

**THE FINANCING OF
AGRICULTURAL MACHINERY**

BY

THE AGRICULTURAL ENGINEERING SERVICE, AGSE

FOOD AND AGRICULTURAL ORGANIZATION OF UNITED NATIONS

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FOREWORD

This occasional paper has been commissioned by the Agricultural Engineering Service (AGSE) in response to the many requests received for information on the financing of farm machinery. Many of the requests have come from the former centrally planned economies of Eastern and Central Europe. In most of these countries there is no experience of private persons and companies borrowing money to finance capital goods for farm business development. Similarly, there is no expertise or experience of lending within the newly emerging banking sector. The paper is thus orientated to the European (and to a lesser extent, North American) situation and should be read in that light.

The paper was written for us by Mr. David Pullen of the British agency ADAS¹ and has been produced as part of AGSE's regular programme activities for Central and Eastern Europe. AGSE is concentrating on the restructuring required in the change from a centrally organized, supply driven system to a free market demand driven farm machinery sector. The paper is also available in the Russian language from AGSE.

The paper is a review of the methods of financing agricultural machinery in western Europe using examples from Great Britain. Financial options in Great Britain are considered in relation to limited information available from mainland European Union countries.

Business plans and cashflow projections together are identified as important elements in obtaining confidence of prospective finance providers. The part that cashflow projection can contribute to "customised" financing is described. Government controls and taxation affecting the best finance method are mentioned.

Six modalities of financing machinery or mechanisation are described together with the advantages and disadvantages of each method. Ownership and taxation issues are also examined. The recent developments of Contract Hire and Operating Lease are also examined in the context of changing business conditions.

The increasing practice of manufacturer supported finance schemes is described. The benefits to the manufacturer as well as to the farming business are discussed. Low initial cost leasing and hire purchase schemes and the effect of inflation on these schemes are described. Zero or low rate interest schemes supported by the manufacturers are outlined with examples.

The place of used machinery trading, its financing both at distributor and farmer level, and its importance generally in the provision of mechanisation in Europe are discussed.

Lastly the financing of machinery for contractors and machinery rings, and jointly owned machines is outlined.

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¹ ADAS is the former "Agricultural Development and Advisory Services" which used to be the government run agricultural advisory service. ADAS is now a special agency which offers a consultancy service to clients in the Food, Farming, Land and Leisure industries.

1 INTRODUCTION

Financing machinery purchase for private sector farming presents a particular challenge throughout the world. The majority of developed countries, and indeed developing countries, are reliant on mechanised agriculture which is highly demanding on financial capital. This is true for all mechanised industries but agriculture, with its largely seasonal output and long lead times on investment return, has special problems. It is thus normal for machinery and plant to be "financed" by borrowing or leasing with repayments taking retrospectively over the life of the machine.

Methods of financing farm machinery in the private sector are of increasing importance to the emergence of private farming in Eastern and Central European countries. As these countries transform from centrally planned economies there is a vital need for mechanisation resources to be available for smaller units and under the direct business control of the farmer. The demand for finance schemes to enable farms to start up is likely to initially outstrip the ability of financial service companies and banks to respond. It is therefore vital that the widest range of financial options are examined to ensure that the most suitable methods are employed.

This paper examines business methods and finance schemes that operate in Great Britain. In researching this paper it has become evident that there is a far wider range of finance options in Great Britain than anywhere else in Western Europe and also the world, with the possible exception of the USA. Therefore while Great Britain cannot be described as typical of Western Europe it does offer the widest example of schemes for analysis for application in countries with developing market economies. Most other European countries offer a combination of similar methods depending on the banking and taxation structure in the country in question.

2 FARM MACHINERY FINANCE - PLANNING AND TAXATION

2.1 Business Plans

Whatever form of finance is used for farm machinery purchase it is vital that the business can afford the capital outlay. In the case of loans, hire purchase or other finance schemes where the capital is loaned to the farmer, it is also very important that the lender has confidence in the farmer. For example, business plans, projected cashflows and machinery investment plans are often requested by banks and finance companies before approving finance agreements.

