

S E M I N A RONEXISTING AND NEW FORMS OF FINANCING

University of Auckland, 27 May 1982

CONTENTS

CHAPMAN TRIPP

Papers:

- |  |      |
|--|------|
| Outline of Paper: Financing through the use of<br>Taxation Planning            | P.3  |
| <u>DAVID J. ROSS</u><br>Chartered Accountant and<br>Company Director, Auckland |      |
| Off-Shore Borrowing  | P.6  |
| <u>RUDOLF A DE MONCHY</u><br>Merchant Banker, Auckland                         |      |
| Leveraged Leasing and Project Financing  | P.25 |
| <u>BARRY J McWILLIAMS</u><br>Barrister and Solicitor<br>Auckland               |      |

Printed by West Plaza Copy Centre  
 ISBN 0 - 908581 - 17 - 3

Legal Research Foundation Inc.

PAPER 1

**REFINANCING THROUGH THE USE OF  
TAXATION PLANNING**

A brief summary of matters covered in a paper  
presented to the Legal Research Foundation — May 1982

by

DAVID J. ROSS, Chartered Accountant

FINANCING THROUGH THE USE OF TAXATION PLANNING

by David J. Ross, BCom, ACA, CMA

A brief summary of matters covered in a paper presented to the Legal Research Foundation - May 1982

1. We are living in turbulent times, partially due to the effect of inflation and the uncertain world situation.
2. Disclosed corporate profits require major adjustments to compensate for inflation, and major profit increases by leading companies are having very little effect on share market prices. Share market prices on average are less than three-quarters of the disclosed asset backing of the companies concerned.
3. Liquidity and cash flow are becoming more important than earnings as a positive cash flow means survival, whereas profitability without cash flow can mean disaster.
4. Taxation could be regarded as a 'business expense' or as a distribution from profits that have been earned - should taxation be regarded as a cost of operating a business?
5. An emotional area of taxation planning - tax avoidance and tax evasion.
6. Lease or purchase decisions - taxation advantages and non balance sheet disclosure.
7. Off-shore borrowing - taxation treatment of currency gains and losses.
8. Corporate restructuring - particular emphasis on the family group of companies or the private company.
9. Family trusts - the income spreader.

10. Superannuation funds - traditional corporate funds and funds for the family and for the self-employed.
11. Capital structuring - convertible notes and specified preference shares.
12. Front end loadings - structuring a loan to maximise taxation advantages.
13. Government handouts - a brief comment on incentives and subsidised industries.
14. Acquisitions - the effect of 'Big is Beautiful'.
15. Tax shelters - taxation planning for the self-employed.

-----

PAPER 2

**OFF SHORE BORROWING**

by

**RUDOLF de MONCHY**, Merchant Banker

Chase NBA New Zealand Group Ltd.

The purpose of this paper is to give some information about the various aspects of offshore borrowings. It is written for people with a legal or an accountancy background, but it is not intended to be a document which exhaustively outlines all the aspects and its pitfalls of that type of financing.

OFFSHORE BORROWINGS

Spurred by the growth of international trade and the development of the Euro-currency markets, the local and international capital markets have opened to a greater number of sovereign and corporate borrowers. We will talk this afternoon about how the corporation can finance its own business or finance its international buyers and the choice it has of fixed or floating rate term lending from a variety of sources, including export finance schemes, in a variety of currencies.

Before explaining the various types of financing, I will give you a brief run-down of what a Euro-currency is and how it is developed.

EURO-CURRENCY LOANSWhat is a Euro-currency?

A Euro-currency is a convertible currency on deposit in a bank outside of the country of issue. The fact that it is called a Euro-currency does not indicate that it is limited to European currency. Also non-European currencies are called Euro-currencies when they relate to transactions outside their home country. For example, a dollar on deposit in London or Paris would be a Euro-dollar because it is on deposit in a bank outside of the United States. Although a Euro-dollar is a United States dollar on deposit with a bank outside the United States, the dollars actually are on deposit in the United States. Namely, that outside bank will have a dollar account with an American bank where it has placed the dollar on deposit, but it merely represents a change in the deposit's ownership. The reason that a currency is ultimately always on deposit in the country of origin is because nowhere else can one actually use that currency (you cannot pay for your local groceries in New Zealand with US dollars).

An example makes it all the more understandable. (Because the Euro-dollar is still the major currency in the Euro-market, the example will be based on a US dollar transaction).

Let us assume that a US company purchased New Zealand meat and will pay in US dollars. That US company will instruct his US bank to charge his account for, say, US\$100,000 and will pay it to the meat works in Auckland. His bank will charge his account and credit the account of a NZ bank in its books for the meat works' account. The New Zealand bank, in turn, will show a US\$100,000 deposit for the meat works on its books. By this means of transferring US\$100,000 from one account to another account with the same bank, the US\$100,000 become Euro-dollars, because they are now represented by a deposit in the name of a New Zealand company at the US bank.

The New Zealand bank receiving the Euro-dollar deposit may employ the funds in 3 principal ways. Firstly, it may re-deposit the funds with another bank including an American banking branch located outside the USA. Secondly, it may lend the funds to a final non-bank user. Thirdly, if it is placed with an American branch, the latter may transfer the Euro-dollar deposit to its Head Office in the United States.

