accepted standard. Usually, large truck fleets will often have three to four trailers per power unit. As you get down to the smaller fleets, you'll notice fewer trailers, with ratios of 1:1 or at most 2:1.

With a foundation laid about where our economy has been and how small and large fleets typically approach the buy vs lease decision, let's look at how leasing is a strategic way for some fleets to rightsize their operations.

Leasing Leads to Success

Brent Russell of Contract Leasing Corporation has been in the trucking industry well over 18 years, and he brings specific insight into leasing. He explains that having a balanced fleet is key. What this does is give organizations flexibility. "The phrase, 'Don't put your eggs all in one basket,' is very true in this industry," Russell said Doing so will increase rates and reduce a company's ability to react to a changing market.

"By no means am I here to say that leasing is the only option for a fleet or the only option to help reduce cost or shore up a balance sheet, but there are numerous factors that we have to consider," said Russell.



In a perfect world, the graph above would be the ideal solution with everything being equal. However, that won't work, and it may not be ideal either. Every fleet is different, so it's impossible to have everything equal. Some fleets may need more leased assets than owned ones, and vice versa.

Russell has discussions regarding leasing versus owning with fleet executives, from CFOs to CEOs, daily. One main question he asks throughout all these conversations is why do you own? The two most common responses are "That's what we have always done," and "Accelerated depreciation." In today's world with operating ratios of 95% and above, most fleets don't realize they have more depreciation than needed. Plus, doing things the same way will not get you far, especially if it's not working.

According to Russell, it's important to understand that the best fleets have a balanced fleet that is linked to their customers, their freight mix, and their contract terms. Leasing can help achieve all these goals.

Russell shares an example where he says "cash is king." Take a 100-unit lease. For the 100 units, the contract terms will read 60 months with a payment of around $350 a month. If you're purchasing, you're looking at 100 assets times around $32,000 which is around $3.2 million in cash. In reality, no one is writing a check for $3.2 million. You'll most likely finance that through a bank. Add standard financing rates for 60 months means $600 a month to buy compared to the $350 a month to lease.

In this scenario, leasing saves $250 per asset, multiplied by 100 assets, and that's $25,000 a month in free cash flow. A lot of things can be done with a free cash flow of $25,000, from expanding your land, acquiring land, and paying other debt. Also, if needed, you still have money left over to get another 100 assets. As you can see, leasing allows you to fuel your growth, according to Russell.

Looking at the other side, purchasing 100 units, you are stuck with them. That's not a bad thing, but when they're clogging your yard or if the economy slows and you don't have as much freight to haul, it can become a waste of money. Add to the fact, as mentioned by Dean, the current trucking market is down. Try selling assets in a down economy, it won't go well, because others are trying to sell those same assets, which then drops the value of the used equipment.

One of the most important factors of commanding your fleet is to keep to your core. Whether you're a trucking company or transportation entity, your sole focus is to move freight efficiently, deliver products on time, and serve your customer. Selling assets is outside of a fleet's range, as it disrupts your business. No fleet needs those kinds of uncertainties.

The comparison of the next two graphs will showcase the difference between a balanced, well-maintained fleet and a fleet that has struggled with various maintenance costs.

As you can see, the major high and low spikes in the top graph display a business purchasing large fleets of equipment in various years, which will create challenges down the road. Leasing will fix the issue as you see in the bottom graph. This creates much more flexibility and balance for your business.

YOUR FLEET'S FUTURE IS BRIGHT WITH LEASING

When you look back at the unbalanced fleet versus the balanced fleet, you can easily structure your fleet to be balanced with a strong leasing partner. As Russell explains, leasing isn't the sole strategy to improve your fleet, but a leasing strategy can help your fleet achieve goals. It will help you do the right thing for your organization at the right time.

For more information about monitoring, tracking, and managing detention times, visit spireon.com/trailer-management or call one of our friendly experts at 800.557.1449.

Brent Russell and Dean Croke were the featured guest speakers for "Cost of Ownership – Leasing vs. Buying," a recent webinar hosted by Spireon. To see the upcoming slate of Spireon webinars featuring fleet and trailer management, visit spireon.com/webinars.

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