NEW COLUMN:

Leasing, financing and your business

Answers to some of the most common questions from manufacturers

By Ken Hurwitz



Ken Hurwitz

I've been reading Canadian Metalworking (and Machinery) monthly for as long as I can remember. I'm the fourth generation in my family to work in the machine tool industry (Gross Machinery Group was founded by grandfather Harold Gross in 1931 and operated until 2009). Although we sold product from all over the world, we were best known as the first North American importer and distributor for some of largest and most successful machine tool builders in Japan.

When I was presented with the opportunity to write for Canadian Metalworking, it was a significant achievement on two levels — professionally and personally. On a professional level, it's been four years since I transitioned my career from machinery sales to machinery leasing. I hope with my extensive machinery knowledge and manufacturing background, I can continue to help Canadian manufacturers make good business decisions, which will keep them profitable for many years to come.

On a personal level, I'm sure my late grandfather is proud of my continued career in the machine tool industry. Every time I walk through a plant and see equipment sold by Gross Machinery Group running productively, it validates my belief that with good equipment and a sound business strategy, manufacturing in Canada can, and will, remain strong for the long term.

My transition from machinery sales to machinery leasing has enabled me to continue a rewarding career in the machinery and manufacturing sector and allowed me to stay in touch with former clients as well as meet new ones. I thought as an opening article I would answer the most frequently asked questions that are posed by both existing and potential clients when they look to finance their equipment purchases:

Ken, why should I lease?

The textbook answer is "pay cash for assets that appreciate, and lease or finance assets which depreciate" but as we all know, real life rarely works on textbook answers so here are a few real-world replies to that question:

1. ***Comfortable monthly payments*** — With leasing, you have the ability to match monthly lease expenses directly to revenue, instead of dealing with a big cash outlay for a machinery purchase. The lease payment is usually (or ought to be) a small percentage of the monthly revenue generated by the equipment. For example, a $100,000 vertical machining centre would work out to be approximately $1,900 per month over five years but should generate a minimum of $12,000-$14,000 per month in revenue.
2. ***Working capital is king*** — All businesses struggle with cash flow. Customers string you out on receivables, or you took a big order and need to purchase additional material, tooling, or hire another operator. There's no need to tie up valuable cash in expenditures that can be financed. Your cash is better used in places that can't be financed, such as business development costs related to hiring an additional sales or applications manager, product development, or as a deposit to buy your current unit or manufacturing facility. People assume financing is for the guy who can't write a cheque but my biggest clients are successful manufacturers who can write a cheque but choose to spend their money elsewhere.
3. ***Increase borrowing capacity*** — The typical leasing company isn't looking to be your bank. In a perfect world, leasing companies complement the financing you already have in place. Most manufacturers use their bank for an operating line to cover short term needs, and use lease financing for long term debt. As a business owner you should never use short-term financing like an operating line to pay for a long term asset such as manufacturing equipment.
4. ***Simple and convenient*** — Most of the inquiries I get are from manufacturers who have either just secured a contract and won some new business, or got more work from a good customer. In either case, time is of the essence and getting machinery or capital in place quickly is paramount. A well-organized leasing company has the ability to react within hours and at worst in a matter of a few days. This type of response isn't what most

... continues on page 96

 ... continues from page 29

people experience with their banks or preferred lending institution. However simplicity and convenience extends far beyond quick responses, once a deal is signed and assuming the account remains in good standing (payments are made on time each month) you will never hear from us except during the holiday season when we send out gift baskets. Doing business with a bank will mean monthly reporting from either your accounting department or bookkeeper, as well as yearly reviews. These additional costs, which can be significant, are not reflected in the rate they charge. I tell my customers that bankers are usually my best salesmen.

5. ***Fixed rate*** — This one doesn't come up as much as it should but once you sign a lease, the monthly payment and interest rate is fixed. A bank or lending institution will rarely, if ever, fix a rate, so over a five-year period the customer is subject to interest rate fluctuations. We're currently in a time of historically-low interest rates but the Canadian economy is the strongest it's been in the last two years and showing signs of a significant period of growth. This will no doubt lead to increases in lending rates at some point in the future.
6. ***Tax write-off*** – Although I'm not an accountant, I can tell you 99 per cent of my clients write off their lease payment 100 per cent as an expense no different than tooling, material, wages, etc. That said, I always tell my clients to have a conversation with their accountant or bookkeeper before they proceed if this is a factor in their decision-making process.

Ken, you're a charming, witty, and handsome guy but I have a great relationship with my bank manager and to be honest, your rates are just too high.

Okay, maybe that's not exactly how the question is framed, but let me answer each one of these separately.

BANK RELATIONSHIP

The typical leasing company isn't trying to replace a bank and I always ask my potential clients: "do you have only one customer?" Usually, the answer is "no." So then why would you only have one lender?

A bank will look at a business and put a number against it and unless something changes in either direction, that number won't change. In other words, there will be very little opportunity to finance growth with a bank because everyone knows growth doesn't show up on financial statements until it has already occurred.

On a personal level, I can give you another example of why having one lender doesn't make much sense. Our family business had a 40-year relationship with a chartered bank. At our height we had 45 employees and $40 million in sales. We had a $12 million letter of credit facility and a $1 million operating line, which we never used because when business was good we able to cash flow our sales. All we needed a bank for was to issue letters of credit to a Japanese machine tool manufacturer (a letter of credit is the only way an overseas supplier will release equipment beyond receiving the entire purchase price prior to shipment).

