



by Tom Jackson



# EQUIPMENT financing

Finding the right financial products to keep your cash flowing and the dirt moving

**T**he majority of equipment purchases today are financed with conventional loans, sometimes called retail or installment contracts. With these you typically put in a down payment of some kind, pay off the monthly installments and at the end of the contract – 36, 48, 60 or

some number of months – the equipment is yours outright. Retail loans allow you to deduct the interest and depreciation on the equipment from your taxes and, as you build up equity through your payments, you can also claim that value as a company-held asset.

Leases, on the other hand, can be structured in a variety of ways and tailor made to fit specific job and cash flow requirements. "In the past people were somewhat apprehensive about leasing because they didn't understand it," says Tom Meredith, executive vice president and general manager of CitiCapital's construction equipment finance group. "But as people understand it more, the benefits become more apparent."

Conserving cash flow is perhaps the biggest advantage of a lease, Meredith says. "Your monthly payments are normally lower than a loan, and in general you can get into a lease with less money up front. In addition at the end of the term you may be able walk away from it depending on the type of lease you enter into."

With a lease you don't get to write off interest and depreciation like you do with a loan, but your payments are treated as a business expense. To determine whether or not you come out ahead expensing the payments of a lease or deducting the interest and depreciation of a loan requires a comprehensive review with your accountant and tax advisor. No one solution or formula will work for everyone.

But cash flow and accounting considerations should play a big role in this decision.

"Cash flow is the driving force now in business," says Kevin Freidheim, vice president and director of Key Equipment Finance's construction and industrial group. "You need to have liquidity, some flexibility in your business and an understanding of the timing of your cash inflows and outlays. It doesn't make financial sense to tie up all your working capital paying cash for hard assets, especially a first time buyer. He probably is spending much more than he's earning, and if he puts all his cash into his equipment he's not going to have any operating capital to run his business. His balance sheet can get pretty thin."

The extra cash flow can also benefit your bonding status. Most bonding companies like to see a lot of cash flow and little debt. With the ability to qualify for higher bonds you can also sometimes qualify for larger jobs.

**Firm commitment or a trial run**

One of the big advantages of a lease is that it can be structured with a great deal of flexibility to meet short-term job requirements or enable you to react quicker to changing market conditions.

Jack Pattison, manager of market development for

John Deere Credit, says one of the first variables to consider is how long you will need the equipment. "Are you replacing a machine that you're using day in and day out, or is this being acquired because of a specific job or short-term need?" he asks. A core machine, one you plan to use on all your jobs year in and year out, is often best financed with a loan. But if you need that capacity for one big temporary job and you can't say for certain you'll need it after that job, a lease can be set up for as little as 12 months. "That's a very big advantage of a lease," he says. "Why make a long-term commitment today when you could postpone that decision for 12 or 24 months. At that point you'll have a clearer idea of your ongoing business needs as well as any changes in the market."

"Loans are pretty straight forward," Pattison says. "But a lease can look very much like a loan where you own the equipment at the end of the term for as little as a dollar, or they can be structured similar to a rental payment where you have a very short-term commitment to the machine and you're just paying for the use of it." Leases can also be constructed to give you the ability to change the terms in mid-stream. If work picks up, some leases allow you to convert to a loan.

"Contractors can sometimes get hung up on having that ultimate low payment and get into a lease that doesn't match their work at hand," says Anthony Travis, manager of strategic sales and leasing for CNH Capital. "We give contractors the flexibility to make an economic decision during the term of the lease and several options on the backside or end of the lease. Contractors can choose to purchase, walk, trade, renew or refinance the lease."

**Big vs. small, young vs. old**

Large contractors often have a mix of financing arrangements for their fleets, says Mark Bainbridge, Cat Financial's manager of the U.S. Southern region, to meet a number of criteria, both job related and accounting related. "You may have a customer who owns a certain percentage of their machines, leases a certain percent and rents a smaller portion to maximize flexibility of their equipment utilization," he says. Many small contractors tend to prefer taking out a loan on their machines, while many large contractors seek to lease core machines, rent for spot needs and elect to purchase at later date. The advantage of leasing these core machines is that they're brand new, have lower maintenance costs, plus in many



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cases customers can bundle a service and maintenance agreement into the lease.

Company culture may also play a deciding role in your choice of financial products. Pride in ownership can be a strong motivator. Bainbridge says. Some people have strong feelings about ownership. Others prefer to lease and flip their equipment every 36 months," Bainbridge says.

And while it's dangerous to make any generalizations, there is a trend toward ownership with older contractors and toward more flexible financial arrangements with their sons and daughters who have been to business school and understand the time value of money.

