A CHASE THOUGHT LEADERSHIP INITIATIVE

THE STRATEGIC ADVANTAGES OF EQUIPMENT FINANCING

A healthier economy and growth in the equipment finance market are creating equipment acquisition opportunities.
THE PULSE OF THE MARKET

For small and mid-sized businesses (SMBs), acquiring the equipment, machinery and software needed to compete while preserving the capital needed to operate is a delicate balancing act.

Most business owners, it's fair to say, would be reluctant to fund their capital expenditures out-of-pocket and run the risk of depleting cash reserves and interrupting cash flow. As organizations wrestle with the decision to replace, upgrade or band-aid their equipment, an improving economic climate and the growth of the equipment finance market are ratcheting up the level of optimism.

VITAL SIGNS

It is expected that businesses, nonprofits and government agencies will spend in excess of $1.5 trillion in capital goods or fixed business investment (including software) in 2014 according to the Equipment Leasing and Finance Association (ELFA). Driven by an improving economy and favorable financing conditions, U.S. companies will be in a better position to fulfill their equipment acquisition needs to operate, compete and grow.

• Despite the deceleration in Q4 2013, the U.S. economy still expanded 3.4 percent in the second half of 2013, relative to 1.8 percent in the first, suggesting that economic fundamentals are solidifying. Overall, the U.S. economy is expected to grow 2.8 percent in 2014, the fastest pace since the 2008-09 recession.

• Consumer spending and exports were particularly strong in Q4 2013, and looking ahead, a congressional budget agreement and reduced uncertainty from Washington could help the economy emerge from its “start-stop” growth.

• The sustainable housing market recovery, low natural gas prices, strong auto sales, record high household wealth, steadily improving credit availability, and employment gains all point to a year of stronger growth and the possibility of “break out” growth close to 3 percent.

• Growth in equipment and software investment accelerated from a 2.2 percent annualized rate in Q3 2013 to 8.9 percent in Q4. Moving forward, sector growth is expected to be modest with a forecast of 4.2 percent growth in 2014.

There is some downside risk in the marketplace. Severe weather conditions in Q1 2014 along with high oil prices and the uncertainty of political wild cards during this year’s mid-term election year are all potential bumps in the road.

Public and Private Investment in Equipment and Software

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* Estimated on partial-year data.

Source: U.S. Department of Commerce Bureau of Economic Analysis and IHS.


2. Ibid. 1.
The ELFA estimates that seven out of 10 U.S. businesses will use at least one form of financing this year to acquire equipment.

Business growth by sector within the equipment financing market – as shown in the chart above – indicates where the activity will reside:

- Investment in construction machinery will continue to experience solid growth and should trend positive over multiple quarters as the housing market continues to recover.
- Railroad equipment investment along with increased demand for financing the acquisition of trucks is projected to accelerate as economic activity improves and competitive diesel prices keep trucking transport competitive.
- Software investment will be moderate as companies continue to make investments in software applications and cloud technologies.

OUTLOOK AND TRENDS FOR 2014

The ELFA estimates that seven out of 10 U.S. businesses will use at least one form of financing this year to acquire equipment. Of the projected $1.5 trillion investment in plant, equipment and software, $860 billion of it – or 57 percent – is expected to be financed by loans, leases and lines of credit. This represents a slight increase from 55 percent in 2013.

In evaluating the marketplace, the ELFA has forecasted a number of trends for 2014 that business leaders will need to consider – from a dynamic environment of economic growth to wider credit availability to favorable interest rates – in their equipment acquisition analysis and decisionmaking. These trends include:

- Credit market conditions will remain favorable for long-term equipment financing. In a continuing trend from last year, businesses will generally find an increasing credit supply as they consider equipment acquisitions.
- A low short-term interest rate environment will continue, while long-term rates will rise but remain below the historical average. Businesses that want to conserve cash and take advantage of the many other benefits of financing their equipment acquisitions can look forward to the prospect of continued low short-term interest rates until 2015.

• Equipment replacement demand to manage obsolescence will continue to drive investment. Stronger economic growth will boost businesses’ confidence and appetite for capital expenditures. Until businesses find they need to expand their capacity to meet operational demands, their equipment investment will be in replacing existing aging or obsolete equipment.

