Options for Financing Capital Expenditures

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In a recent article, we discussed the importance of devising a strategic plan for how you will allocate your company's capital expenditures (or CAPEX) budget. Such a plan should detail what physical assets should be acquired and when, how they will be used, their expected ROI and/or payback period, and how the assets will be paid for.

The last point is especially critical, because all the benefits that may be accrued from making wise CAPEX decisions can be diluted or even negated if the wrong CAPEX financing strategy is used.

CAPEX Financing Methods

Your goal in financing CAPEX should be to choose the financing option that will result in the most efficient use of your working capital and provide you with the most flexibility when it comes to ownership of the assets. There are three primary methods that can be used to finance CAPEX:

Internal financing

The easiest option may be to simply buy the assets outright in cash. The biggest benefit of this method is that you'll incur no interest expense. But the decision is more complicated than it might seem at first glance.

For starters, today's machinery and equipment (especially high-tech) can be very expensive, and many companies don't have enough liquid cash on hand to purchase the assets they need outright. You could save up for the purchase over a number of years if you plan well, but sometimes, machinery and equipment break down or fail when you least expect it. Finally, you must consider the opportunity cost of investing large sums of money in a depreciating asset compared to other potentially more productive uses for your cash.

External financing via a bank loan

Bank term loans are commonly used to finance CAPEX purchases. Borrowing the money instead of buying assets outright frees up working capital that can be used for other more productive purposes. Term loans can be structured according to the asset type and based on the useful life of the asset being acquired.

Businesses that require ongoing investments in certain types of assets may be able to receive a pre-approved CAPEX line from their bank. This provides a consistent and predictable level of financing throughout the year, which helps with CAPEX budgeting and cash flow.

External financing via an equipment lease

Leasing often provides the most flexibility with regard to maximizing cash flow and providing flexible ownership options. Like a term loan, an equipment lease frees up working capital, and it also helps preserve credit capacity.

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Another benefit of leasing is that it enables you to match your cash flow to the expected life of the asset being financed. For example, suppose your business receives a four-year contract to supply parts to a large automobile manufacturer. To meet the terms of the contract, however, you will need to acquire a new state-of-the-art piece of equipment with a 20-year useful life.

The lease could be structured with an early buy-out option of four years, which would allow your ownership of the equipment to match the life of the contract. Also, rather than investing your cash in a depreciating asset, you could instead use it to fund activities that may generate a higher ROI.

In addition, leases help guard against equipment obsolescence, and there may be significant tax benefits to a lease. Practically any kind of asset used by businesses today can be leased, including manufacturing and construction equipment, heavy machinery, over-the-road vehicles, printing presses, telecommunications gear, and medical and specialty equipment.

Concluding Thoughts

Deciding how to finance assets is a critical part of a strategic CAPEX plan for Los Angeles and Southern California CEOs and CFOs. If you need assistance in determining the best CAPEX financing option for your business, an outsourced CFO services provider may be able to help. Such a provider can share expertise gleaned from helping other businesses similar to yours meet their CAPEX financing challenges.

About CFO Edge

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