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Leasing Versus Purchasing and the Effect on Bonding

By Bruce Jay

The acquisition and maintenance of construction equipment is crucial to the productivity of companies engaged in heavy construction. It helps these contractors secure competitively bid projects and is a direct contributor to job profitability. Equipment as an asset in a contractor's financial statement is also crucial for surety underwriters. The value of the equipment, its utilization rates, the cost of maintaining it, and how a contractor elects to acquire equipment can have an important bearing on the extent of bonding support made available to the contractor by the surety.

To begin with, not all bond companies view equipment in the same light. One surety may see the equipment as a pure fixed asset, just like a job trailer or a laptop computer. Another surety may count it as a direct contributor to working capital. Before developing a strategy for acquiring equipment, a contractor should understand how surety underwriters consider contractor's equipment in relation to contractor bondability.

Balance sheet liquidity is enhanced by leasing equipment instead of purchasing. Company cash remains available as working capital rather than being tied up in equipment.

Corporate assets that the surety counts on in its underwriting process are not pledged either directly or contingently in support of an equipment purchase finance program. Equipment debt erodes corporate equity, while the cash used for deposits on purchased equipment reduces the contractor's working capital.

The need for elaborate equipment repair and maintenance facilities and personnel is significantly reduced with a leased fleet policy. Not only is an equipment maintenance and repair facility a distraction from the contractor's core, profit-making business, it is an absolute expense to its operations with little or no direct return.

One of the strong points of leasing is the conservation of the cash component of contractor working capital. Even though there are bond underwriters that will ascribe a value to equipment as a working capital contribution, establishing this value is more of an art than a science. With cash in the bank there is no dispute over its value, which is recognized by all underwriters as the core component of working capital. A leased fleet contributes to a cleaner balance sheet overall. There is more cash, less debt, a much reduced fixed asset account and little depreciation to contend with. All of this contributes to a financial structure that is optimized for a single focused, profit-driven contracting operation.

Equity in owned equipment is attractive to underwriters as ballast to a contractor's balance sheet. However, the presence of equipment in the yard can seduce contractors into taking projects that should be passed by. Contractors may fall into the trap of taking inadequately priced work when they can't stand to see idle.

Equipment leasing replaces depreciation with lease costs. The equipment costs attributed to any job are immediately apparent, and job profitability is easier to determine. Depreciation for owned equipment is often ignored or underapplied as a project cost. It is afterward on the corporate revenue statement that the effect of depreciation is fully recognized. In this way an owned equipment operation can be more clearly evaluated from the perspective of cash flow, and contracting firms leasing the bulk of their equipment are more precisely profit oriented.

The decision to lease equipment rather than own is not solely an internal decision. The effect of financing availability and the cost of money often drives the decision-making process.

And there are legacy considerations: contractors with established maintenance and repair facilities are not likely to want to switch to a leased equipment strategy. Newly formed businesses, however, will probably be highly attracted to equipment leasing as a cornerstone of their business model. One reason is that if leasing doesn't suit you, it is relatively easy to move to ownership. The same cannot be said about going from ownership to leasing.

In summary, as a general statement, and from a surety perspective, as long as interest rates and residual values are reasonable, leasing rather than owning equipment will earn the contractor a more supportive surety relationship, one where the bond company will make decisions favorable to the contractor more quickly and with fewer requests for additional information and clarification.

So if you are in a quandary over whether to lease or own the equipment necessary to your contracting business, if bonding is a consideration, then you can't go wrong to try leasing.

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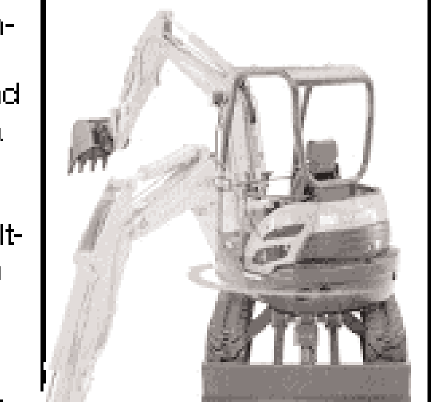

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