• Rebounding industry sectors will drive equipment types. The housing industry will have spillover effects on construction equipment as well as trucking and rail transportation to ship homebuilding supplies. Manufacturers’ plans for billions of dollars in investments to leverage cheap and expanding U.S. supplies of oil and natural gas will increase both production capacity for energy products and demand for industrial equipment.

• Technology innovations will continue to improve the customer experience. With the demand for software and technology equipment expected to remain robust, equipment finance companies will use technology to optimize their customer service to meet a growing demand for cloud and mobile technology as well as access to real-time company data and business intelligence.

THE SECTION 179 TAX DEDUCTION AT-A-GLANCE

One of the most important provisions in the U.S. Tax code is the Section 179 deduction, and it’s prudent for all business professionals to be familiar with it.

As expected, the IRS changed the benefits of Section 179 effective December 31, 2013 on new or used equipment purchased. According to the IRS, the Section 179 tax deduction limit as of January 1st 2014 is $25,000 and the purchase limit to qualify is $200,000. This presents an opportunity for businesses to deduct a certain amount of equipment, technology and software purchases when it comes time to prepare and file their taxes.

For qualifying property purchased and placed in service during the year, the Section 179 deduction allows a business owner to deduct up to $25,000 of the property’s cost in the first year, rather than to gradually depreciate that cost over the property’s useful life. Moreover, if the cost of the new property exceeds the $25,000 limit, Section 179 allows a carryover of unused amounts to future years.

Case Study: Versatility Tool Works

Versatility Tool Works, based in Alsip, IL, provides complex fabricated components for the architectural, institutional and high-security lighting industries by leveraging its expertise in engineering, stamping, tooling, machining, hardware insertion, robotic welding and assembly.

Challenge: Continued business growth drove expansion to a new, 10,000-square-foot facility. Before this move could be made, however, the company had to ensure that its commitment to innovation for handling high-performance, high-precision jobs would not be compromised.

Solution: A Chase capital equipment loan provided Versatility Tool Works with customized financing to acquire a state-of-the-art C1 Punch/Laser Combination Machine to support the workflow while increasing the performance and productivity of their “tooling team.”

Results: The machine’s unique capabilities have enabled the seamless integration of multiple operations and the elimination of labor-intensive processes. As a result, the benefits of lower part costs and shorter lead times are being passed on to customers.
WHAT QUALIFIES?

Most tangible goods, including “off-the-shelf” software and business-use vehicles (with some restrictions), qualify for the Section 179 deduction along with:

- Equipment (machines, etc.) and computers purchased for business use
- Tangible personal property used in business
- Office furniture and equipment
- Property attached to your building that is not a structural component of the building (i.e. printing press or large manufacturing tools)

Equipment, vehicle(s), and/or software acquired must be used for business purposes more than 50 percent of the time to qualify. There is no deduction available for property used solely for personal purposes or to manage investments or otherwise produce non-business income. To determine the eligible amount, multiply the cost of the equipment, vehicle(s), and/or software by the percentage of business-use.

There is another key limitation regarding the business use of property. It must be used over half the time for business in the year in which it’s purchased. You can’t convert property you previously used for personal use to business use and claim a Section 179 deduction for the cost.

Some lawmakers have proposed a higher Section 179 deduction limit along with a permanent extension of the tax provision to help U.S. businesses purchase more equipment, hire more workers and achieve a healthier bottom line. However, if Congress doesn’t take action, the total amount that a business can expense via Section 179 will remain $25,000 in 2014 and beyond.

STRATEGIC BENEFITS

For SMBs, regardless of economic and market conditions, financing the acquisition of equipment rather than using cash may offer significant benefits while mitigating risk:

- **Capital preservation.** Financing and the type of financing selected – lease vs. loan – can help to reduce the uncertainty of investing in a capital asset that may not yield the desired return or increase efficiency, cost savings or future sales.

- **100 percent financing with no down payment.** The sweet spot for preserving cash flow and retaining cash reserves. Funds can be deployed against revenue-generating areas of the business such as worksite improvements, marketing, or research and development. Plus business lines of credit are not affected.

- **Improves expense planning.** Major capital disbursements to acquire equipment can result in unnecessary budget fluctuations. Financing provides a higher degree of certainty for budgeting purposes by setting up customized, recurring payments to match cash flow.

