Work Sample

Financing Capital Expenditures

EVALUATING THE PRIMARY OPTIONS

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Periodic capital expenditures are vital to an organization's ability to maintain and expand operations, build revenue and enhance profitability. Nearly as vital is making good decisions about the manner in which capital goods are financed. That's because an organization's financing choices determine, among other things, the after-tax cost of acquiring needed capital equipment, and the availability of working capital for other uses.

Industry research suggests a growing volume of capital goods are being financed through leases or loans.

Estimates by the Equipment Leasing & Finance Foundation[1] indicate that in 2017, the proportion of equipment purchases financed via leases or borrowing will reach 63% of the $1.7 trillion in total purchases, up from 53% in 2011. In addition, the dollar volume of lease- or debt-financed equipment purchases will have grown by 52% since 2011, versus only 32% for non-financed equipment

[1] 2015 State of the Equipment Finance Industry report

acquisition.

Had interest rates dropped significantly over this six-year period, that might help to explain the trend. But since interest rates have remained relatively stable, the more logical explanation for the rise of financed capital equipment purchases lies elsewhere, including innovation and growing flexibility in financing arrangements.

Financing Advantages

A quick review of the basic elements and benefits of financing equipment acquisition via lease or secured borrowing sets the stage for a closer examination of the topic. For the equipment acquirer, the following are benefits common to borrowing and leasing:

- ***Cash conservation:*** Working capital remains available for alternative purposes.

- ***Inflation hedge:*** Should inflation heat up, the equipment acquirer will be making future loan or lease payments with increasingly "cheap" dollars.

- ***Superior expense planning:*** With fixed loan or lease terms, you know exactly what you will be paying for the next few years, making it easier to generate cash flow forecasts and budgets.

- ***Obsolescence management:*** Setting specific time limits on financing periods and ownership duration ensures you will be able to replace equipment at regular intervals.

- ***Relationships with equipment experts:*** If you work with a financial institution with a robust equipment financing department, you gain access to expertise on the durability, quality and pricing of various equipment brands.

- ***Product and service bundling:*** Adding equipment leases and/or secured loans to the portfolio of financing and cash management services you are already using can generate synergies and preferred pricing from your financial institution.

Loans Versus Leases

Borrowing and leasing have their own distinct benefits and drawbacks.

With a loan, the borrower owns the financed equipment outright, subject to the lender's security interest in the equipment should loan covenants be violated. Ownership conveys tax benefits to the borrower, including depreciation, tax credits and deductibility of interest.

On the other hand, loans can weigh on the balance sheet, constrain further borrowing, and entail giving up some cash for a down payment.

A lease, in contrast, does not require a down payment, nor involve ownership of the equipment. That means at the conclusion of the lease term, the lessor is left with the task of disposing of the equipment or, depending upon the lease terms, selling it to the lessee (at the lessee's option) at a price whose formula is established in the lease contract.

Lease payments are tax deductible. Other tax attributes depend upon the nature of the lease.

With a *tax lease*, also known as an *operating lease*, the lessor owns the equipment for tax purposes and claims tax credits and depreciation deductions. The lessor's lower after-tax cost of acquiring and owning is factored into terms offered the lessee.

In contrast, a *capital lease* (also called a *finance lease*) enables the lessee to claim tax benefits. However, capital leases are subject to at least one of four requirements that, in effect, transfer more of the risks of owning the assets to the lessee. Here are the four:

1. The present value of the lease at the outset must exceed 90% of the original cost of the asset,

2. The lease term exceeds 75% of the useful life of the leased asset,

3. Title to the leased assets must convey to the lessee at the end of the lease, or the lessee can purchase the equipment for a price below its market value, or

4. The leased asset is for a highly specialized purpose with no alternative use to the lessor.

Tax Rules and Accounting Standards

Assessing the relative attractiveness of leasing versus financing capital purchases with debt can be like aiming at a moving target, due to changing tax rules and accounting standards.

In 2015, Congress altered the equation by enacting the "Protecting Americans from Tax Hikes" (PATH) Act. The law enables capital equipment purchasers (or lessors that can claim the tax benefits) to write off up to $500,000 annually for the purchase of new or used equipment in a Section 179 deduction. (Most capital equipment qualifies, along with off-the-shelf software.)

