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Asset-based Finance

Forward Trust

How to pay for today's assets with tomorrow's money

Funding the cost of growth need not be a headache. A recent Bank of England report highlighted concerns that many British businesses still fund the fixed assets they need for growth from overdrafts or even cash flow. But short or medium-term borrowing to fund long-term investment can seriously affect businesses' corporate profitability. Equally, to use the company's own capital resources for such purchases can prove short sighted. Capital safely invested against a rainy day that produces a solid return is far more useful to the company than money spent on an asset that will depreciate. Spending these funds on an asset, even though it may be key to the company's future, reduces the company's working capital which could be better used in many ways – perhaps buying raw materials, improving wages or paying suppliers.

Using a bank loan or, even worse, an overdraft to fund asset purchases can be problematic. Interest rates can be unpredictable when what your business needs is stability in order to plan ahead to compete. Furthermore, does it make sense to have a loan secured on an asset that will depreciate as time goes by?

In spite of this, almost two thirds of the capital investment in plant, machinery, vehicles, ships and aircraft is funded either through cash flow, bank loans or the capital of the company.

But the balance is changing. Increasingly, businesses are looking towards asset finance houses to fund capital equipment. The asset finance idea is well over 60 years old and some finance houses have been providing both practical advice and capital for development for many years. Already some £21 billion of assets are financed this way and the trend, given the tax advantages and the release of capital built into the systems on offer, is increasing.

Basically, there are two ways to acquire assets this way: leasing and hire purchase. The difference is as simple as the names suggest. With leasing you have the use, but not the ownership of the asset, and with hire purchase, you have the use and the option of ownership at the end of the term.

The system that is most advantageous for your business will depend on a number of factors. Every business has its own special needs and problems, so it is wisest to spend some time discussing your own circumstances with an asset finance expert, in order to compare options. All surveys demonstrate that, since tax is tax and interest rates are interest rates, the key factor in the choice of finance house is almost always its ability to add value to the financial package, combined with financial stability.

Nowadays, leasing companies tend to be part of one of the major banking and financial services groups, and have consequently become enormously sophisticated, providing advice on a wide range of subjects, from the tax implications of your decision to the maintenance contracts you may need for your particular kind of asset. You also need to look for what added value they can bring, for example:

- Do they understand your market and the assets you require?
- Do they know how your business operates?
- Do they know what customers you have and what assets you own already?
- Is ownership necessary or will hiring fulfil your purpose?
- Will the asset be coming from Britain or abroad?
- Do you have to pay a deposit?

The questions may seem endless, but there is a practical purpose behind them. The finance company should be aiming to produce a tailored plan for your business that takes into account three key factors:

- What income will be generated by the asset?
- What is its anticipated working life?
- What will its value be at the end of the term?

Simply put, the plan they produce should always match the repayments you have to make to the income that the asset will provide for your business.

So the agreement you enter into, whether it is a lease or hire purchase, can be tailored to suit your business. Today, some top finance houses have built up a track record of specialised experience in particular industries, bringing a particular understanding of the problems and opportunities facing your industry. This means that they can frequently point you to the best supplier for the asset you need, help you to specify the equipment that will suit your business best and can actually suggest ways of working that may not have occurred to you. Some companies in your market may even be able to improve or develop new products or services for you. In addition, if you choose to lease, the financial muscle of these finance companies often means that they have considerable buying power, helping you to minimise costs.

Of course, because financial engineering is their core skill, you should also consider the ingenuity of the finance house. Competition is such that lessors must always seek to provide a financial package that makes the most of every opportunity to cover work in your favour. As well as making the most of your own position, they should also optimise the way you pay interest. For example, you may imagine that two per cent over bank rate is the same, whoever the supplier; but some companies calculate the interest you pay quarterly. So, even though you may have repaid quite a considerable sum by the end of the quarter, the interest you are paying is still being calculated on the amount owing at the start of the period. Ideally, of course, your interest should be calculated on a day-to-day basis.

