



Focus on finance 2010

Despite signs of economic recovery, it may still be difficult to secure funding in the coming year. What are the options for construction firms?

With the wider economy coming out of recession, now is the time to take steps to ensure you have adequate working capital reserves to take full advantage of an upturn, to enable you to invest in replacement plant and continue employing valued staff, while not leaving yourself exposed to a sudden downsizing or even withdrawal of an overdraft facility.

This year will prove yet more difficult when it comes to securing external sources of funds or even maintaining existing bank facilities. However, there are ways and means, some of which could allow injections of cash into the business without requiring security on a property or business.

There is no hiding the fact that 2009 was a bad year for the construction industry and the second half of 2008 was not too good either. However, 2008 audited accounts had the

benefit of a reasonable first half, particularly for those with September year ends. Generally, 2008 accounts were good enough to convince the bank manager to maintain overdraft facilities, loans, and so on, so that businesses could carry on trading.

Unfortunately, 2009's accounts are unlikely to make such good reading, which is why, combined with the fact that many banks want to reduce their exposure to the construction industry, the figures may make life difficult just as the industry is emerging from the recession.

Talk to experts

Separating asset finance from the day-to-day bank funding is likely to prove a good tactic. Approaching your bank to help purchase £200,000 of plant when your latest set of accounts show a 50% drop in turnover and the consequent negative impact on cashflow, may not elicit the right response, even when you explain that your trade-ins will

reduce this figure by £60,000. On the other hand, a specialist plant finance company, which understands the industry and plant residual values, will look to take its security against the value of the plant itself. It would regard this transaction as 'asset secure', because the trade-in would be the equivalent of a 30% deposit.

Cash injection

However, for the right contractor or plant hirer with evidence of contracts secured and likely cash-flow streams, the same plant finance company may view a 20% deposit as sufficient. Then, in conjunction with the supplying dealer, the finance company might be happy to lend £160,000 against the new plant, which could allow the business to take £20,000 in cash.

This could prove to be a very prudent move, because it is when companies emerge from a recession and business picks up, that working capital can be stretched to breaking point. The £20,000 cash injection could



provide a useful buffer against this eventuality while no other form of security has been asked for and the finance terms can be fixed at today's low interest rates. And, unlike an overdraft, it cannot be withdrawn once given.

Timing is also important. Interest rates are likely to increase towards the second half of 2010, so it could be a good idea to lock in to a three-year fixed rate now – this could help a business remain competitive for the next three years.

Plant finance rates are still very competitive, while official figures have revealed that bank loans are proving more costly than at any time in the past nine years. Even though the base rate is 0.5%, banks are now charging the highest interest rates on loans since 2001; in some cases a whopping 12.4%, up from 12.1% last year and 7.8% in 2006.

Balloon payments

Some manufacturers are offering preferential interest rates, 0% in some cases, to help sell their plant. While this makes any hire purchase agreement an attractive interest-free proposition, particularly when compared with the rates on an overdraft, it may be worth considering alternative repayment structures such as a balloon payment.

The balloon payment is an amount that remains unpaid until the end of the agreement. This has the effect of reducing your payments because you are paying less capital back each month. Over a three-year agreement you will pay more interest because the capital amount of the balloon payment does not reduce – it is repaid only at the end of the term.

However, if the finance itself is at a very low rate or interest free, this is of no concern because someone else is paying the bulk, if not all, of the interest. This can make certain balloon payment deals even more attractive than normal and may also present an opportunity for a cash injection.

A plant finance company would be prepared to set a nominal end of term balloon payment – perhaps half of the expected residual value. Therefore, at the end of three years, the residual value of the



plant would be far higher than the cost of the balloon payment. The skill is to leave enough value in the machine so that the trade-in not only pays off the balloon payment, but also provides a sufficient deposit for the replacement machine.

A rough rule of thumb to calculate the monthly savings

that a balloon can offer on a three-year agreement is: for every £4,000 added to the final payment, the monthly cost will be reduced by £100.

However, it may be possible to convert this monthly saving in to a cash injection at the outset. Take a new JCB costing £45,000, against which there is a part

exchange worth £25,000, leaving the cost to change at £20,000. Financed over three years on fixed rate hire purchase, this equates to about £605 a month. Add a £4,000 balloon and the monthly payments fall to about £503.

