



ASK THE EXPERT

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An equipment strategy that keeps you current with trends

I'm a processor being urged to produce products that meet every new diet craze out there. How do I know whether to invest in the equipment I need to meet these demands?

Whether it's a slow moving trend or a hot food fad, consumer demand for new products will always be with us. Keeping up with this demand means buying new capital equipment that calls for a sound purchasing strategy.

Many companies wait too long before considering a capital purchase. Waiting for a machine to fail and then either repairing or replacing it is not really a strategy at all. Too often, equipment breaks down when it is being pushed the hardest, like meeting an urgent delivery deadline.

Instead, repairs and replacements should be part of overall equipment maintenance and a replacement policy should consider future cost and timing. Here are several decision-making tools to make your decision easier.

Payback is a measure of the time it will take to recoup the original dollars invested. It can be a useful model when you need to pick the best solution from several proposals, for example, if you have a pressing need to save money, you do not need a precise profitability estimate, or the investment is risky.

One weakness of this measure is that it does not consider the time value of money, or the investment's profitability. Just because a project has an acceptable payback does not mean it is necessarily better than one with a longer payback.

A variation on payback is the bailout factor, which evaluates competing proposals according to which has the best exit strategy. Compare the original investment of each alternative, considering also the salvage value of the equipment at the end of its useful life. Some equipment may have a high initial price tag, but if it also has a high value on the used equipment market, considering bailout in your calculations may make it score better.

Discounted cash flow and the internal rate of return models consider the expected cash flow from several possi-

ble investments, discounted to acknowledge the time frame involved. They can be good ways to evaluate long-range decisions and large capital investments.

One limitation is that they assume a world of certainty regarding factors like the cost of capital, cost of labour and raw materials and demand for the product. The volatility of today's food market means that none of that can be certain, but changes in assumptions can be addressed with an adequate sensitivity analysis.

Quite likely, energy costs will be a significant contributor at present and are likely to become even more important in the future. Interest rates are also likely to change over the life of the equipment. You can manage these costs through fixed-rate or longer term financing, possibly through fixing the interest rate to match the useful life of the equipment.

In the return on investment or accrual accounting method, the projected lifetime income from a piece of capital equipment is divided by the cost of the investment. Accrual accounting is subject to rules designed to measure current income rather than make long-term capital budgeting decisions. Consequently, it is the least desirable model and should be used with caution. It has a way of distorting the decision-making process. A manager who is rewarded for keeping a high rate of return, for example, may decide to keep this number up by not investing in new equipment. While the manager earns a bonus, without investment in capital equipment, the prospects for the facility's long-term success are dim.

Before making any capital investment decision, consider the motivation for this decision. If the hope is to increase capacity, you should perhaps see if you are sitting on untapped productive capacity instead.

Capital investments can be both nerve-wracking and exciting. Using one of these methods or a combination of a few may clarify the answer.

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