The finance period is also important. An experienced finance house will understand your business and, recognising that some assets have a longer life-span than others, will advise you what the best timing should be; usually anything from three to seven years. They should also recognise that this period may well need to involve the time taken to set up the equipment – a printing press for example – before it can begin to produce an income. If this is the case, the company you choose should be prepared to look at low initial repayments, rising to the full scale when the machine is operating at peak efficiency. They should also understand the need for seasonal payment for assets such as coaches or food processing equipment for a particular crop, and cars, a subject that interests managers in most companies, are a matter of much consideration; how many miles, what type of miles, what kind of servicing? These are the kind of details that any business should consider before pursuing a relationship with a finance house. But all financing, whether hire purchase or a lease, will offer your company similar, broad benefits, as well as the particular advantages offered by individual companies.

First, it allows companies to plan ahead and provide considerable reassurance for the financial director.

Second, a choice of repayment methods, including fixed rates, means that you can budget more accurately because all your costs are pre-determined, not simply in terms of the repayments you make, but, with contract hire, in terms of the costs of running the asset itself. If, for example, you have a vehicle that the finance company has arranged to be kept in good order, you can be sure it will be properly maintained and that you will have the vital use of that asset for your business. The maintenance package may be arranged through the finance house or even through the manufacturer of the asset itself. Cars, for example, would be covered by the finance company, but heavy manufacturing machinery could well be the subject of an agreement made between the finance house and the manufacturer, to keep the asset in good running order for you. Once again, the finance house should tailor the most suitable package for your company.

Third, your financing costs can be fixed. At the start of the agreement, you agree with the finance house the period of the agreement, the repayments that are necessary, and the rates you will have to pay.

Fourth, and possibly most reassuringly, this route is increasingly proving to be the best way to use a company's resources. Because it frees up your cash flow as well as your capital, asset finance can actually help your company grow. It is becoming an important part of the overall strategic plan for a great many companies; and, as its effectiveness is proved, it is increasingly being built into a company's strategy, rather than simply being used on an *ad hoc* basis. It puts your own money to work, doing what it should do: supporting your business.

You can also benefit from considerable tax advantages when using both leasing and hire purchase. Before outlining the major benefits of these, it is sensible to consider the basic question: do you need to own the asset eventually or do you simply need to have the use of it for a certain period of time?

Though the finance house will usually help you decide the answer to this question and will provide useful pointers, it is worth outlining the advantages of the two main routes.

Hire purchase

Hire purchase is a system whereby you pay a specified amount of money over a pre-determined period. At the end of the agreement, you pay the option to purchase fee that can be arranged to suit your business' financial situation. If ownership is really important to your company, this is the way to go.

The particular tax advantages it offers are that, although the asset does not belong to you until the end of the term, you can claim a tax deduction on all the interest paid against your profit and loss account. The other advantage is that you can claim the capital allowance, so a percentage of the cost of the asset can be offset against the tax you have to pay.

In addition, if your business is VATable, you can claim all the VAT paid on the asset as if you had bought it outright. The only exception to this rule is in the case of cars, which are regarded by the Inland Revenue as a separate case.

In all these three cases, the tax rights of ownership belong to your company, although the asset is actually owned by the finance house. This is called 'deemed belonging'.

As you are treated as the owner as far as tax and accounting are concerned, you can also claim depreciation in your books. As far as the Inland Revenue is concerned, there is no difference between an asset that is yours under a hire purchase agreement and one that you own outright. It is dealt with in just the same way as any other fixed asset.

Leasing

There are two forms of leasing: Finance Leasing and Operating Leasing. The decision to go the leasing route is also a matter for discussion with the finance house and your business advisers. You might, for example, prefer to lease if you cannot claim your capital allowance due to lack of profits. If this is the case, you can benefit from the tax allowances that the finance house can claim, as they will pass them on to you in the form of lower repayments. Or perhaps the way that you look at a discounted cash flow in your business might make it more financially viable to lease; and, of course, it is possible for a lease to be off balance sheet. There are many reasons you might consider.

