CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

Equipment Acquisition & Disposal Strategies

By Michael McLin

When contractors are considering purchasing equipment for their fleet there are several factors that must be considered. These factors include how the equipment will be purchased, if the equipment should be bought vs. leased vs. rented, the financial impact of the acquisition, the logistical considerations, and the disposal strategies. In this article, we will unpack the decision-making process and provide guidance on the factors to be considered.

The purchase of equipment can be accomplished by using cash to make an outright purchase, financing through a loan, leasing the equipment, or renting the equipment. Each method has a potential downside. The two primary factors to consider when it comes to acquiring equipment comes down to the financial impact and utilization. The purchasing strategy should align with the company's risk propensity and should consider the impact on cash flow and debt leverage. When purchasing with cash, the company's weighted average cost of capital (WACC) should be considered and compared to interest rates being offered on a loan. Typically, a loan carries a lower imputed interest rate than a company's WACC. Most contractors are debt averse and so they end up using equity to finance purchases. Given the risk profile of contracting, companies should expect a return on equity of 20-40% which if far more expensive than traditional loans running at 8%. When financing with a loan, the company must pay the interest and that becomes a sunk cost. If a company chooses to lease the equipment, they are locked into a fixed payment for a time period. Lastly, if the choice is to rent, the company will see no residual value in the asset. Generally speaking, companies should buy equipment that will be used daily, lease equipment to hedge your bets against a market shift or change in work mix, and rent equipment for maximum flexibility.

There are additional financial factors that should be evaluated when considering a purchase. Utilization is imperative. Generally speaking a company should buy equipment that will be used a minimum of 1,000 hours per year (active time). The utilization may be lower on highly specialized equipment and that should be factored into the economics. The company should also determine if they have the available capital and whether or not the purchase is a good deal. The new lease rules (recognition on financial statements) should also be evaluated. The objective is to preserve the company's credit while maximizing tax deductions and depreciation methods. The recommended approach is to conduct a five-year forecast of the equipment utilization and maintenance costs and compare it against a fixed return on net assets. It is also recommended to obtain guaranteed buybacks and negotiate warranties for purchased equipment.
Logistical considerations should also be factored in. Questions to consider include:

- Do we have the available space to store the equipment when it is not in use?
- Do we have the ability and the licensing to haul the equipment?
- Do we have the ability to maintain the equipment?
- Are there special skills required of the operator?

The answers to these questions will help provide guidance on the decision to buy vs. lease vs. rent.

Many companies tend to hang on to equipment for too long. A proper disposal or fleet optimization strategy should be in place. As a general rule, when you're done with it, get rid of it. Don't park it in the back lot to leak oil and rust. If the equipment is old, replace it if the utilization warrants it. The net book value of the equipment should run in the 40-60% range to ensure that the fleet is not too old and that we are not buying too much equipment, thus overleveraging the balance sheet. If the equipment has been sitting idle and has not hit the utilization targets, disposal should be considered. There are also times when equipment is in demand and a good profit can be made by selling excess or underutilized equipment. Technology is also constantly changing, and that may mean that there is a better piece of equipment available.

When seeking disposal of equipment, there are a number of options available. Physical auctions such as Ritchie Brothers are very popular. The online marketplace has also exploded over the years with sites such as **Iron Planet**. Other alternatives include a direct sale, a trade in, use of equipment brokers, and consignment. Trump's tax laws eliminated other options like the 1031 like-kind exchange.

In conclusion, the acquisition and disposal of equipment is a complex matter that requires a range of knowledge and skills from a variety of disciplines. Having a properly established set of guidelines will help ensure that the purchases are made under the right decision-making criteria. Utilizing business partners to help evaluate the decisions and the overall optimization of the fleet are key factors to driving maximum profitability out of the fleet.

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