5-15-1985

Farm Machinery Financing Terms

Todd Lone
South Dakota State University

COOPERATIVE EXTENSION SERVICE

Economics Newsletter

Editor: Donald C. Taylor

Economics Department SDSU, Box 504A Brookings, SD 57007 Tele: (605) 688-4141

No. 221 May 15, 1985

Farm Machinery Financing Terms

by
Todd Lone
Graduate Research Assistant
and
Dr. Larry Janssen
Associate Professor of Economics

Farm machinery investment and maintenance are major expenses in most farm operations. In this newsletter, we discuss two methods of acquiring and financing farm machinery: **credit-purchase** and **financial leasing.** Advantages and disadvantages of each financing method are discussed and results from a recent farm machinery finance survey in eastern South Dakota are presented.

Machinery Finance Alternatives

Credit-purchase is the most common method of acquiring machinery. A credit-purchase agreement is a contract between a lender and borrower (farmer) in which the lender supplies the money needed to purchase the machinery. The borrower acquires ownership of the machinery and makes periodic payments to the lender until the debt is paid.

Major advantages to the farmer of a credit-purchase agreement are: (1) his having investment tax credit and accelerated depreciation tax benefits and (2) the benefit of any resale value the machinery has and its value as collateral for future borrowing. Disadvantages to the farmer are: (1) possible obsolescence of machinery and (2) all costs of ownership and operation including insurance, taxes, and repairs being assumed by the farmer. This requires high capital investment with its associated risks.

A financial lease is a contract between a lessor and a lessee (farmer) in which the lessee agrees to make period payments in return for the use of the machinery. The lessee does not acquire ownership of the asset, only use of it. In many cases, the farmer has the option to purchase the equipment at the end of the lease period.

Major advantages to the farmer of a lease are: (1) lease payments are a tax-deductible expense and (2) in some leases the lessor pays for insurance and major repairs. Disadvantages to the farmer are: (1) high tax bracket farmers receive no use of tax benefits, such as investment tax credit and accelerated depreciation, (2) possible obsolescence of machinery at the end of lease, and (3) the farmer having to pay major repairs and insurance if the lease does not have a full service contract.

South Dakota Machinery Finance Survey

The purpose of a machinery finance survey was to obtain current information on financing terms and lender/farmer use of credit-purchase and leasing agreements. The survey was sent in November and December, 1984 to 65 commercial banks and 65 farm implement dealers located in 38 towns and cities in eastern and central South Dakota. Loan officers from 23 banks and 27 farm implement dealers completed the survey. Respondents to the survey exhibit characteristics typical of banks and implement dealerships in the region. (Insurance company leasing programs were not included in the survey.)

All respondents (bankers and dealers) offered credit-purchase programs. Almost all responding machinery dealers offered the lease option to their customers while only 39% of respondent bankers did. Relatively few (5%) farm customers of banks or dealers used financial lease agreements, although bankers and dealers indicated financial leasing has become more popular during the past 5 years. Respondents indicated most farmers and ranchers preferred to own instead of lease equipment. Further, 70% of the dealers and 91% of respondent bankers indicated a lack of understanding about leases by both parties of potential lease agreements.

Credit Purchase Agreements

The common financial terms of a credit purchase agreement from dealers and banks are given in Table 1. The downpayment typically required by dealers was greater than that by bankers. The Annual Percentage Rate of Interest (APR) was also 0.5-1.5% higher than rates reported by banks. the timing of loan payments was similar for bankers and implement dealers.

Table 1. Credit Purchase Agreement

	Dealers	Banks
Downpayment (% of purchase price)	30-35%	20-30%
Length of agreement (yrs)		
Most equipment	3-5	3-5
Irrigation equipment	7-10	7-10
Payments are made:		
Annually	76%	65%
Semi-annually	8%	13%
Quarterly	0%	0%
Monthly	8%	4%
Buyers choice (varies)	8%	17%
Annual Percentage Rate of Interest (APR)	15.5-16.5%	14-15.0%

All respondent dealers, but few bankers, offered interest waiver periods usually extending to next year's use date. Nearly one-fourth of dealer and banker repondents offered a deferred first payment option while others required a downpayment at time of purchase.