"Contractors are realizing how valuable it is to stay liquid and to keep cash invested in their business," Pattison says. "Sheet metal is important but as an investment it's not the best thing if they can pay for the use of it and keep money in the business and internally get high rates of return. Certainly for the younger contractor, cash flow is king."

The broader answer to the question of leases vs. loans comes down to understanding the total cost of operating the equipment, says Don Pralle, senior director of construction financial services for CNH Capital. "You want to make sure with the cash flows that the hour utilization matches with the project requirements," he says. "At the end of the day the tax benefits are important, but you don't want to make it too complicated. On the lease side it's really the payment stream that makes the difference. On the loan side it's the total cost of ownership."

**Getting prepared**

As a contractor the amount of homework and preparation you do prior to talking to your sources of financing is key to your success.

The first question you're liable to get hit with is, "Why do you need this piece of equipment and how does it fit into the financial goals of your company?"

"The contractor should know something about how the equipment will be used, the additional revenue it will generate and any additional costs associated with it," Meredith says. "It's also helpful for the contractor to provide projections regarding his or her expectations of where the business is going over the next few years because most financial institutions want to know how the lease or loan is going to be repaid."

"The first question we ask is, 'Why?'" says Travis. "A

lower down payment or a lower payment stream is not necessarily the best for everybody. The contractor needs to determine if his motivations are tax driven or accounting driven. So we ask the contractor a lot of questions and offer him alternatives. I always want the customer to come back so I want to make sure I give him the right product. It may be a case where a customer is set on a lease and I have to steer him into a loan because a loan best fits his needs."

Also be prepared to give an accurate, complete and detailed report on your company's financial status. "Any credit department is going to want to see a basic set of year end and interim financial statements, including cash flow, P&L and a balance sheet," Bainbridge says, "For the beginning contractor just getting underway, these can be fairly basic statements, but statements that are important and necessary nonetheless."

If the year end financial statement is more than six months old, an interim statement would also be helpful, Meredith adds.

As a contractor gets bigger and looks to finance greater dollar amounts the financial reports need to reflect their increasing complexity. "The contractors who are just getting underway in many instances don't have even basic financial statements," Bainbridge says. "But it would be helpful if they did. This would demonstrate to the finance company that this is someone who has taken the time to sit down and think about what he or she wants

their business to be and where he or she wants it to go in the next couple of years." This doesn't have to be a 10-year plan, but a one-, three- or five-year plan can certainly help, he says. "As the customer grows and their exposure level gets higher they're going to have to get a little more sophisticated in how they're producing those statements and eventually have an outside accounting firm helping to assist in the preparation of their financial statements and in many cases auditing their statements," he says.

Inevitably a credit check will be run at the time you apply for your lease or loan and it pays to check out your own credit history beforehand to correct any mistakes or prepare to answer any questions the lessor may have. "For first time buyers it helps to have a mortgage, a car or maybe a business truck purchase to show you have some established credit history," Freidheim says.

If you've had trouble in the past with credit problems,



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don't try to hide it; deal with it upfront. "Someone who may have had a bad year or some credit issues in the past should be prepared to talk about it," Meredith says. "Talk about what happened, why it happened and what you've done to make sure it won't happen again."

The first-time buyer needs to put his best foot forward and supply credit and bank references, Freidheim says. Make sure everything is done right. Fill out the applications completely. "I can't tell you how many half-filled applications we get," he says. "And if you supply references, let those people know so they'll return a call for you. That's one of the things that typically slows down our credit approval is trying to get the references to call back."

If you've had credit or payment problems in the past it won't make you ineligible for a business loan or lease, but since your risk profile is higher you may have to pay higher interest rates or put up larger down payments until you can reestablish your credit rating.

### Avoiding surprises

In negotiating the terms of a lease it's important to pay attention to the conditions and restrictions for the final disposition of the equipment at the end of a lease. Just like many car leases, equipment leases often specify how many hours the machine will be used over the course of the lease and in what condition it will be returned.

In some cases a contractor wanting to get the lowest possible payment will underestimate the number of hours he needs the machine or the severity of the application, Travis says. If that happens and the leasing company is expecting a machine with a higher residual value, the contractor may have a liability for the difference.

The solution is to review the terms of your lease carefully and to be honest with yourself. If you're not entirely sure what your usage will be you can always set up a lease purchase option or other arrangement that gives you some flexibility during the lease.

### Quicker than you think

As complex as the qualifying process may sound, if you have all your ducks in order, approval may take less than an hour and, depending on the equipment source and inventory, you could be loading up your trailer with a new machine the same day. This is especially true for financed amounts under a certain dollar figure.

"We have credit scoring tools for smaller dollar transactions," Bainbridge says. "So a transaction that comes in under those levels can be very quickly scored, auto-approved and a document package produced at the Caterpillar dealership for the customer to sign and take delivery of the equipment that day."