One day, our bank manager picked-up the phone to call my grandfather and the conversation went something like this: "We're sorry Mr. Gross but we just don't want to be in the manufacturing sector anymore. Thanks for the business." The situation led to some tumultuous times for our business.

HIGHER RATES / SECURED ASSETS

A chartered bank gets its money from customers and the cost of funds is basically whatever they pay on deposits. If you have any money in the bank, you know isn't much — less than 0.5 per cent. This allows them to put out cheap money but in order to secure their investments, they take far more than the equipment they're funding as collateral.

They'll insist on the guarantee of the owners, and put a general security agreement in place (GSA), which basically means all the current and future assets of the company, including existing equipment and receivables are also secured to support the loan. In many instances, the owner's personal residence and other property is also secured.

A private non-bank leasing company gets its money from a number of different places, but it's not a deposit-taking institution and therefore has a higher cost of funds. However, the higher cost can be justified in a number of ways. First, leasing companies specialize in particular industries and have experts on staff with excellent knowledge of the assets they're financing, and they will entertain deals banks won't consider.

Second, in a normal transaction the only security is the asset itself. Plus, by leasing there are additional savings by avoiding the necessary legal fees required to get a deal in place with a bank, as well as the ongoing monthly and yearly reporting requirements, which also have hard costs associated with them.

When put in into real-world terms and to continue to use the $100,000 example, paying a three per cent premium in interest rate works out to be $150 per month. If the difference between bringing in a new piece of equipment which will generate an additional $12,000 to $14,000 per month in revenue or not proceeding at all because your bank manager rejects the loan is predicated on not wanting to pay an additional $150 per month, then you have to take a moment to wonder why you're in business in the first place.

Ken, can I pay-off early?

This is another question I get all the time. There's no penalty to paying a lease off early but there isn't a lot of

benefit either. Mentally, I understand everyone wants to be debt free. Believe me, if I could pay off my mortgage tomorrow I would, but at the same time, if paying off my mortgage is going to cripple my ability to buy groceries or pay for gas, it probably doesn't make a lot of sense.

From a tax standpoint, the lease is normally a tax-friendly solution so paying it off early will impact that benefit. I've written hundreds of leases in the last four years and the amount of customers that actually pay off early is less than two per cent. Normally, the payment becomes part of the monthly overhead, and because the equipment is generating so much additional revenue, it's easily justified.

Usually, my customers tend to finish the lease and then start another one for a new piece because they've become accustomed to making the monthly payment.

Ken, what if I want to upgrade or raise some working capital?
The answers to these questions are much more similar than they would seem. If my customer finds after a few years, the 40 x 20 VMC is too small or inefficient, and what they really need is a 60 x 30 or a horizontal, they just have to approach their selected vendor (dealer) and trade it in against the new piece.

If the trade-in credit is less than what is owed, the difference is financed in the new lease. If the credit is more than what is owed, the savings reduce the amount financed and in turn reduces the monthly payment.

If the client is in growth mode but running short of working capital, we can actually raise money against the equipment because we know there's available equity. To continue with the $100,000 example, we know that a good piece of equipment will hold its value and after about three and a half years, the machine may still be worth close to $60,000 (assuming it's been properly maintained) even though the amount owed against it might be closer to $40,000. This means we can easily get the client $20,000 in cash and re-write the lease.

The main point here is, dealing with a private leasing company as opposed to the typical bank allows for more flexibility and many additional options.

I know I've covered a lot of territory here, but if there is one thing I want you take away from my first article, it's that investing in good equipment, either in cash or with lease financing, is always a smart move, because good equipment will always provide value to your business.

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ADVERTISERS INDEX

ADVERTISER	PAGE
Amada Canada, Ltd.	9
AMT Machine Tools Ltd.	20, 17
Blaser Swisslube Inc.	53
Brubaker Tool	33
Carl Zeiss IMT Corporation	6
Cosen Saws	22
CWB Group	72
Data Flute	33
Dillon Manufacturing, Inc.	43
DiPaolo	13
Elliott Matsuura	6
ERI America Inc.	55
Eriez	50
FastCut Tool	33
Fein Power Tool Company	79
Ferric Machinery	75
Flexovit	89
GMN USA	42
Gravotech - Gravograph	35
Gravotech - Technifor	35
Haas Automation Inc.	26
Heule Tool Corporation	56
Hiwin Corporation	77
Horn USA, Inc.	11
Hurco USA	IFC
Ingersoll	15
Iscar	OBC
ITI Tooling Company Inc.	49
Kinetic Cutting Systems Inc.	62
Koma Precision, Inc.	45
Kyocera Cutting Tool Division	51
Lincoln Electric Co. of Canada	61
LVD Strippit	71
Machineries Isotop	14
Makino	28
Messer cutting Tools	22
Micro 100 Tool Corporation	16
Multicyl	18
Natex Tools & Natex Machinery Group	37
Okuma	21
PFERD	59
Renishaw (Canada) Limited	87
Retention Knob Supply & Mfg. Co. Inc.	97
Salvagnini	81
Sandvik	4,5
Scientific Cutting Tools	23
Scotchman Industries, Inc.	63
SGS Tool Company	47
Sirco Machinery	26
SME FABTECH	85
SME MMTS	67
Star CNC Machine Tool Co.	17
Thomas Skinner	26
TRUMPF Inc.	IBC
Tungaloy America Inc.	3
United Grinding	39
US Shop Tools	57
Victor Technologies	24
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