2.2 Cashflow Projections

In particular, cashflow projection will help with scheduling payment of finance charges. Lease and hire purchase plans can be individually designed to suit the farmer's income from crop, milk or livestock sales. This is sometimes called "customised" finance.

2.3 Government Control and Taxation

Selecting which finance method is best for each farmer depends on the financial controls, accounting procedures and taxation policies which Government's impose. The simplest example is where a Government wishes to encourage purchase of a particular machine and reduces taxation in order to encourage this to take place. The complex interaction of these financial policies is very important because no two countries will be the same. Therefore, it is vital to understand that the best finance method in one country is not necessarily the best in another even if the farmers, land and

climate are virtually identical.

3 MACHINERY FINANCING MODALITIES

A wide range of modalities of financing machinery, plant and equipment are available in Western Europe:

- (i) Cash reserves.
- (ii) Bank loan.
- (iii) Overdraft.
- (iv) Hire purchase.
- (v) Finance lease.
- (vi) Contract hire and operating leases.

It is important to note that, with the exception of using cash reserves, all of the other finance methods, including manufacturer supported versions of these schemes, are based on banks or financial institutions. The financial services sector in Great Britain is very highly developed and is a major reason why there is such a wide range of finance options available.

3.1 Machinery Purchase from Cash Reserves

Modality: Money (cash) that is in a bank account, savings account or kept as hard cash is used to pay directly for the machine.

Ownership: The machine is wholly owned by the purchaser as soon as the money is paid to the supplier. The machine may only be taken from the owner if the entire business is bankrupt and the asset value of the machine is required to repay another debt.

Advantages: If a farmer has cash which is not needed to run the business it is advantageous to use it to purchase machinery rather than borrow money or lease machinery. This is because interest rates paid on money in savings accounts or in bank deposit accounts are always lower than the interest rates charged on loans, hire purchase or leases. Typical interest rates in Western Europe in mid-1994 were 4½-5% interest paid on savings and deposit accounts, and 10-12% charged on business development loans.

Disadvantages: Available cash is more useful to purchase short-term production requirements and inputs, for example seeds, fertilisers and animal feed. This is because these costs should be recovered during the farm trading cycle when the crops and livestock are sold, and thus avoiding the higher cost of financing production from a bank overdraft. Machinery purchased by this method may make the business short of cash for day-to-day working.

Taxation: There is normally no tax advantage in using cash reserves for machinery purchase in Great Britain. Machines bought on hire purchase, bank overdraft or from cash reserves are treated equally for annual depreciation. Annual depreciation is the reduction in value of the machine over one year and accountants can deduct this from the profits before taxation.

3.2 Machinery Purchased by Bank Loan

Modality: The farmer buys the machine using money loaned to him by a bank. It is normal to borrow the money from the same bank that handles the normal trading activities for the farm. The maximum loan is generally 70% of the new machine cost with the other 30% provided from the farmer's cash reserves, or through selling a used machine either directly to a third party or by part-exchange ("trade-in"). Repayment of the loan capital and interest is by equal monthly payments although alternative payment periods can sometimes be negotiated if the farmer is a good risk. For example, if the farmer already has a good repayment record. Normally loan agreements are for 3-5 years and a loan arrangement fee is also charged when the agreement is signed.

Ownership: The farmer owns the machine as soon as the supplier has been paid for it. In some cases the bank may pay the loaned sum direct to the supplier. If the machine has been given as security for the loan it may be repossessed by the bank if the farmer defaults on the loan payments. Alternatively, if another asset, for example a house or land, has been used as collateral for the loan, this may be seized to repay the loan. In the cases of houses or land as collateral the bank will hold the legal papers as proof of security.

Advantages: Some banks are able to give preferentially low interest rates to farmers compared to other industries. This is usually the case when the national bank lends to commercial banks at preferential rates. This is often used as an instrument of policy by governments. This is particularly common in France through the specialised rural bank, "Credit Agricole". Where credit security is particularly good, for example if the farmer owns all of his land and has no other loans outstanding, then interest rates may be negotiable at a lower level.

Disadvantages: The biggest problem is providing collateral for loan security. In assessing security the bank will examine details of all the farmer's loans and commitments, and the assets which are in use as collateral. For example, if the land is partly mortgaged to the bank already, then the interest rate charged may be rather high to reflect the greater risk that the bank is taking.

