

Choices in financing

Making accurate decisions on financing can be a make-or-break proposition for your ROI



by Dennis Mellersh

Improving the bottom line can be a tough challenge for construction contractors. One way to improve the profit picture is to make sure that the financing model or models chosen when acquiring heavy equipment offers the best return on investment possible.

As our discussions with a number of industry experts revealed, a variety of financing options are emerging for heavy equipment that increasingly recognize the particular needs of construction contractors. Some of these include:

- Payments specifically geared to cash flow
- Low or no down payments
- Equity-building models
- Terms reflecting actual equipment use
- Flexible payment structures
- Higher residuals

Bill Scarlett, senior territory manager, Caterpillar Financial Services, Oakville, Ont., told *On-Site* that while leasing had previously been driven mostly by tax benefits, "Today we see an increasing number of customers asking for leases largely to address cash-flow management."

Some of the key factors to consider

when deciding to lease or purchase can be summed up by answering the basic question of whether ownership is intended after the financing term, or whether it will be a case of "use and return."

"If the intent is to use the equipment to achieve the lowest operating cost and ownership is not an issue, leasing can help accomplish this goal. As profit margins decrease and costs go up, leasing can be an attractive alternative over purchasing," Scarlett says.

He emphasizes that the key is to have good cash flow. "Structuring a deal properly where the 'machine pays for itself as it works' will provide for better cash flow and put some profit back into the contractor's pocket," he says.

Scarlett also noted that "The trends that have grown out of managing cash are certain types of lease products that do not involve a large initial cash outlay up-front. Unlike loan financing where provincial sales tax and GST may be requested by the lender to be paid up-front, lease products, on the other hand, collect the provincial sales tax and the GST along with the monthly payment."

He says that one finance model that is becoming very popular is a "capital lease where the lessee can take all of the

capital cost allowance (depreciation) and still have the luxury of paying the applicable taxes along with the monthly payment."

Looking at financial models overall, Scarlett says that although most lease and loan products are comparative, "What you find is a lot more creativity regarding the actual structure of the deals."

According to Mark Smye, senior vice president, sales and marketing, transportation and construction, CIT Canada, equity-building approaches are now playing a new and larger role in the marketplace. Increasingly, contractors are looking to match their equipment assets to the projects they are doing, such as having a 36-month lease for a 36-month project.

Smye also notes a growing trend toward rentals, which is more of a short-term focus where a lease is generally longer-term. "There might be a need with a contractor, for example, for requiring a particular piece of equipment for a shorter period of time than a normal lease would involve. It might be for 12 months, for instance, whereas a typical lease could be in the area of 48 to 60 months. So there is a trend to rental for short-term requirements," he says.

One factor in the lease-versus-buy decision that Smye says should be considered

by contractors is whether manufacturers are offering incentives for the purchase of their equipment, such as a 0 per cent financing charge for 36 months. "The contractor may want to buy under this circumstance," he says.

Frank Rizzardo, president and general manager of Emcon Services Inc., a highway maintenance contractor headquartered in Merritt, B.C., says that although "we generally lease to purchase, in Alberta we have some instances where we lease to return. It usually depends on the terms offered by the dealer."

Rizzardo gave an example of financing innovation in Alberta where a dealer rents a truck for road maintenance for five months and then converts the truck for concrete for seven months and rents it again. "After a few years, the dealer would sell it to either one of the users. This has not been available in B.C., but was available in Alberta through a dealer package."

"Generally," Rizzardo says, "we are looking for residual values that relate to how the use of the equipment impacts on the life of the vehicle. Also, we are usually seeking higher residuals, governed by hours of use, which results in lower monthly payment terms."

"We also want to increase the number of options in the lease. An example is exit windows if the volume of the work changes. Also, payment windows are good if you are in a position of having extra cash."

Another development Rizzardo describes is "the growing number of rental firms that are linked to specific manufacturers. They fund the rental house and replace the equipment on a periodic basis. In that case the rental rates are very competitive because the rental house has built-in means of disposing of the used asset."

"Leasing as a whole has changed over the years – it used to be a much stricter and standardized format. Now leasing is becoming much more flexible to get the business," Rizzardo says.

At the dealer level, Helene Bernardo, finance manager, Fort McMurray and

Ten questions construction contractors should answer before signing a lease

1. How am I planning to use this equipment and for how long will I need it?
2. Does the lessor understand my business and the role of this transaction in it?
3. What is the total lease payment, and are there any other costs I could incur before the lease ends?
4. What happens if I want to change the lease or end it before the term expires?
5. How am I responsible if the equipment is damaged or destroyed?
6. What are my obligations for the equipment in terms of insurance, taxes, and maintenance during the lease term?
7. Can I upgrade the equipment or add equipment under this lease?
8. What are my options at the end of the lease?
9. How do I return the equipment?
10. Are there any costs at the end of the lease?

Source: *Canadian Finance and Leasing Association and the Equipment Leasing Association of America*

Canadian construction contractors 2007 equipment overview

Almost half of contractors plan to invest in new or pre-owned equipment in 2007. Thirty-eight percent expect to acquire new equipment.

Contractors plan to meet 18 percent of their equipment needs in 2007 with machinery they lease, rent, or rent with an option to buy. Seventeen percent say they will rent more equipment in 2007.

Contractors cited a variety of reasons for renting rather than buying equipment, including limited need (68 percent), lower cost (30 percent), and unexpected need (24 percent).

Seventy-six percent of contractors said that interest rates are an important factor in selecting a financial services partner.