Just over half the dealers (56%) responding said the interest rate (APR) was variable, while 50% of the banks said the APR could be fixed or variable depending on customer's choice, loan amount, loan length, and other terms. If a fixed rate loan is set up, the bank charges an interest rate 1/4 to 1% higher than the current rate on a comparable variable rate loan. Dealers and banks agree that the interest rate on a variable rate loan can change monthly.

The dealer financed loan paper is usually sold to a manufacturer-credit corporation or a commercial bank. The most common credit corporations cited were JD, IHCC, ACCC, Sperry, Case, Borg-Warner, and Clark Credit Corp.

Financial Leases

The terms of typical leases offered by the dealers and banks are more diverse than the usual terms of purchase agreements (Table 2). There is a much broader range in the first payment percentage and payment factor percentage (lease payment as a percent of original price of machinery) offered by banks than those offered by dealers. The probable reason is that some banks allow lease payments to be made more frequently than once per year. The payment factors are similar when expressed on an annual basis.

Table 2. Financial Leases

	Dealers	Banks
First payment (% of purchase price)	20-25	10-25
Payment factor (%)	20-25	9-22.5
Agreement length (yrs)		
Most equipment	4-5	3-5
Irrigation equipment	7-10	7-10
Payments are made:		
Annually	75%	43%
Semi-annually	5%	0%
Quarterly	0%	0%
Monthly	5%	0%
Buyers choice (varies)	15%	57%
Fixed purchase price (buyout percentage) as percent of original price	10-15	10-15

The lease agreement length is comparable for dealers and bankers. Relatively few bankers or dealers have minimum dollar value requirements before a lease is set up. Most dealers and all banks require the first lease payment at the time the agreement is made. Dealers and bankers also agree that the payment factor is fixed for the life of the agreement. In addition, all dealers and most banks offer a purchase option at the end of the lease, with the majority of both having the purchase price a fixed percentage (commonly 10-15%) of the original cost.

Who gets the investment credit (TC) is an area of some diversity depending on which institution the farmer deals with. Of the dealers responding, 77% said the lessor kept the investment credit. Bankers said the investment credit could go to the bank or to the farmer depending on customer need and the specific terms set forth in the lease.

Dealers and bankers generally agreed that taxes, insurance, and repair costs would be paid by the lessee, although a few indicated these were negotiable items.

Implement dealers generally set up financial leases offered by manufacturing company leasing subsidiaries. Some dealers also offered leasing programs from insurance companies or banks. Bankers generally offered leasing programs through a leasing subsidiary, an affiliate company, or a correspondent bank.

Application Requirements

Financial statements (balance sheets) are required for both lease and credit-purchase agreements. Credit references and past repayment records are also important to dealers and banks. Tax records, cash flow statements, and a courthouse record search are considered more important by banks than by dealers when making the decision of whether or not they will sign an agreement with a customer. A majority of bankers and dealers required a more thorough credit evaluation for lease than purchase agreements.

Past Trends/Future Directions

Dealers and bankers observed significant changes in lease and purchase agreements over the past 5 years. Dealers indicated financial leasing was on the rise and cited the following reasons for this: 1) more competitive payment factor, 2) fixed purchase options, and 3) better company programs which they felt made leasing cheaper than purchasing for many customers. The bankers indicated lower downpayments and capital requirements, and guaranteed buy out were significant changes because leases now generally fit farmers' cash flows better and don't require as much immediate cash.

Bankers and dealers cited variable interest rates and interest waiver periods as significant changes in credit-purchase agreements. Bankers indicated a trend to shorter loan periods and larger downpayments.

Bankers and dealers both indicated financial leasing of machinery would increase in the future. Bankers believe there will be 1) more bank involvement as the lease market increases, 2) increased lease usage on bigger items, and 3) possible decrease in lease usage if new tax laws eliminate tax writeoffs. Bankers indicate these would be significant changes because leases keep operating loan amounts down and many farmers don't have the capital for big item purchases.

Overall, the differences in leasing and credit purchase terms are considerable. Furthermore, the financial advantage of leasing compared to credit purchase will vary by a producer's financial and tax situation. Producers with relatively low income tax rates, those who cannot make full use of investment credit in the first year or accelerated depreciation terms, or those who are in a cash flow pinch may find financial leasing to be attractive.