Where the bank has part ownership of a specialist machinery finance company, as is common in UK, local bank managers usually refer all enquiries on machine finance to that company. This is because they prefer not to compete in what is considered a specialist financial service.

Taxation: Annual depreciation is an allowable deduction from profits before taxation is calculated in Great Britain.

3.3 Machinery Purchased by Bank Overdraft

Modality: A bank overdraft is withdrawal or spending of money in excess of the amount in the account, i.e. the account has a negative balance. Farmers may operate their businesses with a continual overdraft but with a limit agreed annually with the bank manager. When a machine is purchased using an overdraft the farmer either writes a cheque for the agreed price of the machine or obtains a bankers draft. Interest

charges commence immediately but there is no formal agreement on the length of the arrangement.

It is normal, and good practice, to agree an overdraft and negotiate the interest rate payable before spending this money. In this case an arrangement fee is normally charged for administration by the bank. Unauthorised overdrafts are charged a very high rate of interest and may also incur a retrospective arrangement fee. Interest rates are set by the bank depending on a credit risk rating which includes assessing the good character and personality of the farmer.

Ownership: The machine is wholly owned by the farmer immediately he has paid for it. The bank does not have any special right to repossess the machine unless the business is made bankrupt. The asset value of the machine can then be realised to repay any debts which may include bank debts but the bank will only have equal status with other debtors.

Advantages: Where a machine will repay its costs very quickly it can be cheaper to use a bank overdraft as a short-term finance method to avoid a long finance agreement. For example, it may be possible to repay or reduce the overdraft in say 6 months whereas most other agreements are for at least a year.

Relatively small cost machines, for example hand power tools or second-hand machinery, is often purchased this way because the machine will have virtually zero collateral value to enable purchase by any other method.

Disadvantages: As part of an overdraft agreement the bank has complete control over the level of debt that the farmer owes to the bank. This can, and does, cause problems for farmers if the banks suddenly, and without any reason, chooses to recall the debt. This can happen even if the overdraft is within previously agreed limits. The bank may also, without warning, shorten the agreed period over which an overdraft is being reduced.

In essence a farmer purchasing machinery, which is usually a long term investment, on overdraft can be putting his business in danger and he is in a very weak position compared to the bank.

Due to the personal assessment element overdraft financing is only possible when there is a well established farmer-banker relationship.

Taxation: Annual depreciation of the machine is an allowable deduction before taxation is calculated in Great Britain.

3.4 Hire Purchase of Machinery

Modality: The price of the machine together with the down payment is agreed between the farmer and the supplier. The price will include any discounts and part-exchange allowances. The hire purchase company (finance company), pays the supplier the rest of the purchase price, usually a maximum of 60% of the full retail price of the machine. Repayments of the balance of the purchase price and interest charges are made by the farmer in monthly or annual instalments. "Customised" repayment plans are also negotiable as described in Section 2. Normal agreements are for 3-5 years.

Hire purchase is normally arranged by the machinery dealer/supplier who is normally paid a commission by the finance company. An example of a hire purchase payment scheme is at Appendix I.

Ownership: The machine is wholly owned by the hire purchase company until the final payment is made. Upon final payment ownership of the machine passes wholly to the farmer. In the case of default of payment the hire purchase company can repossess the machine and sell it to a third party. Depending on the outstanding payments, the farmer may receive some of the value of the machine.

Advantages: Providing the farmer can afford the payments, the system is very flexible because there are no problems with collateral for the loan. The hire purchase company takes the risk but retains ownership until it has received all of its money. The 60% maximum loan by the hire purchase company safeguards the difference between the new and used value of the machine. In this way if repossession and re-sale become necessary it is far less likely that the finance company will lose money.

For farmers with little collateral security, but who are good farmers and can afford the repayments, this is a very important method of financing machinery.

Disadvantages: Compared with a finance lease (see next section 3.5), hire purchase has slightly higher repayment charges. Therefore, in countries where purchase of the machine is allowable at the end of the lease, hire purchase might not be quite so financially advantageous as leasing.

