EQUIPMENT FINANCE

BREAKING DOWN YOUR EQUIPMENT FINANCE OPTIONS

This article is a compilation of news, information and perspective on matters affecting businesses and business leaders today. This insight is being provided to keep you up to date on the latest developments and trends influencing these topics. These views do not necessarily represent the views and opinions of PNC. For additional research on these topics, please consult the sources cited in this article.

The equipment financing decision goes beyond determining how to pay for an item. It is a decision that needs to be made in the context of a company's overall financial situation. There are four main ways to purchase equipment for a company:

- Paying cash
- Equipment loans
- Operating leases
- Capital leases

Let's take a look at some of the features of these options.

PAYING CASH

Paying cash is straightforward. A company can write a check for the cost of the equipment and they own it. A company can reduce one asset, cash, and add another asset, equipment. Over the life of the piece of equipment, the owner can expense the depreciation charge for tax purposes while the company benefits from the output of the equipment.

The downside of this approach is that the cash is gone. Buying this piece of equipment may or may not have been the best use of money, which is now unavailable to fund other business needs. Further, an up-front cash investment typically doesn't align well with the long-term use of commercial equipment where benefits are derived over time.

AN EQUIPMENT LOAN

With an equipment loan, a company can borrow some or all of the money to purchase equipment. The loan is repaid over time with interest. The company owns the equipment free and clear at the end of the loan term after all payments have been made. The interest is a tax-deductible expense, as is the depreciation on the value of the equipment.

The advantage of an equipment loan is that companies are preserving cash for the current needs of their business. This frees up cash for operating expenses or other uses. The loan is secured by the equipment itself, but is also based on the credit of the business.

Using a loan also allows companies to employ the use of leverage in their businesses. This refers to using borrowed funds to increase or leverage up profits.

A loan can be a bad idea in the case of a company that already has a significant amount of debt on its balance sheet. Too much debt can expose a company to extra financial risk should the business environment sour. This can also make obtaining additional financing difficult and expensive in the future.

AN OPERATING LEASE

An operating lease is a transaction that allows the company to use the equipment without taking ownership of the equipment. Think of an operating lease as a "pay for what you use" arrangement where a primary advantage is the ability to manage equipment life cycles more effectively.

A properly structured operating lease allows companies to obtain the equipment they need within their budgetary constraints. Payments can be tailored to their unique financial situation and needs.

An operating lease is essentially a rental agreement for the equipment. At the end of the lease period, after all required lease payments have been made, the company doesn't retain ownership, or have

There are many factors to consider in deciding the best option for obtaining the equipment businesses need to move forward.

any other financial obligations with regard to the equipment.

This can be a good solution if the equipment is the type that can become obsolete, allowing the company to have access to up-to-date equipment for its needs without tying up cash.

The operating lease may offer a tax deduction for the lease payments and there may also be a tax deduction available in connection with the removal of any old equipment, if applicable.[1]

CAPITAL LEASE

A capital lease differs from an operating lease in several ways. First, the equipment appears on the lessee's balance sheet as if they owned the asset. The company leasing the equipment can claim a tax deduction for both depreciation and the interest portion of the lease payments.

Current GAAP accounting rules require certain conditions to classify a lease as operating capital lease, including:

- A transfer of ownership at the end of the lease period.
- The lease terms must contain a bargain purchase option at the end of the lease term, allowing the lessee to purchase the equipment at a discounted price.
- The lease term must be at least 75% of the asset's estimated life.
- The present value of the lease payments must be at least 90% of the equipment's total.

At least one of these conditions must be met in order for the lease to be considered a capital lease.

This option is, in many ways, similar to a loan in that there is little, or no cash outlay up front, conserving the lessee's cash for other business purposes. The transfer of ownership and the bargain purchase option might also appeal to companies that want to retain ownership of the equipment after the lease term.[2,3]

BUSINESS FACTORS TO CONSIDER

There are many factors to consider in deciding the best option for obtaining the equipment businesses need to move forward. A few things to consider:

- **The current capital structure of a company and the balance sheet implications of various equipment financing/purchase alternatives.** Our dedicated equipment financing team at PNC will look at the potential implications on the firm's capital structures, along with other factors, to help decide on the best financial option to obtain the equipment needed to grow the business.[4]
- **Companies' equipment and capital spending plans.** Rather than looking at financing options for a single piece of equipment in a vacuum, PNC works to look at all of a company's capital spending plans over the next few years and help decide on the best financing option for equipment needs in the context of these plans.
- **Cash considerations.** Investing cash to fund "current" core business operations instead of funding depreciating capital expenditures is a generally accepted best practice. In addition, financing allows the business to match revenues to expenses over the useful life of the asset more effectively.

- **The tax implications of an equipment financing decision.** This can be a large factor and our experienced team works with companies and their tax advisers to help make the best decision.
- **Financial statement/profitability considerations.** This can be critical to a company's ability to obtain financing for both short-term operating needs and long-term growth.
- **The decision as to the terms and type of any financing arrangement.** You should consider how long the equipment will be needed, the expected life of the asset and whether or not your company wants to own the equipment at the end of the financial term.

The decision to obtain new equipment for businesses is one that is not made lightly and involves taking a strategic look at a company over the long term. The decision as to how to best finance that purchase is also a strategic one.

To discuss these topics in more detail, please contact your PNC Relationship Manager.

1 https://www.investopedia.com/terms/o/operatinglease.asp

2 https://www.investopedia.com/terms/c/capitallease.asp

3 http://biostarlighting.com/tax-advantages-of-operating-leases/

4 https://s3.amazonaws.com/external_clips/attachments/1534421/original/GTK_EquipmentFinance.pdf?1510151877

5 https://bondstreet.com/blog/equipment-financing-guide/ (used as a general source)

CIB BC PDF 0218-0149-728503

PNC EQUIPMENT FINANCE