That in itself is good news, but what if you would prefer to keep

the payments close to the original £605 and have a cash injection into the business? This could be arranged with the JCB dealer by banking £4,000 of the trade-in value today and borrowing £24,000 with a £4,000 balloon (payable at the end of the term), which equates to about £624 a month.

The advantage of a three-year balloon agreement is that it offers more flexibility at the end of the term. When the payment falls due there are a number of options: pay the balloon and keep the machine; extend the agreement by refinancing the balloon over another year; or trade-in the machine and repay the balloon out of the part-exchange proceeds.

Fixed rate or variable interest

With interest rates destined to rise this year, it may seem sensible to opt for a fixed rate hire purchase agreement. But also consider that fixed-rate deals do not offer the same flexibility as variable rate agreements where lump sum payments are possible and the option of early settlement is easy because the interest is calculated daily.

JCB Finance has introduced a product called VIP Flexibuy that gives customers the best of both a fixed and a variable rate deal. This is a hire purchase agreement that offers the flexibility of shortening or extending the period but at a fixed interest rate negotiated at the start of the agreement.

For ease of budgeting, there are fixed monthly payments of capital and interest, but there is also the option of paying off lump sums early, which would shorten the repayment period and reduce the interest paid.

VIP Flexibuy can be combined with an award-winning facility called Take a Break, which enables plant buyers to take a payment holiday and extend the finance period. This facility has proved popular because up to three payment holidays can be taken during a three-year agreement.

Each holiday can either be one month or two consecutive months, with one holiday per agreement year. Customers



choose how many payment holidays they take – the maximum would total six months and the minimum could be a single one-month holiday, or none at all.

All the plant buyer needs to do is to give 15 days' notice to allow time to alter the direct debit. The cost of any payment holiday is calculated using the original interest rate. Increasingly, up to 40% of JCB Finance's customers are selecting this option.

Indeed, Take a Break was proving so popular that during the disruption caused by the snow at the start of 2010, JCB Finance emailed 750 customers who currently used this type of agreement to offer them the option of missing their January/February or February/March payments. The company received a positive reaction to this proactive initiative – helping customers without waiting to be asked, using email (and an application form on its website) to speed up the process.

When considering any of the points raised in these articles, it is important to remember that the figures used are for illustrative purposes only and JCB Finance cannot be held responsible for these or predictions about changes in interest rates. Every business should review its own position and seek advice from

THE ANNUAL INVESTMENT ALLOWANCE

Introduced in the tax year commencing April 2008, the Annual Investment Allowance was designed to encourage investment in eligible plant and machinery (new or used, but not cars) against taxable profits in the year in which the qualifying expenditure was made.

The same rules applied to all businesses, large or small, sole traders or limited companies. The first £50,000 is 100% allowable against tax, with any excess attracting the Writing Down Allowance of 20% in the first year and 20% thereafter on a reducing balance. To complicate matters further, a 40% First Year Allowance was reintroduced in April 2009, but will be withdrawn after the end of the 2009-2010 tax year.

Suffice to say that, given the right scenario and an investment of £50,000 in plant, HM Revenue & Customs could pay the equivalent of the deposit and the first year's finance payments on a three-year hire purchase agreement.

How is this possible?

Imagine the following scenario. A sole trader and JCB backhoe owner-operator, who also dabbles in property development, is rapidly approaching the end of his tax year and his accountant is warning him that he is facing a big income tax bill. Having bailed out of the property market and not reinvested his £50,000 net profit, this could attract an additional tax bill of £20,000 (40% income tax).

However, investing in £50,000 of new or used replacement plant will remove the risk of paying tax at 40%. In reality, paying a 10% deposit (possibly funded by part-exchanging his old machine) and borrowing £45,000 at 0% over three years equates to a £20,000 outlay in the first year, followed by £15,000 in each of the subsequent years. That £20,000 first year's outlay equates to the £20,000 tax bill saved, so it is not too far from truth to state that HM Revenue & Customs has paid the equivalent of the deposit and the first year's hire purchase payments.

a financial adviser – be it an accountant or finance director.

The message to take from this is that 2010 will be a year where cash flow is king and where the arguments for preserving working capital will be strongest.