Taxation: In Great Britain, hire purchase is treated for taxation purposes in the same way as full ownership. Farmers can therefore deduct the annual depreciation allowance from profits before taxation even though the machine is not owned by them until the final payment is made.

3.5 Machinery Provided on Finance Lease

Modality: The machine is purchased on behalf of the farmer by the leasing company, usually a specialist machinery finance company. The farmer signs an agreement to pay the leasing charges for the agreed period of 2-5 years. The farmer negotiates the price of the machine including any allowances for a traded-in machine and any discounts and may also pay a deposit or down payment for part of the cost. The outstanding balance of the machine price is used to calculate the leasing charges. An example is given in Appendix II.

Ownership: The leasing company is always the owner of the machine whilst it is being leased to the farmer. At the end of the lease the machine is either sold to another party, or it can continue to be leased to the farmer under a separate secondary lease agreement.

In Great Britain the farmer is not allowed to purchase the machine at the end of the lease. However, the money raised by the sale of the machine is returned to the farmer. This money is usually used as part payment on a new machine to replace the previous one.

Advantages: Because ownership of the machine remains with the leasing company, there is no problem for the farmer in providing security for credit ("collateral"). The leasing

company takes the risk of bad payment and can simply dispose of the machine if the farmer does not pay the leasing charges (defaults). There is no need to instigate legal repossession since the farmer does not own the machine. However, in practice farmers rarely default. Also they treat the machine as their own property because the money raised from the sale of the machine at the end of the lease will be greater if it is in good condition.

Disadvantages: Because the machine does not belong to the farmer, he cannot offset the machine depreciation against trading profits in order to reduce his tax commitment. The depreciation allowance against tax is always used by the leasing company to offset its own tax liability.

Some types of machines, such as combine harvesters which are typically used by a farmer for up to 10 years or more, cannot be advantageously financed by leasing. This is because it is cheaper to buy the machine on hire purchase rather than the alternative of a costly secondary lease period.

Taxation: All of the lease charges are treated as trading costs and are therefore offset against profits before tax is calculated. This does offset the loss of the depreciation allowance to some extent, especially if the farming business is very profitable.

3.6 Contract Hire and Operating Leases

Modality: The machine is hired or leased to the farmer from a specialist machinery hire company for up to 5 years although the normal period is 3 years. This method is generally only used for self-propelled machines, for example tractors, harvesters, sprayers, and forklifts. A very similar system is used in car hire and leasing which is established practice worldwide.

These methods are essentially a way of financing "mechanisation services" rather than financing machinery purchase.

Contract hire is arranged to cover all the machine costs, apart from fuel, regular maintenance and labour, over typically a 3 year period. This modality is increasingly used for large machines which are not required on the farm for the whole year.

An operating lease differs from contract hire in that the farmer carries out all repairs, agreements are usually longer, and the machine is not hired to any other farmer during this contract period.

Ownership: The machine is at all times the property of the machinery hiring company. At the end of the hire or lease period the farmer may be able to purchase the machine from the hire company at a preferential price.

Advantages: If the hired or leased machine has a major breakdown a replacement is immediately available from the hire company.

Contract hire is mostly suitable for seasonal machines which are not fully utilised all of the year. Contract farming companies who may only have a short agreement to farm on behalf of the landowner find this method easier because the exact costs of mechanisation are known from the outset. Also there are no assets to dispose of at the end of the contract farming period. The operating lease is cheaper than

contract hire for longer term agreements.

Disadvantages: Contract hire is not economic for machines that are needed on the farm for every day use throughout the year. In these cases it will be cheaper to purchase such machines compared to the hire charges.

Operating leases are only available to farmers with workshops who can demonstrate their ability to service and maintain the machines. This is essential to safeguard the value of the machine at the end of the lease period.

Taxation: The hire or leasing charges for machines are treated as normal trading expenses and can be fully offset against income before profit is calculated.

