Financing a business asset

BY DAVID BOYCE, CEO, NZ TRUCKING ASSOCIATION

When starting out in a new business or expanding an existing business, chances are you will need to obtain finance to purchase business assets – anything from plant and equipment to vehicles. There are many ways this can be done, ranging from extending the mortgage on an existing property that you own, to taking out asset-only finance that is secured against the asset. The option that is best for your business will depend on a number of factors. No two businesses are the same.

Let's look at the options:

Extending your mortgage

This can be an easy option if you own your own property and have sufficient financial equity. The main advantage is giving you access to cheaper mortgage interest rates than would be available through a business loan. Potential downsides include difficulty obtaining full tax deductions. The danger of adding the additional borrowings to an existing 20- to 30-year mortgage means that if it is not structured correctly you will still be paying for the asset long after its economic use-by date. There is also the risk of exposing your family home to the success or otherwise of your business venture.

Revolving credit facility

A revolving credit facility is a flexible, floating interest rate loan that is similar to a bank overdraft. The facility is usually secured against property or assets that you own. The interest rates are normally in line with current mortgage floating interest rates. A revolving credit facility is usually part of a transactional account, typically a cheque account. You may use or withdraw funds up to a pre-approved credit limit. The amount of available credit decreases and increases as funds are borrowed and then repaid. The credit can be used repeatedly. Interest is only charged on the amount actually used or withdrawn. The loan can be repaid in full at any time without early repayment penalties. This type of facility is only suitable for those who are highly disciplined. A well-managed revolving credit facility can reduce your interest costs substantially. It is best to seek advice from your accountant or financial advisor to ensure that the loan is structured to minimise your income tax liabilities.

Asset finance

This type of finance has grown in popularity in recent years, especially for high value plant, equipment and vehicles. Interest rates can vary widely, with a range of fixed or floating rates available. Many lenders are offering interest rates only slightly higher than traditional mortgage lending. The asset is used as security for the loan, which minimises the risk for the lender. Many lenders are offering asset finance loans up to 100 percent of the value of the asset. Asset finance does not usually impact on a business' ability to obtain credit for other purposes. Usually asset finance is tailored to match the economic life of the asset, and is normally limited up to five years. Asset finance can be structured to allow for seasonal cashflow.

Hire purchase

More commonly used by small- to medium-sized businesses as a means of financing lower value capital items. The asset is used as security for the loan. Most lenders offer finance up to 100 percent of the value of the asset. Loan terms are normally up to five years. The interest rate is usually fixed for the term of the loan. Interest rates have traditionally been higher than asset finance rates, although competition between lenders is making this less of an issue nowadays. One downside is early repayment penalties can be significant if you wish to dispose of the asset before the term of the loan ends.

Finance lease

This is also known as a lease to own. A finance lease is a good option for businesses that regularly update their assets, especially vehicles. The asset is used as security for the loan. Interest rates are usually fixed for the term of the loan, and usually finance is available for up to 100 percent of the assets value. At the end of the lease period there are a number of options, including paying the residual value in full and retaining ownership of the asset; selling the asset and settling any outstanding residual value; refinancing the residual value until the asset is fully paid for and retaining ownership of the asset.

Operating lease

An operating lease is a long-term asset rental agreement. This takes away the risks involved in owning or disposing of an asset. At the end of the lease the asset is returned, without any further obligations, other than reinstatement for any damage to the asset. Most operating leases will have an allowance for fair wear and tear. Rental payments are usually fixed for the term of the lease, and don't usually require an upfront deposit. Lease rates are usually reasonably competitive with forms of ownership-based lending, especially for vehicles that are travelling significant distances over a short period of time. Ownership-based lending usually works out best for vehicles that are travelling lessor distances per annum. Operating lease payments are fully tax deductible.

Regardless of which type of business asset financing best suits your business requirements don't be tempted to reduce your monthly repayments to a level where you are still paying the asset off long after the asset has passed its usable economic life. As an example if a vehicle has an economic life of one-million kilometres then you don't want to still be paying off the finance when the vehicle has done 1.5-million kilometres as it is likely that the repairs and maintenance costs will exceed the cost of paying for a new vehicle.

Making sure that you tailor the financial package correctly can reduce your interest payments by thousands of dollars.

Let's look at some examples:

1. A $300,000 loan assuming an interest rate of eight percent interest over five years equals a monthly payment of $6082. Over the life of the loan you will pay a total of $364,975, which includes interest of $64,975.
2. A $300,000 loan assuming an interest rate of eight percent interest over four years equals a monthly payment of $7605. Over the life of the loan you will pay a total of $349,255, which includes interest of $49,255, a saving of $15,720 in interest over the period for the shorter loan term.

The lesson here is to structure your financial commitments to allow sufficient business cashflow, but always structure for the shortest term possibly affordable.

If you would like some help sorting out the options, NZ Trucking Association would be pleased to put your various business asset finance options through its industry leading cost model facility to help you work out what is the best option for your business. ■

For more information, call 0800 338 338 or email info@nztruckingassn.co.nz