Examples of equipment contractors expect to rent in 2007

- Excavating equipment 17%
- Compaction equipment 15 %
- Crawler/dozers/wheel dozers/ bulldozers/tractors 7%
- Loaders/backhoes 6%
- Trucks 4%

Source: *CIT Construction Industry Forecast 2007: Canadian Overview Section*

Edmonton, Alberta sales office of Hammer Equipment Sales Ltd., told *On-Site*, "Leasing can improve cash flow and cash flow is what it's all about these days. The client-side need for strong cash flow is the real driver in leasing."

"The payments are generally smaller and more affordable versus a purchase. What clients want is to get the low-

est payment they can arrange. And if a residual is involved, the client wants full disclosure of the established residual at the end of the lease. The client can buy or trade the equipment at the end of the lease. Because of the lower payments and flexibility involved in leasing, clients can obtain more equipment," Bernardo says.

“We can structure the lease for the trends of the construction industry and, for example, offer lower payments and even no payments in the client’s non-busy times. The idea is to tailor the lease as much as possible to the client’s cash flow,” Bernardo notes.

“An alternative to the regular lease is an equity builder in which there are no down payments and accelerated payments at the beginning. Generally speaking, if the client has good credit rating, there can be less down and more accelerated payments at the beginning of the contract, such as for six to nine months,” Bernardo says.

“There is a tremendous opportunity cost to the ineffectual use of capital. Equipment that is used three or even six months of the year is generally a poor candidate for purchase.”

David Powell, president of the Canadian Financing and Leasing Association says that leasing has good flexibility and can amount to significant savings annually. Because construction can be a seasonal business, the payments “can be structured so they are geared to cash flow. Essentially, leasing is cash-flow based, compared, for example, with a traditional loan that tends to be based on a net-worth approach. Leasing is not necessarily the cheapest way to go, but you pay as you go with the revenue the asset is producing.”

The desire of customers to want to pay for “power by the hour” is one of the trends seen by Richard McAuliffe, chief operating officer of Key Equipment Finance Canada Ltd. “Customers are starting to want true operating

leases and bigger back ends. They want the economic repayment terms to match the depreciation of the asset. Customers with lower usage want payments based on use. They want structured transactions.”

McAuliffe cites a number of key factors that should be considered in making equipment-financing decisions:

- Cash flow
- Tax savings
- Balance sheet management
- Economic structure
- Simplicity

On tax savings, for example, McAuliffe notes that leases are 100 per cent tax



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deductible and the after-tax cost may be less than a loan. He also says that operating leases do not attract capital tax, where a traditional loan does.

On structure, McAuliffe says, "The idea is that customers want to match revenue with expenses, or asset life with debt repayment. A lease gives multiple purchase and renewal options. In leasing, the asset itself is usually the only asset required."

Regarding simplicity, McAuliffe says leasing is a straightforward process with easy documentation and there is an ability to renew or upgrade during the term.

An emerging trend he sees is "early term buyout for customers with excess cash. Generally, customers want more financing flexibility and if you are not flexible, you will not get the business. Customers are now looking for the same kind of flexibility that is available in mortgages, such as being able to change terms."

"Projects like the Oil Sands are setting trends. People need the equipment now and want to pay for it with future earnings. Customers are looking for flexible return provisions, including hours of use, location for equipment return and even specifying the tire tread wear. The main factors are flexibility, and the dollars and terms they need for big projects," McAuliffe says.

Renting offers its own unique opportunities. Michael Kneeland, executive vice president of United Rentals Inc. gave *On-Site* what he considers the top ten reasons to rent:

1. Conserve capital and control expenses
2. Ensure the right equipment for the job
3. Reduce downtime 24/7
4. Eliminate costly upkeep
5. Save on disposal costs
6. Achieve zero obsolescence
7. Simplify documentation
8. Encourage accountability
9. Improve regulatory compliance
10. Achieve accounting control

Locating financing sources

In addition to talking with construction equipment dealers, one of the ways you might want to start your search for a financing source is to check out the website of the Canadian Finance and Leasing Association (CFLA) at www.cfla-acfl.ca.

The CFLA website has a section titled, "find a financing partner." The section includes a construction equipment section and a listing of products such as loans and sales financing, operating leases, and capital financing leases. You then indicate the value of the transaction you are contemplating for the equipment you are considering from a number of options such as \$100,000 to \$250,000 or \$250,000 to \$500,000, ranging up to \$10 million. The website then generates a list of companies offering the services you need for your type of transaction and financing product desired.

The site also features a detailed glossary and explanation of financing terms that may be helpful.

As an example, on conserving capital and controlling expenses, Kneeland says, "When equipment is purchased, the buyer assumes all costs of ownership, including capital outlay, transportation, storage, preventive maintenance, repairs, parts, licenses and insurance. When equipment is rented, these costs and responsibilities shift to the rental company, while the customer's capital is preserved for other, more profitable uses. There is a tremendous opportunity cost to the ineffectual use of capital. Equipment that is used three or even six months of the year is generally a poor candidate for purchase."

In saving on disposal costs, Kneeland says, "Many equipment owners sell their used equipment when it still has market value, so they can replace it with newer models. Disposal costs can mount up: cleaning, pre-sale servicing, advertising, time spent selling, and in some cases, transporting the equipment. This can make it tempting to hold onto tired equipment much longer than is advisable. With renting, the customer

doesn't have to turn equipment to get the benefit of the newest, most productive model on every job."

Overall, a common piece of advice from those knowledgeable about heavy equipment financing methods is that there can be tax implications with whatever method is used to pay for the use of equipment, whether it is ownership, long term leasing, or shorter term renting. Experts advise construction contractors to consult with a tax expert before making final decisions. ♦

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