3.7 SUMMARY TABLE

Modality	Interim Ownership	Final Ownership	Principal Advantage	Principal Disadvantage	Taxation
Cash Reserves	Farmer	Farmer	Lower interest charges	Lack of cash for short-term business needs	Depreciation of machine value allowed against taxable profits
Bank Loan	Farmer	Farmer	Lower interest charges with some rural Banks	Collateral needed for loan security	Depreciation of machine value allowed against taxable profits
Bank Overdraft	Farmer	Farmer	Short-term loans	Bank has control of the debt and can demand payment without any notice	Depreciation of machine value allowed against taxable profits
Hire Purchase	Finance Company	Farmer	Collateral is owned by finance company	None	Depreciation of machine value allowed against taxable profits
Finance Lease	Leasing Company	Third Party	Collateral not needed by farmer	Not economic for machines kept over 5 years	Finance charges fully offset against profits before taxation
Contract Hire	Machinery Supply Company	Machinery Supply Company	Seasonal machines specialised machines No assets to dispose of	Most expensive for machines needed all the year on the farm	Hire charges fully offset against profits before taxation
Operating Lease	Machinery Supply Company	Machinery Supply Company	Cheaper than contract hire for long-term lease	Requires proven good maintenance record by farmer	Hire charges fully offset against profits before taxation

4 FINANCING SCHEMES OFFERED BY MACHINERY MANUFACTURERS

Most tractor and machinery manufacturers in Great Britain offer a range of supporting finance schemes through associated or subsidiary finance companies. Examples are:

Massey Ferguson Finance Ltd

Ford New Holland Finance Ltd (Barclays Mercantile)

Fiatagri Finance (Barclays Mercantile)

John Deere Finance Ltd (Highland Leasing)

Renault Agriculture "Capitalshift" (NMB Farm Finance)

4.1 Low Cost or Discount Finance Schemes

The finance companies work in co-operation with the production and selling plans of the manufacturers to promote and market machines. They do this by "discounting" finance charges on certain machines and at different times of the year, and by price adjustments. For example combine harvesters purchased in the preceding autumn, before they will first be used, are usually offered with "0%" finance schemes in order to stimulate and confirm sales outside of the normal buying season. In fact 0% is actually only a marketing aid or sales gimmick. An example of a 0% scheme for a combine harvester purchase in November is given in Appendix III. Although the payments do not include any interest charges it should be noted that the actual sum borrowed is only 40% of the full machine cost because the initial payment is made at the outset and therefore this money is not actually borrowed at all. The interest that this money would either earn in a savings account, or be charged on a bank overdraft, means the actual interest rate is definitely not 0%.

A further important point is that manufacturers can only cover their costs in operating these schemes by higher initial machinery prices that create sufficient profit margin to pay for the finance scheme. There is in machinery finance, as in all other financial management, no such thing as a "free lunch"!

4.2 Deferred Finance ("Balloon" Leasing)

Several manufacturers finance companies are now offering schemes with low annual or monthly repayments but a large final payment at the end of the agreement. An example is at Appendix IV. This scheme called "Capitalshift" is offered by NMB Farm Finance specifically for Renault tractors. The manufacturer guarantees the minimum value of the tractor at the end of the lease or hire purchase agreement which is at least as much as the residual payment. In effect ownership of part of the machine remains with the finance company until the residual or final payment is made. In periods of high inflation the high final payment may become easier to make by the farmer due to the inflation effect on the relative value of money. However, in these conditions there will also be high interest rates which will make the monthly or annual payments much higher than with low inflation.

5 FINANCE FOR USED MACHINERY

Used machinery is a very important mechanisation resource for small farm businesses throughout Western Europe. Used tractors, combine harvesters, forage harvesters, and root harvesters, i.e. the more expensive machines, are all traded extensively throughout Europe. At regional level in Great Britain there are established registers and secondhand machinery brokers. This extends to specialised reconditioning and recycling of spare parts for high value machines. In Europe, currently (1994), the secondhand market is more buoyant than the new market due to strict cost control by farmers. This trade in used machines prevents large farms from being overstocked with machines by offering viable trade-in values, and provides the opportunity for smaller farms to afford mechanisation.

Because used machinery has already depreciated by typically 50% of its original value, it is unattractive to leasing companies and hence hire purchase is the normal finance method. As there is no advantage to manufacturers to encourage used machinery at the farmer level there is virtually no support to this part of the machinery trade cycle. However for large machines, typically combine harvesters, the manufacturers do provide extended credit to the machinery dealers for about 6 months to cover the value of the machine traded in against a new one.

