Should You Buy or Lease Your Next Vehicle?

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- Though many drivers lease their vehicle, this may not be the most advantageous financial decision.
- For those interested in leasing, however, COMPASS has provided some of the key factors to consider.

Each year about 20% of new vehicle transactions are leases, but is leasing the best option? Other than when business use is involved, purchasing a vehicle is usually the better financial decision, though for some, a decision based on lifestyle may trump a decision based purely on economics.

The monthly lease payment will be less than the loan payment for the same car because with a lease, in the most basic terms, you are paying for the vehicle's depreciation during the lease term, whereas with a purchase, you are paying for the entire vehicle cost. In essence, a lease obligates you to pay for the vehicle's depreciation without the benefit of receiving any of the vehicle's equity. A lessee always has a monthly payment and never has any equity. A vehicle owner enjoys the equity, or the difference between the vehicle's value less any loan outstanding. This equity can ultimately be used as a down payment on the next vehicle's purchase.

If you plan to hold onto a vehicle for five or more years, then a purchase is likely to be a better financial decision than a lease. However, factors such as whether you finance a purchase, the available interest rates for purchases versus leases, and how much money is used as a down payment can impact the holding period before a vehicle purchase is less costly than a lease.

Owners hold onto their vehicles for six years on average, according to R.L. Polk & Co. An analysis conducted by Edmunds Inc. determined that the total out-of-pocket costs over six years of purchasing a new vehicle were less than leasing when the equity of the (owned) vehicle was included. Edmunds' analysis assumed the purchase was financed over five years and leasing was comprised of two 3-year leases. The cost difference equated to 28% of the vehicle's original purchase price.

The Decision to Lease

If your circumstances warrant leasing a vehicle, you should be aware of several factors regarding the terms of your lease. First, from a financial perspective, your monthly lease payments should not be the focus. Just as with a vehicle purchase, you should negotiate the lowest purchase price possible (this is known as the "capitalized cost" in the leasing world). The lower your capitalized cost, the lower your monthly lease payment.

But you should also focus on and negotiate two other numbers: the "money factor" and the "residual value." The money factor specifies how much you will pay in finance charges during the lease term. The lower the factor, the lower your monthly lease payment. To convert the money factor to an equivalent annual percentage rate, multiply by 2400. The residual value is the vehicle's predicted value at the end of the lease. The higher the residual value, the lower your monthly lease payment.

Though there are other fees and terms to be aware of, the foregoing are the most critical to determining the cost of your lease. If you exceed the miles allowed in your lease, you will be charged $0.20 - $0.30 per excess mile at the end of the lease. However, if you expect to drive more than the allotted miles, you can elect to pay a higher monthly lease payment from the outset that effectively charges a lower rate for excess miles.

One last suggestion to consider is Guaranteed Auto Protection (GAP) insurance. GAP covers the difference between the insured value of the vehicle and the higher amount you may owe the leasing company if your vehicle is totaled or is stolen. Basically, it covers the immediate depreciation a vehicle suffers upon leaving the dealer's lot. This insurance is usually included by dealers, but not by all banks.