Conserving working capital and lines of credit are of paramount importance to the financial health of your business. Leasing or financing should be considered when acquiring equipment, software, furniture, tenant improvements to your office space and when raising capital. Over 70% of U.S. businesses lease some or all of their equipment, shouldn’t you?

Is leasing appropriate for your business?

Most finance professionals know the statistics: over 90 out of 100 start-ups fail within the first five years of operation. Why do most businesses fail? The reasons are simple, Inexperienced or Poor Management and Insufficient Capitalization. One significant component of poor management is poor cash flow and credit management.

Recently, a prospective client asked me if I could assist them in obtaining financing. The company’s owner projected sales to grow significantly, which would create a severe cash crunch. The company was a startup, losing cash each month and operating at a loss. The monthly losses are understandable; the company is building a customer base. In order to significantly reduce the company’s operating costs the principal purchased over $150,000 of new equipment. He did not finance or lease the equipment.

Within days after the equipment was delivered, the principal recognized he was in trouble. He could not finance the anticipated growth of accounts receivables at a reasonable cost. He was looking to finance existing accounts receivables as well as future contracts.

With the limited amount of cash remaining, the business owner faces the following dilemma:
If I don’t obtain financing quickly, I cannot grow my company and achieve “break-even.”

Since many of my accounts receivables are small, the transactional costs of financing accounts receivables will be high.

Since many of my accounts receivables are from small to mid-sized companies, ones that may not have good credit, these accounts receivables may not be finance-able. If some of the accounts receivables are financed, the advance rate (the amount you can draw against the account receivable) may be low.

Since many of my accounts receivables are from clients that may not have good credit, will the company survive if late paying and non-paying customers are:

- At industry norms
- At 50% above industry norms
- At 100% above industry norms
- At above 100% of industry norms

Did the business owner understand the importance of managing cash and credit? I believe he did not. From the business owner’s prospective, I understand, appreciate and applaud that he wanted to reduce his costs as soon as possible. However, stepping back and looking at the company as an investor, or financier, questions that will be asked include:

- Did the business owner sacrifice the company’s stability for costs savings?
- Did the principal anticipate cash flow problems (due to late payments, bad debts or other reasons) based upon the company’s client base, sales cycles, competition etc.?
- Did the principal understand what sales volume the company needed to justify the equipment purchase?
- Should the principal have waited to acquire the equipment until he knew that equipment it will be utilized at a level above a certain level of the equipment’s capacity? (In this case I estimated that the equipment would be used at a 10%-20% utilization level the company’s current sales volume)
- If the principal would have waited, could the company acquire similar equipment at a lower cost, or better equipment at the same costs?
- Did management exhibit good judgment in its decision making?
acquire similar equipment at a lower cost, or better equipment at the same costs?

Did management exhibit good judgment in its decision making process?

Does an investor or financier to feel confident that management has the financial maturity needed to operate the business?

In my opinion, the principal did not possess the financial maturity needed to effectively operate the business. The principal:

- Put his company in a position where it would run out of cash if the company does not obtain financing quickly.
  - Had he not invested the cash into equipment he could have financed more of the company’s accountants receivables, built a stronger client base and then financed the equipment.

- Increased the company’s cost of financing (to more than offset any cost savings from the pre-mature purchase).
  - The cost of financing accounts receivables usually is greater than the cost of equipment financing.
  - Since the company’s current cash position, and the principal’s cash reserve is more tenuous, the company is more vulnerable. Cost of borrowing is greater when a company’s financial condition is shaky.

- Reduced the amount available for financing
  - It is difficult for a startup company to obtain equipment financing. There are, however, certain financing programs that are available for new equipment, that generally are not available for used equipment.
  - Since, as a startup, the company will need a larger down-payment on the equipment than an established profitable company. With used equipment, you should expect to have a larger down-payment than with new equipment. If the equipment were financed today, If the equipment were financed today, it would be financed as used equipment.

  - In other words, did poor cash flow management put this company at risk? Absolutely!
Reasons for Leasing/Financing:

Some of the benefits of leasing include:

- Flexibility – you can lease almost any kind of equipment
- Flexibility – you can choose the equipment, manufacturer and model
- Flexibility of lease plans
- Improving your working capital position
- Enabling predictable cash flow outlays for furniture, fixtures and equipment
- Leveraging the profits from the equipment to pay for the lease obligation
- Leasing can be the least expensive way to acquire equipment
- Longer term, smaller payments
- Virtually 100% financing for new equipment may be available, with minimal or no initial cash outlay (for established, profitable companies)
- Building your company’s credit
- Accelerating tax write-offs
- Alleviating the need to dilute equity
- Projecting your costs more accurately
- Reducing budget restrictions

Most of the above benefits apply to equipment financing also. It will:

- Improve your working capital position
- Enable predictable cash flow outlays for furniture, fixtures and equipment
- Leverage your profits from the equipment to pay the financing obligation
- Enable you to obtain virtually 100% financing for new equipment (for established, profitable companies)
- Help you to build your company’s credit
- Alleviate need to dilute equity
- Allow you to project costs more accurately

In the above situation, the entrepreneur would have been better served to have waited to acquire the equipment. Assuming after understanding the pitfalls of acquiring the equipment he still wanted to proceed, he should have financed it at the maximum amount available to him (possibly 50% of the purchase price –
since the company is a startup) and held the remainder of its cash as working capital.

A Second Lesson to be Learned:

A second lesson can be learned from this prospective client’s actions. If the company had prepared a well thought out business plan that paid attention to the numbers, the principal would have understood the implications of his actions. Developing the plan enables the principal to better understand the risks of his actions, before he would have taken them. After evaluating the risks, an appropriate financing strategy would have been developed.

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