If your purchase is under \$250,000, for the most part it's a routine decision," Freidheim says. "The finance company is going to look at what you're buying, how much it's worth, how you paid your bills and how you handled your personal finances, and make a decision from there."

"The larger the transaction, the more information we need," Meredith says, "but if it's a transaction of less than \$200,000 we generally don't need a financial statement and the credit decision can be made very quickly with only a credit application."

### Operating vs. capital leases

Textbooks have been written and Ph.D.s have debated for years over the difference between operating and capital leases. In most cases this is stuff for your accountant or tax advisor to sweat over. But it helps to understand the basics since contractors use both types depending on their business needs.

A capital lease is designed to help you acquire capital goods – yellow iron as it were – and in many ways resembles a loan. The lessee keeps the asset on his books and gets to depreciate it and takes on all the risks and rewards of ownership. At the end of the term the lessee typically has a buyout option or balloon payment.

An operating lease is almost like renting the equip-

## Captive vs. independent leasing sources

Unless you're dealing with your local bank you'll be getting your financing from what the industry calls either a "captive" source or an "independent."

The captives are the financing arms of OEM dealers. Their goal is to sell the manufacturers' iron and they can get aggressive on rates for certain types of equipment the OEM wants to push, plus sometimes bundle the dealer's or OEM's warranty and service packages in with the financing. The independents compete primarily on rates and can also arrange your financing

on a variety of equipment from different OEM dealers regardless of brand.

In either case, or even with your local bank, you want to look for a financing source that offers both loans and leases. You'll also want to work with an institution that knows the construction business and the values of the machinery and can create the products that best serve your working and financial needs.

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ment – you have a short-term commitment to the machine and you're basically just making payments for the use of it.

If you're not sure about any of this there are four criteria the government and accountants apply to determine if a lease is a capital lease or an operating lease. To wit, a lease is considered a capital lease if it meets any of the following criteria:

1. If the lessor transfers ownership at the end of the term
2. If the lease contains the option to purchase the asset at a bargain price
3. If the lease term is equal to 75 percent or more of the economic life of the asset
4. If the present value of the lease payments equals 90 percent or more of the asset's total value.

### Master leases vs. individual leases

For mid-sized and larger contractors who acquire significant numbers of machines every year, a master lease may be worth looking into. In a master lease you negotiate rates, terms and conditions just once, to cover a variety of equipment purchases and reduce the paperwork and time you would otherwise spend going through the same process for each individual machine.

"It's a very efficient way of purchasing equipment because you have your basic document agreed to up front and as you purchase additional equipment only minimal documentation is required," Meredith says.

"They're popular with larger customers because it's easier for them, and us, to manage the documentation," Bainbridge says. "We're talking about very large customers with a regional or national presence. With a master lease the customer can buy equipment from any Caterpillar dealer across the country and have one set of documentation to manage that purchase process. No matter where they lease the equipment the terms and conditions will be the same."

### Contractor friendly arrangements and services

If there was ever an industry where "you can have it your way," the equipment financing industry would qualify – as well it should given the dollar amounts involved. As you prepare to start shopping for a source of financ-

## Leases not just for big machines

Companies in the construction industry have historically owned their fleet vehicles such as pickup trucks, says Mark Conroy, national sales vice president for LeasePlan USA. This is primarily because most companies tied their equipment costs into each job; therefore it was not as important to manage those costs. Now, with margins tighter, they are looking for ways to earn margin by efficiently running their fleets. And, as with heavy equipment, leasing your company vehicles can free up cash flow so that you can use that money to invest in your business and your employees.

But successfully managing a fleet is more than just leasing vehicles, Conroy says. It's knowing how to better manage your operating costs, which directly affect your bottom line. From smarter buying and remarketing decisions to managing maintenance costs, an effective fleet management program keeps your drivers on the road and your business moving forward.

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For contractors who shut down for a period of time because of weather or seasonal considerations, skip payments allow them to pay their monthly payments only during the months their equipment is working.

ing understand there are a lot of companies competing for your business and one of the most beneficial ways they compete is by offering tailor-made solutions to your contracting needs.

Skip payments are one such solution. It's not for everybody, but for contractors who shut down for a period of time because of weather or seasonal considerations, skip payments allow them to pay their monthly payments only during the months their equipment is working. Thus you avoid a hit on your cash flow the months when you're not bringing in any cash.

And while leases are generally considered more flexible and customizable than loans, there are creative loan arrangements as well. You can get split rate terms in which the payments are low at first to help get you into the equipment and increase later, or equity-building terms that start with a higher payment to allow you to assume more of the tax advantages of ownership early on. Bottom line: It pays to shop around.

**EW**

## Web resources

### For more information contact:

Caterpillar Financial  
[www.catfinancial.com](http://www.catfinancial.com)

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