Many would be surprised to learn that a well-structured plant finance package can offer cash flow and tax efficiencies that outweigh using cash resources. The next article will examine this claim in some detail. ●

Cash versus finance

With interest rates at a record low, does it make more sense for businesses to fund capital expenditure with cash or to borrow under a hire purchase agreement?

In January 2009, the Bank of England dropped the base rate below 2% for the first time in 315 years. And in March 2009, it reached an all-time low of 0.5%.

With rates so low, should a business be using its own money to fund capital expenditure, or is borrowing the more prudent idea?

Tax efficiency and net interest charges form an important part of this calculation, along with cashflow and working capital. It is the lack of working capital that puts companies out of business, especially as they gear up to take advantage of a construction industry set to emerge from recession.

It is in these circumstances that many companies find their working capital has been gobbled up by paying cash for the extra machinery and plant required to secure new contracts.

What can be learnt from this scenario? And do today's low interest rates require a rethink on funding options and the methods used to maximise cash flow and tax efficiency?

Let's assume two plant hire businesses purchase identical machines at £50,000 each, one paying cash and the other paying over three years on fixed rate hire purchase (HP). During the recession neither business purchased any plant, so both can claim the Annual Investment Allowance (AIA) of 100% of the first £50,000 spent on eligible machinery in that tax year, irrespective of the fact that one pays cash and the other borrows on HP. In addition, the VAT is

reclaimable in full within the first tax quarter regardless of whether the plant was purchased for cash or on HP.

Parity so far, with both businesses claiming the same AIA, and the appeal of your accountant being able to write off the whole expenditure against tax in the last month of the tax year is self-evident. If the plant was acquired on monthly in arrears HP terms, the only outlay in the old tax year would be the deposit (possibly catered for by a trade-in). The first HP payment would be due one month into the new tax year and the company would make a huge saving on the tax bill (up to £20,000 for a partnership paying 40% income tax).

Paying £50,000 in cash on day one does gain the same tax benefits, but it represents very poor cash flow management and would be a severe drain on working capital.

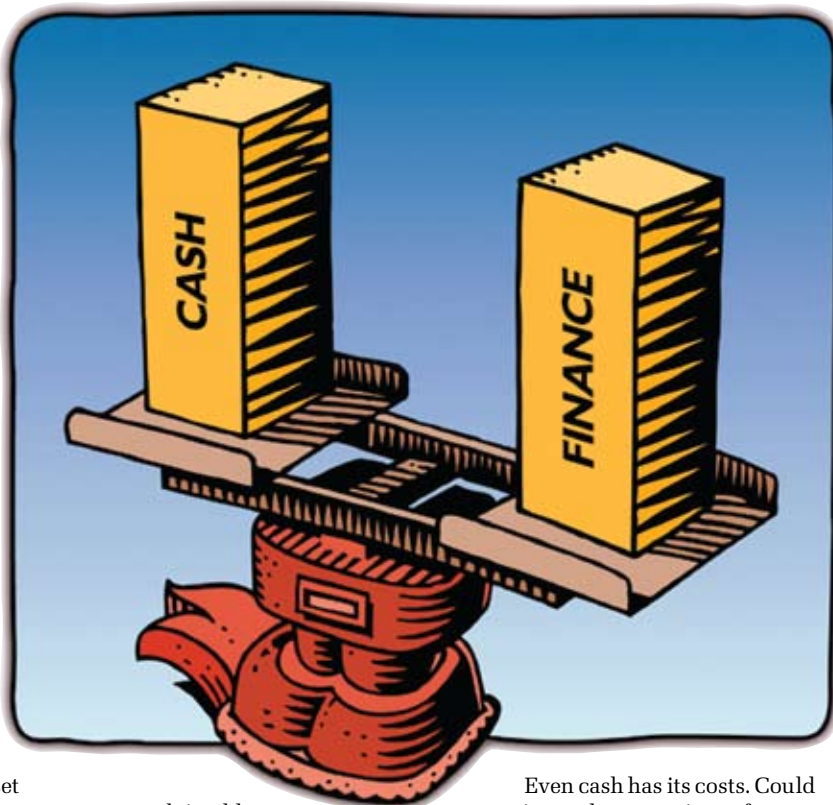
Even cash has its costs. Could tying up large portions of your working capital in machinery leave you exposed if business activity dips? A good argument against paying cash is that you would not pay three years' wages in advance, so why do the same for your plant? Let the plant pay for itself from the income it generates for your business.