Finance leases

Finance leasing is on balance sheet, and operating leasing is off balance sheet, and there are strict rules governing which of the two you can have. A finance lease is simply described as one where all the risks and rewards are transferred to the lessee. If you have benefited from all the tax benefits during the contract and, when the asset is sold by the finance house at the end of the lease, you receive some of the sale proceeds, then you have effectively received the benefits of the asset. Under a finance lease, the sale of the asset is carried out by the lessee, operating as the agent of the finance company. The money from the sale goes to the finance house, but they return up to 95 per cent of it to the client. So the client never actually owns the asset, rather it is seen as being loaned to the client and so should be shown on your balance sheet.

The other benefits are that the rental interest can be variable. Again, this is part of the risk and reward factor. If the bank rate falls, you will benefit; if it rises, you will have to pay more. That is a risk calculation you alone can make.

With a finance leasing agreement you don't pay VAT on the capital cost. But VAT is charged on the rental and you can recover the VAT paid. The leasing rental is classified as a revenue expense.

At the moment, finance leasing volumes are falling off, as companies look to other, less complex forms of leasing and because recent legislation has removed some of the tax advantages they once enjoyed.

Operating leases

An operating lease, with or without maintenance, appears off your balance sheet because most of the rewards and all the risks lie with the finance house.

The way it works is simple. The finance house will discuss the asset you need in just the same detail as with any other contract. In this instance, they will be seeking to find the exact use that you will put the asset to so that they can calculate what its value will be at the end of the term. This is called the residual risk. The finance house is using its experience to determine the value of the asset when the contract is over. The reason is that the repayments you make will be based on the difference between the purchase price and the amount they believe that they can sell the asset for when you have finished with it.

Suppose that you are buying a vehicle – say an HGV and trailer. The finance house will want to know all about your business, the loads you carry, journey times and distances, the qualifications of those driving, where the vehicle will be stored and how it will be maintained. With this knowledge they will decide its value in seven years' time, the period you have decided that you want the use of the vehicle for. You will make regular payments on the pre-determined value of the asset for this period – not the whole life. As a result you will pay a lower rental. Another consideration will be the maintenance of the vehicle to ensure it is to the standard required to achieve its predicted value at the end of your agreement, although this will form part of your contractual negotiations, as maintenance is one of the added value services many finance houses offer as part of their packaging.

You will also benefit from the fact that the finance house, because it actually owns the asset and has taken the risk of forecasting its value, will be able to claim the capital allowance on it and so will be able to charge a lower rental than might otherwise be the case. For hauliers who are non-tax-payers, this reduction can be particularly useful. Your company can also charge the cost of the rental against its corporation tax and, of course, your financial director will be delighted that the payments will remain predictable and that there is no question of any risk in estimating the re-sale value at the end of the term.

The only variation to these general rules applies to cars. Because they are regarded by the Treasury as part perk and part company necessity, they are assessed differently. As a result, you cannot deduct the rental costs against your corporation tax unless the car itself cost less than £12,000. In the case of cars, it is always sensible to discuss the exact use of your fleet with an experienced finance house as they can advise on the most tax efficient route, the timing involved and the maintenance package that will suit you best. Contract hire is also one of the best ways to remove a lot of the problems of maintaining your car fleet from the shoulders of your fleet manager.

The popularity of this method of asset financing is growing rapidly, partly because of its simplicity and the increasing trend to outsourcing, and partly because the alternative route of finance leasing has become less attractive as the tax benefits have been reduced by successive governments.

In fact, so popular has contract hire become that some of the largest deals in the past few years have been on this basis. Planes and boats and trains, the big ticket assets, are very frequently financed in this way and clients have seen enormous benefits.

Case study

ScotRail

In a recent transaction with ScotRail, the client was able to afford to lease 40 trains when they had only expected to be able to lease 38. This was due partly to the construction of the financing and partly to the sheer financial muscle of Forward Trust Rail being a member of HSBC.