For other used machines, if they are being sold on with a warranty, for example reasonably new machines, then hire purchase is the norm. For older machines of low value (typically machines bought at an auction) these are usually paid for in cash, usually on overdraft.

6 MACHINERY FINANCING - CONTRACTORS AND MACHINERY RINGS

In Great Britain farm machinery contracting businesses and farmers in machinery rings use the same range of finance methods as private farmers and farming companies. The only difference in finance for contractors may be increased initial payments imposed on contractors requiring long term finance on certain machines. This is because contractors have a slightly higher lending risk than established farmers who have good collateral in land and stock. Also contractors often suffer acute cash flow problems due to slow payment by farmers and their rate of business failure is thus higher than that of farming businesses.

In Great Britain machinery rings are simply a structured method of farmers contracting for each other, and in fact many farming contractors have also joined the rings. It is important to note that machinery rings in Great Britain are very different to the original concepts as pioneered in Austria and the rest of the mainland Western Europe during the 1970's and 1980's. In those countries the smaller farm size required all farmers to co-operatively own machines in order to afford mechanisation. Finance for such machines, typically owned by a village community, e.g. the village combine, potato harvester, hay baler, silage baler, is usually through rural banks with special subsidised rates for co-operatives. Very high capacity specialist harvesting operations such as 6 row sugar beet harvesters may be financed in a similar way. A sugar beet harvesting consortium will typically have three partners each with one equal share in the machine, or perhaps split in proportion to the area of crop grown. Finance is by individual bank loan, overdraft or cash for each business. However, pea harvesters are usually owned and operated by separate specialised cropping companies and financed by share capital from the farmers who own the company.

APPENDIX I

Hire Purchase Payment Scheme

A typical hire purchase (HP) finance agreement is outlined below:

Tractor purchase, Recommended Retail Price (RRP)	£ 40,000.00
Less dealer discounts and trade-in allowance	£ 16,000.00
Balance to finance	£ 24,000.00
Financed over three years (36 monthly payments) of	£ 759.60
Total repayments	£ 27,345.60

Alternatively:

3 annual payments , (first one in advance), of	£ 8,732.25
Total repayments	£ 26,196.75

APPENDIX II

Machinery Lease Scheme

A typical machinery lease agreement is outlined below:

Tractor Recommended Retail Price (RRP)	£ 40,000.00
Less dealer discounts and trade-in allowance	£ 16,000.00
Balance to finance	£ 24,000.00
Leased over 3 years, 36 monthly payments of £	756.50
Total repayments	£ 27,248.40

Alternatively:

3 annual payments , (first one in advance), of	£ 8,709.75
Total lease payments	£ 26,129.25

APPENDIX III

Low Cost or Discount Finance Scheme

A typical 0% finance agreement is outlined below:

Combine Harvester Lease/Purchase Plan - November 1993

Combine harvester costing	£ 100,000	
Less allowances and trade-ins	£ 40,000	
Balance to finance	£ 60,000	(60%)
Initial payment	£20,000	November 1993
Second payment	£ 20,000	November 1994
Third payment	£ 20,000	November 1995

APPENDIX IV

Deferred Finance Scheme (or "Balloon" Leasing)

A finance scheme illustrating a high or low residual charge is outlined below:

RENAULT AGRICULTURE/NMB FARM FINANCE

"CAPITALSHIFT" LEASE OR HIRE PURCHASE

TRACTOR	RRP	£ 40,000	
	Less	£ 16,000	Allowances/Trade Ins.
	Balance	£ 24,000	(60%) to Finance.

36 PAYMENTS	Highest Residual +Lowest Rental	
(1 + 35)	£ 10,800.00	£ 475.20

Lowest Residual +Highest Rental	
£ 2,400.00	£ 673.68

Alternatively

3 ANNUAL PAYMENTS

(1 + 2)	Highest Residual +Lowest Rental	
	£ 10,800.00	£ 5,443.44

Lowest Residual +Highest Rental	
£ 2,400.00	£ 7,718.64