Nobody likes paying interest charges, but consider the fact that the interest due on HP is 100% tax deductible and the business that kept its £50,000 in a deposit account will earn interest. Hence the true cost of borrowing is lower than many realise. On this purchase the difference may be as little as £500 in the first year, while the company using HP to fund the purchase still has its £50,000 deposited at the bank. This could prove to be a crucial financial reserve.

Ultimately your accountant will need to run the calculations to see what is best for your

BENEFITS OF HIRE PURCHASE

- A business can claim the Annual Investment Allowance and any subsequent annual writing-down allowance, just as if cash had been used for the purchase.
- Interest paid on an HP agreement can also be treated as a business expense in the profit and loss account, further reducing the tax bill.
- VAT is fully reclaimable at the outset.
- Fixed rate HP protects a business against inflation and rising interest rates.
- Variable rate HP allows a business to enjoy savings from falling interest rates and there are no additional costs for early settlements or payments of lump sums.
- Facilitates accurate budgeting.
- Preserves working capital – the life blood of any business.



business, provided there is a sound reason for investing in additional plant and machinery in the first place.

When considering the benefits of hire purchase agreements (see box), it becomes clear that there is a strong argument to use competitively priced HP agreements instead of cash when bank base rates are so low. Managing cash flow is a key element to business survival and well structured hire purchase agreements can smooth out the peaks and troughs of any business' income and expenditure patterns.

When considering the points raised in these articles, remember every business' circumstances are different, with different tax rates and income and expenditure patterns. Always seek advice from your financial adviser – be it your accountant or finance director. Businesses should not make investment decisions purely on a tax basis. ●

Selecting the right source of funding for plant can be as important as choosing the right equipment to do the job. Apart from the obvious desire to lock into today's low interest rates, what other recent trends might influence the decision over choice of funding method?

The strong growth in the waste and recycling industry has led many companies to examine the benefits of leasing plant – benefits that have long been enjoyed in the mining and quarrying sectors. Moving from traditional hire purchase towards leasing may also present opportunities to release cash into the business.

Ownership and the impact on the balance sheet

Depending on the nature of your business, ultimate ownership of your plant and its position as an asset on your balance sheet may not be very important if the plant is part of a materials handling or extraction process and there are already other significant assets, for example, a waste recycling facility or mine.

In these circumstances it is often more important to know how much each piece of plant contributes to the overall cost of processing "x" tonnes of material. Finance products such as operating leases or contract hire allow this clarity because ownership of the plant remains with the leasing company, which retains the assets on its balance sheet and in turn claims the capital allowances, which are then reflected back to the customer in the form of lower monthly instalments. The instalments are further reduced because the predicted residual value remains unpaid (in the same as way a balloon payment lowers payments in a hire purchase agreement).

From the customer's perspective, this off-balance sheet treatment is allowed because the residual value risk and the responsibility for disposing of the plant, to a third-party buyer, rests with the leasing company. The advantage for the customer, who may already be asset rich, is that the removal of the plant from the balance sheet improves financial



A new lease of life

Switching from a traditional hire purchase agreement to leasing can provide a useful cash injection for the business

gearing. Key accounting ratios can be significantly improved, because even if you make the same profits these are reflected against a lower asset base (which will please the shareholders or potential investors).

A key measure of a firm's efficiency in managing its assets in relation to the revenue generated is the total assets to sales ratio. Dramatic improvements to this ratio can be achieved at a stroke of a pen if a firm elects to sell its plant to a leasing company, which then leases the machines back to the firm under a sale and leaseback agreement. In this instance, there could also be a massive injection of cash into the business.

At the other end of the scale, even if a business chooses to lease (rather than buy) its next tracked excavator, it may be able to bank a good proportion of any trade-in. The leasing company would ask for an advanced instalment in lieu of a traditional deposit,

usually one monthly instalment for every year of the agreement. Any surplus raised by the trade-in would be kept by the customer.

An operating lease that is combined with service, repair and maintenance agreements is usually called contact hire. Thus contract hire can represent the ultimate risk-free method of acquiring, running and maintaining plant, putting a ceiling on costs and releasing additional capital to invest in your business.