- **Leading-edge technology.** Financing puts state-of-the-art equipment and technology needed to grow and compete within reach without having to go out-of-pocket to buy it outright.

- **Manage obsolescence.** This is a core benefit of equipment finance. While some industries are more prone to equipment obsolescence than others, most businesses use IT equipment and are subject to the required updating to keep their investment on the leading edge. Financing allows upgrading without having to manage disposal and other ownership responsibilities.

- **Risk reduction.** Investing in capital equipment involves a certain amount of risk, from equipment expertise and large capital outlays to asset management and obsolescence. Financing provides a hedge against inflation by spreading out payments over time and mitigates these risk factors enabling organizations to stay focused on managing their core operations.
ADVANTAGES OF BANK FINANCING

Banks have become the dominant provider of capital for equipment financing in the U.S., adding stability and perspective to an already resilient sector. Accustomed to a relationship-based vs. transactional-based process, banks tend to look beyond the “deal.” By taking a holistic view of the customer’s total financial picture, they are well suited to:

- Help assess the benefits of loan vs. lease.
- Relate the equipment finance investment to overall credit and cash management needs.
- Provide insight and counsel on potential tax and compliance issues.

While needs differ, there are numerous loan and lease options in place that can be customized to meet specific requirements. Some of the more popular financing solutions include:

**Equipment Finance Loans.** Similar to installment loans for tax and accounting purposes; Customer holds title and capitalizes equipment; Bank holds security interest in the equipment:

- Improves cash flow with up to 100 percent financing.
- Tax benefits of ownership include interest and depreciation deductions.
- Available at fixed or variable rates to match customer needs.
- Payments can be matched to useful life of equipment.

**True Lease.** Best for capital equipment that can depreciate, including transportation, manufacturing, construction and computers; Bank owns equipment for tax and accounting purposes; Lessee cannot guarantee any part of the residual nor have equity in the lease:

- Improves cash flow with 100 percent financing.
- Avoids equipment obsolescence.
- May reduce tax obligations and strengthen balance sheet.
- Equipment can be purchased at lease end at Fair Market Value.

**Terminal Rental Adjustment Clause Lease (TRAC).** Used for qualified, over-the-road trucks, tractors and trailers; Bank retains ownership of the vehicle; Lessee has no equity in the lease:

- Improve cash flow with 100 percent financing.
- Option to buy out vehicle(s) at lease end for the pre-determined residual price.
- Bank gets tax benefits of ownership; Benefits passed to customer as lower monthly payments.

**Equipment Finance Draw/Term Loan.** Best used for identified projects or where progress payments are required. Facility with draw period and permanent financing all in one document; Floating rate with interest-only payments during draw period; Floating rate with payments of principal and interest on termed portion. If index matches term (i.e. 5-year TCM and 5-year term), rate will be set at term-out and will not change:

- Single closing.
- Draw period appropriate for project or need.
- Draws only require copy of invoices.
The Small Business Administration (SBA) also offers a variety of finance options to consider:

- **SBA 7(a) Loan Program and SBA Express Term Loans.** Best suited for borrowers needing funds for expansion, for purchasing another business, or for managing cash flow.

- **SBA 504 Loan Program.** Well matched for borrowers planning to expand business through land acquisition, building acquisition, construction, and equipment finance.

- **SBA Express and SBA CAPLine** business lines of credit offer borrowers funds for expansion, to manage cash flow, or for cyclical working capital needs.

All loans, lines and leases are subject to credit approval. In addition, SBA loans are subject to SBA eligibility.
THE TAKEAWAY

Equipment financing offers flexible equipment acquisition to support growth and manage obsolescence without depleting cash reserves. And this is where we can help. Chase equipment financing professionals have the expertise to:

• Design an equipment loan or lease with the most favorable terms.
• Identify any transactional concerns and recommend strategies to address them.
• Leverage prevailing tax advantages in your favor.

Chase is committed to helping you achieve all of your goals and moving your business forward from a position of strength. Our solution set includes credit and cash management services, merchant services, business checking products and other financial tools and resources. All are designed to help you access working capital, accelerate cash flow, compete more effectively…and grow.

For more information, please contact your local Chase Banker today.