

It is January 1st, 2018. You are a senior analyst at Pear Computer Horizons Limited (PCH), one of the leading global technology firms for computers, cell phones, and business services in Canada. The CEO of PCH, Amanda Morrison, has reached out to you to look at two options regarding an investment, building on your analysis from Assignment 1 and Assignment 2.

Purpose

Under this case approach, you will demonstrate your ability to undertake a detailed analysis to evaluate the buy versus lease options for an investment proposal, on a qualitative and quantitative basis. You will also be required to calculate the weighted average cost of capital (WACC). A supplementary scenario analysis of leasing options is required.

Pear Computers Horizons Case Study

Investment Decision

Ms. Morrison is currently weighing her options for new manufacturing equipment that she is considering using to help with the production of several new products that PCH has successfully developed. She is currently working out a deal with Makers Inc., a US manufacturer that is offering to lease brand new equipment it has acquired to PCH. Ms. Morrison is also considering just purchasing the equipment up front from the original equipment manufacturer. She is trying to understand why Makers Inc. would lease equipment to PCH, and what the benefits and drawbacks of leasing would potentially have for PCH. She also wants to know what type of lease is being considered, and what the effects would be on PCH's statement of financial position. She wants you to include this information in your report.

PCH is considering investing in new manufacturing equipment that would cost \$20M if purchased today from the original manufacturer. The CCA rate applicable to this asset is 30%.

Alternatively, PCH could lease the equipment for \$4.2M annually over a six year term, with payments at the beginning of each year. The salvage value is expected to be \$4.6M at the end of six years, according to PCH's CFO Jim Butcher, and the disposal of the assets will not trigger any tax effects. The applicable tax rate is 20%. The leased assets are of a specialized nature, meaning that only PCH would be able to utilize them once installed.

Ms. Morrison wants your advice on whether or not PCH should purchase or lease the asset. She wants you to determine the effect of having payments at the end of the year, rather than at the beginning of the year. She also believes that the salvage value estimation by Jim Butcher is incorrect, and that the salvage value could be as high as \$5M after six years. She wants to know how a salvage value of \$5M will impact the purchase or leasing decision, when payments are either at the beginning or end of a period. Makers Inc. has also offered to have lease payments at the end of each period, as long as PCH puts up a \$2.5M security deposit. Ms. Morrison wants you to evaluate the impact of the security deposit option.

Finally, Ms. Morrison wants to know what lease payment would effectively lead to indifference between leasing and purchasing, under the original offer (i.e., six payments at the beginning of the year and a \$4.6M salvage value).

After taking these scenarios into account, Ms. Morrison would like you to recommend what PCH should ultimately do.

Weighted Average Cost of Capital (WACC)

Ms. Morrison wants you to use the weighted average cost of capital (WACC) as the required return. PCH currently has 40 million common shares that are trading at \$40 per share. The dividend is expected to increase to \$4.00 per share in the next period. PCH also has 1 million preferred shares that get \$2.5M in dividends and are currently trading at \$25 per share. Ms. Morrison wants you to determine the cost of preferred equity and common equity, using dividends and share price. The anticipated constant growth rate for common dividends is 4%.

The total market value of debt that PCH expects to have going into this investment is \$150M. The before-tax cost of debt is approximately 6%. Ms. Morrison wants you to determine the **after-tax cost of debt** to be used in the WACC. A tax rate of 20% has been suggested for use in the analysis.

2. Explain the advantages and disadvantages of leasing, including the possible reasons, right or wrong, that would make a company lease an asset (from the lessor and lessee perspective).
3. Calculate the weighted average cost of capital (WACC) to use in your net advantage to leasing (NAL) analysis, rounding to the nearest one tenth of a percent.
4. Prepare your Net Advantage to Leasing analysis of the investment using the WACC as the discount rate. In addition, determine the impacts of the sensitivity analysis in the case, including
 - a. changes in payments from beginning of period to end;
 - b. changes in salvage value;
 - c. security deposit; and
 - d. the break-even lease payment.

5. Explain and evaluate if the investment should be purchased or leased, depending on the different scenarios analyzed.
6. Determine the classification of the lease option being considered, and indicate what the effect would be on the statement of financial position.

Format for Submission

- Your report narratives may be done in Word or Excel, but calculations and tables of values must be prepared in Excel with the amounts derived from actual formulas that use your variables, rounded to four (4) decimals or lower.