

## events calendar

### May 2008

- 13-15 ALAW 2008  
Plymouth, Mich
- 21 Building Lean Safety into the  
Company Culture  
Livonia (Detroit), Mich.
- 28 FabCast--Maximizing Your R&D  
Tax Credit Opportunities  
10 -11:30 a.m. CDT

### June 2008

- 3 Robotics for Fabricating  
Norcross (Atlanta), Ga.
- 3-4 Practical Lean Certificate Level II:  
Train-the-Trainer  
Park Ridge (Chicago), Ill.
- 4 Managerial Success for the  
Emerging Team Leader  
Livonia (Detroit), Mich.
- 4 Fundamentals of Tube and Pipe  
Fabricating  
Norcross (Atlanta), Ga.
- 5 FabCast--International Business: A  
Focus on Mexico  
10 -11:30 a.m. CDT
- 10-11 Practical Engineering Principles for  
Stamping Dies  
Livonia (Detroit), Mich.
- 12 Fundamentals of Die Maintenance  
Livonia (Detroit), Mich.

Details at [fmanet.org](http://fmanet.org)

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## Is Your Company 'Old School' or 'New School' When Acquiring Equipment?

*By William P. Summers*

Many "old-school" business owners and managers who have never leased equipment before often assume leasing is not the best way to acquire equipment. They view leasing only as a last resort.

When asked why leasing isn't for them, their responses are usually the same:

"Our company has never leased equipment. Why change a winning recipe?"

"I don't want to lease – I'd rather own my new, big, beautiful, strong, and shiny press brake!"

"I have plenty of cash, I don't need to lease."

"Leasing is too expensive."

"I only finance with my bank."

What many of these same professionals don't realize is that more than 80 percent of the *Fortune* 500® companies acquire equipment through leasing.<sup>1</sup> Generally speaking, these are the same companies that pay the highest salaries and consulting fees to receive the absolute best financial and managerial advice.

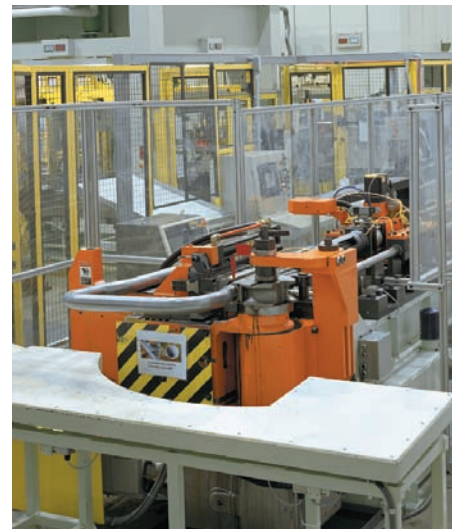
Since the largest and most successful companies in the world are leasing equipment, simple logic dictates that it may in fact make good business sense for small and midsize manufacturing companies also to consider leasing as an alternative to bank financing or paying cash for their equipment acquisitions.

### *Advantages to Leasing Equipment*

Equipment leasing serves as a financing vehicle similar to a bank loan. However, depending on how a lease is structured, there are several key advantages to leasing over bank financing.

A lease can be structured whereby neither the lease asset nor the lease liability is reported on the balance sheet. Accordingly, leasing can be a form of off-balance-sheet financing, which means there are specific tax and financial advantages can be gained by lessees:

- Net operating asset turnover (NOAT) is higher because reported operating assets are lower while revenues are unaffected.
- The portion of return on equity (ROE) derived from operating activities (return on net operating assets (RNOA) appears higher, which improves the perceived quality of the company's ROE.



# Is Your Company 'Old School' or 'New School'... cont.

- Since lease liability is not reported on the balance sheet, the balance sheet measure of financial leverage is improved (total liabilities-to-equity ratio). Many business managers insist that this improved financial leverage results in better credit ratings and, ultimately, lower interest rates on borrowed funds.
- Lease payments may be 100 percent tax-deductible and considered rent expense.
- A lease can have variable payments to match a lessee's seasonal cash inflows or have graduated payments for start-up companies or newer ventures.

Leases usually require only minimum initial payments, such as first and last payments, in advance. Bank financing typically covers only between 70 and 80 percent of the asset value. For a 60-month lease, this equates to 3.4 percent upfront compared to 20 to 30 percent equity upfront on bank loans. For companies with stronger credit history, leases often can be structured with 0 percent down.

During the early years of the lease term, rent expense reported for a lease is less than the depreciation and interest expense reported for a loan. Therefore, leasing increases net income during the early years of the lease. If the company is growing and continues to add operating lease assets, the level of profits continues to remain higher during the growth period.

Not only does leasing offer advantages over bank financing, it offers advantages over paying cash for equipment.

It is a fact that revenues are created from the use of equipment, not from the ownership of equipment. Many successful business managers point out that it doesn't make good business sense to use cash for equipment purchases. They claim that paying cash for equipment is akin to paying several years' worth of employee wages in advance. Why would you pay for something upfront when you are not going to receive the full benefit until later?



Spending cash on equipment significantly reduces working capital (net working capital = current assets - current liabilities). Using cash for equipment purchases could potentially have an adverse effect on a company's finances, because less cash means the company is less liquid. Working capital is the lifeblood of any business and is the most crucial component of a firm's success.

Many business managers believe that using cash to purchase equipment is in fact more expensive than leasing. Take, for example, a new machine costing \$100,000. Assuming the company is in the 40 percent tax bracket, the company must first earn \$166,666 (pretax) in order to afford the purchase.

To lease that same piece of equipment, it might cost \$2,240 per month (pre-tax) over the course of 48 months.<sup>2</sup> Total pretax leasing payments therefore equal \$107,520 spread over 48 months compared with \$166,666 upfront for cash purchase. The after-tax cost for cash purchase is \$100,000, while the after tax cost of the lease spread out over the four-year term is only \$64,512.

## *Working Capital & Cash*



By now you might be asking, "What should my company do with all the cash we were able to keep in working capital by leasing our equipment instead of outright purchasing?" Working capital should be preserved for meeting the operational needs of the business, such as discounts for monthly inventory purchases, parts purchases, and raw materials purchases.

Let's suppose that you (1) preserve cash as working capital to pay for these types of purchases and do not have to borrow from a bank line of credit because you didn't tie your cash up in equipment and (2) that you are able to negotiate a 1.5 percent discount for prompt payment of each invoice. The result would be that you end up earning 18 percent per year on your working capital simply by discounting invoices. At the same time, you would eliminate the bank fees that you are charged when you draw down on your line of credit because the line of credit is no longer needed.

Staying competitive in today's global business environment requires new perspectives and "outside-of-the-box thinking." Will your firm's next equipment acquisition be "old school" or "new school?"

<sup>1</sup>According to ELFA, the Equipment Leasing & Finance Association.

<sup>2</sup>Depending on the situation (e.g., credit strength, asset value), the lease payments may be less or more.



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