It allows you to concentrate on your core business activity rather than worry about buying, selling and maintaining machinery, and removes the administrative burden and financial risk of predicting the running costs of your plant for the next three, four or five years.

If required, contract hire can even include relief machines in the event of breakdowns – all combined to become one agreed budgetary expense. All the other

tax and accounting benefits of contact hire mirror those of an operating lease:

- Low capital outlay;
- Spreads the impact of VAT, which is collected on each instalment as it falls due;
- Low fixed instalments;
- Tax efficient – the instalments are 100% allowable against taxable profits;
- Preserves working capital reserves;
- Removes residual value risk;
- Off balance sheet funding;
- Easily combined with repair and maintenance contracts to offer total peace of mind.

Operating leases are a popular option within niche sectors and their appeal is rapidly broadening to other sectors. However, no matter what form of leasing is considered, no two businesses are the same and your accountant is best placed to analyse whether leasing would be the more cost and tax-efficient funding option for your business. ●



Lending a helping hand

JCB Finance traces its origins back to the establishment of JCB Credit Ltd on 12 February 1970

A pioneer in the field of sales aid finance with a national field force of locally based territory managers providing hire purchase, leasing and contract hire facilities at the point of sale, JCB Credit was one of the first manufacturer-linked finance houses in the UK. In its first year of operation, the business – originally known as JCB Credit Limited – achieved a turnover of £900,000. It passed £500m in lending balances in December 2007.

Over the years it has gained a reputation for providing fast, flexible finance through good times and the bad – supporting construction, agricultural and industrial customers through four recessions and the foot and mouth outbreak. The maxim of supporting customers was especially true during the recent recession as JCB Finance continued to lend when other lenders would not.

The firm finances almost 90% of all JCB equipment purchased on finance in the UK. It also funds other non-competitive plant, machinery and vehicles, meeting the majority of its customers' asset finance requirements.

JCB Finance's ethos of supporting and helping customers to grow is perhaps best illustrated by statements from two long-standing customers.

"R Savage Plant Hire was a young, newly established company when we first used JCB Finance in the early 1970s," recalls Joy Smith, joint managing director. "The recession of 1973 was a particularly trying time, but JCB Finance was prepared to assist our company, enabling us to purchase new JCB equipment and move the company forward. We are proud after all these years that our business relationship with JCB Finance has grown and we hope to be using its services for many more years to come. We

congratulate JCB Finance on its success over the past 40 years."

Hugh Edeleanu, chairman of the HE Services Group of Companies, says, "We have been doing business with JCB Finance for more than 30 years and have found it to be very approachable, helpful and competitive. It understands the needs of construction plant companies and we would class its administrative staff as being first rate.

"Even during recessionary times, JCB Finance continues to prove that it is not just a 'fair weather friend', always willing to support and stand by its customers as it knows the value of plant and factors this in to its lending decisions. We

congratulate the company on its 40th anniversary and would recommend it to any potential purchaser of equipment where finance is needed."

In August 1998, the company changed its name to JCB Finance Limited, the result of a desire from JCB to replicate across the world the success of its UK finance arm under a common brand. By November 1998, JCB Finance had moved into newly developed headquarters in the Mill. The building stands on the outskirts of Rocester, opposite JCB's world headquarters, and combines a preserved water mill with an impressive new extension, providing modern office accommodation without losing the character of the original – a perfect blend of old and new.

JCB Finance's managing director, David Burgess, says, "The company will continue to use its skills and intimate knowledge, backed up by award-winning systems, to support its customers as they emerge from the recession. It is by providing such assistance in difficult times that we have helped customers to survive and ultimately thrive so that they can continue to buy more JCBs in the future." ●



JCB Insurance Services takes a look at the issues of insuring contractors' plant

THE CONSTRUCTION

industry is arguably the industry hit hardest by this recession. A firm's plant can form a major asset and plant hired in, a major liability. Ensuring that this plant is correctly insured could be vital to the firm's financial stability.

The first thing to get right is the sum insured - this sounds obvious but this is not always as easy as it may seem. Some insurance policies pay claims on a 'new for old' basis on plant anything up to 2 or even 3 years old whilst others only pay claims based on the market value of the kit. Your Broker should let you know what type of policy they have arranged for you.