'Our buying power and strength in the marketplace enabled us to use the economies of scale in our negotiations with the rolling stock manufacturers,' said Peter Aldridge of Forward Trust Rail.

This particular transaction began with detailed discussions between Forward Trust Rail and ScotRail itself. If a financier is to provide the best results for the client, a detailed picture of every part of the customer's objectives needs to be established. Only when this is complete can a realistic proposal be made. The timing, specification and structure of the bid between Forward Trust and ScotRail were all ironed out prior to discussions with potential manufacturers. ScotRail specifically requested that the financiers give their best price in the tender response rather than getting involved in long, drawn-out haggling at a later date.

Time was of the essence throughout the transaction and was exacerbated by the fact that, as a result of a franchise commitment, ScotRail needed to have the rolling stock in service by March 2000. At the appointment of Forward Trust Rail, the two parties set about creating a detailed specification for the trains which was given to three manufacturers for tender.

'We had negotiated some 95 per cent of the contents of the lease with ScotRail before we even spoke to the manufacturer,' said Peter. At the same time, Forward Trust Rail negotiated both a spares and maintenance agreement with the manufacturers. Two of the 50 engineers who work for Forward Trust Rail were employed at this stage, as their expertise was vital. Forward Trust aims to work in partnership with its customers, providing a portfolio of services and knowledge in addition to finance.

The lease agreement does not require ScotRail to make payments while the trains are being built. However, Forward Trust Rail has already started paying the manufacturers in stages, with the largest payments made on delivery of the rolling stock. To protect and support the interests of both parties during the building process, four engineers from Forward Trust are working with ScotRail.

The finance house should always aim to make the purchase and use of the assets required to run your business as simple and as painless as possible. To do this:

- They need to have access to considerable financial strength because you want to be sure that they will continue to back you throughout the whole term of the contact.
- They should be independent. By not being tied to any one manufacturer, they will be able to shop around on your behalf and make the best buys for you.
- They should be able to offer you the benefits of buying in bulk that will serve to lower your costs.
- They should have the depth of expertise to be able to offer you more than just money.
- They should understand your business and the market you operate in. This will allow them not only to tell you where the best place to buy tyres can be found, but to advise you on market trends that might affect the way you run your own business.

As in so many financial markets today, it is the added value that counts; the service that goes with the cash should be the most important factor in your decision about which finance house to choose and which system will suit you best.

All reasonable care has been taken in the preparation of this article, but it is intended only to be a general guide. You should check the position of your own company, with regard to financing assets in this way, with a professional financial adviser; the treatment of leases, for example, can vary depending on an individual auditor's interpretation. You should also make certain that there have not been any fundamental changes in accounting, taxation or legal requirements.

Extract from Bank of England 'Finance for Small Firms – An Eighth Report' (March 2001)

The Finance and Leasing Association (FLA) is the major UK representative organisation for the asset-based finance industry, accounting for approximately 90% of the sector. In February 2001 the association had 95 full members and 71 associate members, drawn from high street banks' subsidiaries, merchant banks, building societies, leading finance houses, leasing companies and the finance sections of manufacturing and retail companies. Business finance excluding big-ticket items (defined as a finance facility of greater than or equal to £20 million for a single project) has grown consistently, to around 19.1 billion in 1999.

SMEs account for a significant proportion of FLA business. Firms with a turnover of less than £5 million accounted for 58% of new business in 1999. Furthermore, nearly £7 billion (30% of new business) went to firms with an annual turnover of less than £1 million. The FLA believes that asset finance provides the products that allow SMEs to grow, right through the size spectrum – from leasing a single computer to using asset finance in the run-up to flotation. The FLA is currently campaigning for the removal of the exclusion of leased assets from enhanced fiscal depreciation for SME. Owner-users of plant and equipment, who satisfy the conditions on corporate size, can generally claim a first-year allowance of 40%, but if they lease the assets, the lessor can claim 25% writing-down allowances.