That $500,000 annual cap is reduced, however, dollar for dollar, by the amount that the company's total capital goods investment in a given year exceeds $2.5 million. For example, if a company invested $2.6 million in equipment in 2017, its maximum deduction would be limited to $400,000, since $2.6 million exceeds $2.5 million by $100,000, which is subtracted from the $500,000 ceiling.

Under the PATH Act formula, a company that invests at least $3 million in equipment in a given year would lose out on the Section 179 deduction altogether. Therefore, if operationally feasible, a company might elect to pace its equipment acquisition in a manner that would allow it to maximize Section 179 deductions.

However, there is no annual dollar limit to equipment acquisition to claim bonus depreciation, another tax incentive contained in the PATH Act. Bonus depreciation is only available for new equipment purchases, and it will be phased out, unless Congress decides to renew it.

With bonus depreciation, the equipment purchaser (or lessor in the case of a capital lease) can deduct 50% of the equipment's value in the first year, in addition to taking a Section 179 deduction. Also, the 50% first-year bonus depreciation is in addition to the regular MACRS (Modified Accelerated Cost Recovery System) depreciation schedule deductions for the given category of capital good.

In 2018, the 50% first-year bonus is scheduled to be reduced to 40%, then to 30% in 2019, and eliminated in 2020.

When total allowable depreciation deductions exceed corporate profits, unused deductions can be applied against future earnings as a loss carry-forward.

Another factor influencing the leasing environment is pending changes to accounting standards that, in 2019, will require operating leases to be recorded on corporate balance sheets.

Conduct a Holistic Review

Determining the best way to finance a capital equipment purchase, including not financing at all and instead tapping available cash, requires a holistic review of your financial, tax and accounting situation. The accompanying case studies illustrate scenarios in which each of the four possible approaches made sense to different companies.

Having options is a good thing. The equipment financing professionals at BB&T are ready to help you determine which ones might be most appropriate for you.

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Rationalizing the Four Different Strategies

The following four "real life" transactions illuminate the thought processes that led BB&T clients to choose different capital equipment financing strategies.

▪ **Choice: capital lease** (lessee receives tax benefits)

Basic facts: $2,718,560 needed to pay for 20 new Volvo over-the-road tractors. Company chose a 48-month TRAC (terminal rental adjustment clause) lease over a 60-month full payout loan.

Primary rationale: The lease payment was lower than the loan payment, improving monthly cash flow, and the lessee replaces its tractor inventory every four years. This lease structure lets the company turn the tractors in at the end of the four-year term.

Monthly lease payment: $45,284.93.

Loan payment would have been: $48,797.91.

▪ **Choice: operating lease** (lessor retains tax benefits)

Basic facts: $3,425,000 needed for new construction equipment. The company chose a 48-month fair market value lease with a 36-month early buyout option, rather than opt for a 60-month-full payout loan.

Rationale: The ability to return the equipment at the end of four years was attractive, and the lease payment was less expensive, improving monthly cash flow. Also, this structure qualified as an operating lease, so the lessee was able to move the debt off balance sheet.

Monthly lease payment: $53,698.10

Loan payment would have been: $61,099.53.

▪ **Choice: loan**

***Basic facts*:** $1,057,229 needed for new lab testing equipment. The client considered two options: a 42-month fair market value lease and a 48-month full payout loan.

Rationale: The company wanted to be the owner of the equipment and take the depreciation, monthly loan payments were less expensive than the lease payments, and the borrower planned to keep the equipment for at least 10 years.

Monthly loan payment: $23,362.58

Lease payment would have been: $24,706.45

▪ **Choice: acquire with cash**

Basic facts: $896,149 price tag for new office furniture, a telephone system and highly efficient lighting equipment. The client considered paying cash as well as taking out a loan or leasing.

Rationale: The total interest cost over the course of a five-year loan would have been about $46,000. The client planned to keep the equipment long term (about 20 years). The total project included about $300,000 for new wiring, drywall and other construction related costs. Since these “soft costs” did not qualify for traditional equipment financing, the company would have had to pay cash for about one-third of the project anyway. Also, this company has significant liquidity and prefers avoiding leverage when it can.