If your policy is on a 'new for old' basis the value you insure your plant for must be the new replacement value, including extras like hammer pipework or immobilisers. Take care not to deduct any discounts you may have negotiated when you bought the plant because, if it gets stolen, those discounts might not be available when you come to replace it. However, make sure you reduce these when the plant gets to the end of the 'new for old' period otherwise you will be paying too much insurance premium.

This is relatively easy when insuring individual machines but extra care is needed when looking at a fleet of machines with a rolling replacement programme and older machines. Many plant owners insure the 'written down' value of their plant but this is often less than the 'market value' because of

aggressive depreciation and this could expose you to having 'Average' applied to your claim by the Insurance company. In very basic terms 'Average' is where the value of a claim is reduced in direct proportion to the level of under insurance - hence the importance of getting the sum insured right.

Example of 'Average'

You have insured your total plant asset for £750,000 and the loss adjuster proves the true figure should have been £1,000,000 then your plant is only 75% insured and, more importantly, you will receive only 75% of any claim. In simple terms, if you have a machine with a market value of £40,000 stolen, you will recover only £30,000 before the policy excess.

Most policies will have a limit for any one loss - make sure this is sufficient if you have more kit than usual stood in one place either because of the recession or because of holidays such as Christmas or Easter. Some insurance policies do give an automatic uplift for Christmas but make sure you check.

For example, your total plant value is £1,000,000 and your insurance has a limit for any one loss of £250,000. This is usually fine because you rarely have too much plant in any one place. However, it's just after Christmas, the snow and ice are awful and as a result you've got 10 machines stood in the yard with a value of around £330,000. Someone breaks in and sets fire to one but because they're all

packed tightly into the yard, the fire has spread from machine to machine and all the machines are lost. In this scenario you would be £80,000 short on your insurance claim.

Hired-In Plant insurance will have a limit for any one loss or any one machine, make sure you know which and that it is sufficient for what you need. In addition, if an item hired in under CPA conditions is stolen, you are liable for 2/3 of the hire rate until the claim is settled - not all Insurance policies cover this; make sure yours does and make sure you know how long for. Plant is insured based on what it is used for. For example, plant hired out under CPA conditions 100% of the time is less expensive to insure than plant used for own contracts. Not only does the occupation affect premium, it also determines whether or not it is covered because there will be conditions and exclusions on the policy. In times of recession, we all do what we've got to do to get by and this might mean a Groundworker undertaking a demolition job or a Plant Hirer taking on a groundworks contract or hiring machines out without CPA conditions - this will affect your Insurance and potentially put your business at risk, so make sure your Insurer knows what activities you are involved in.

Finally, Plant Security has never been more important. History shows that in recession, there are more thefts. Now is the time to focus on security of plant, not

forgetting attachments, and to consider investing in security. Thatcham launched their 3 Star security criteria in March last year and by fitting a CESAR registration system, an ignition keypad or unique key and an approved immobiliser it needn't be too expensive to meet the criteria. Insurance companies are now recognising and rewarding plant operators who take a proactive approach to security with insurance discounts of up to 40% available and often hefty theft excesses waived

if the Thatcham criteria are met. Plant security is therefore an investment worth considering especially when you factor in the 'hidden cost' of a theft in wasted management time, down time on a contract etc., which can mount up to more than the cost of the claim itself and can't be recovered by Insurance.

Your Insurance Broker should be working hard on your behalf to give you the right advice and arrange the right insurance for you but they must fully understand your industry.

JCB Insurance Services are specialist Insurance Brokers with access to a very wide range of Insurance companies to ensure a great deal on all your Plant, (not just JCBs) Liability, Motor Fleet and more, together with giving expert, realistic advice on protecting your business.

Contact them on 08001412877 or email: insurance@jcb.com

www.jcbinsurance.com

Example based on Insurance policy paying claims at Market Value vs 'New for Old' for 2 years

4 machines purchased new at £40,000 each in 2008	2008	2009	2010
Insurance Sum Insured - New for Old Policy for 2 years	£160,000	£160,000	£115,600
Insurance Sum Insured - Market Value Policy	£160,000	£136,000	£115,600