The re-depositing of Euro-dollars with another banking office outside the United States creates additional book-keeping entries raising both the assets and liabilities of the second bank. Such re-depositing may continue through a third or fourth bank with equal increases in debits and credits, but such inter-bank re-depositing involves nothing more than successive transfers of ownership of the original deposit in the United States, without any real expansion of credit, but it creates an accumulation of Euro-deposits.



If the money is lent to a final non-bank user, for instance a multinational corporation, credit expansion may occur.

The third possibility is of transferring the funds from an American branch outside the United States to its US Head Office. No increase occurs in US bank resources as a result of this transfer, only a shift of resources from one US bank to another, as the original deposit is merely transferred from the original US bank to the Head Office of the bank whose overseas branch accepted the deposit.

How did the Euro-dollar market develop?

There is no universal agreement as to why this pool of funds developed, but most experts trace its origin to the substantial US balance of payments deficit in the sixties; the interest rate premium over US held dollars which Euro-dollars have offered to the depositor, and the US exchange control regulations which have obliged US and overseas borrowers to raise finance overseas which previously could be borrowed in the United States. Whatever the reason may have been, the result was a gradual build-up of dollar deposits abroad. Rather than keeping the dollars on deposit with Central banks or commercial banks, the thought occurred that they could lend those dollars directly to users outside United States, and that, in itself, is the actual creation of the Euro-dollar market. That market is now very large and liquid, namely around \$1,655 billion in deposits with an average maturity of eight months.

Why did London become the centre of this activity?

The creation had to be in a financial centre where borrowers and lenders came together and that was actually the case in the London market. The presence of many large institutions in that city and an excellent communications network permit fast commitments. London's regulatory

tradition of encouraging a free market in international deposits and loans has made the City ever more attractive, as national authorities in other countries have attempted to regulate the foreign operations of local institutions by imposing leverage ratios, foreign exposure limits, reserve requirements on loans and deposits and the like.

Is London the only Euro-dollar currency centre?

Although London is the main centre, other growing centres are Singapore and Hong Kong, which have developed in the late 70's; possibly New York will become one in the not-too-distant future, because it has had an offshore banking centre since December 1981. Worth noting is that earlier Euro-currency originated in Asia were called Asian currencies, but in the seventies that name was changed into the more internationally accepted name of Euro-currency.

As mentioned earlier, a Euro-bank's source of funds is generally not customer deposits, but the inter-bank market, where any financial institution with an accepted name can obtain funds within a narrow differential of a free determined market cost. The bank prices its loans not on a cartel or prime rate basis, as is the case domestically, but according to a marginal relationship over its cost of funds for a particular maturity. This assures the lender of a pre-set interest spread, provided that he matches the maturity of his loan with a corresponding deposit. Loans have been made at a certain spread above the certain rate called LIBOR Rate. This stands for London Interbank Offered Rate, and this refers to the interest rate that banks charge one another on loans of dollars or other currencies. That rate corresponds with the national interest rate of that currency, but adjusted to regulatory factors - such as the reserve requirement - which affect domestic rates.

As we all know, Euro-currency loans are now widely accepted and syndication of major loans among several banks has become standard practice. The objective of a loan syndication is spreading risks, earning a useful management fee and publicity for the managing bank, and also establishing mutually profitable relationships with other banks in the market. From the borrower's standpoint, syndications establish potential banking relationships with a large number of banks.

How strong is the Euro-dollar market?

It was feared that the Euro-dollar market might collapse stemming from the common notion that an original Euro-dollar deposit pyramided throughout the system via a series of inter-bank deposits, leaving in its wake an accumulation of deposit liabilities in the Euro-banks through which it passed far in excess of a single New York asset from which it originated. The fear is that if one of these Euro-banks were to default in its obligation to repay Euro-dollars to a preceding bank, that that preceding bank may be caused to default as a result of that, culminating finally in a general breakdown of the system. The risk of default and ultimate collapse of the Euro-dollar market is in theory there, but we should bear in mind that all the participants of the Euro-dollar market, being the Euro-banks, are all governed by their own country's Central Bank's regulations. Although the Euro-dollar market is in theory unrestricted, it is very unlikely that in case a major bank of country Y was in default the Central Bank of that country would not intervene, because it would tremendously affect the confidence in the banking control system of that country. In addition, it must be remembered that in speaking of Euro-banks, one is referring to the world's most respected and highest quality banking institutions, and it is inconceivable that these institutions would ever allow themselves to default on their maturing Euro-dollar liabilities because they had unwittingly loaded their asset portfolios with too many long term

Euro-dollar loans. Moreover, bear in mind that it is the practice to match assets and liabilities and maturities in their balance sheets. A completely matched balance sheet is one in which, for aggregate deposits of a certain maturity in a currency, there are assets of the same amount, currency, and maturity. A matched balance sheet, however, is all very well in theory but when large banks are involved simply the numbers make it impossible that they cannot repay one specific Euro-currency deposit. Also one should bear in mind that the infra-structure in the Euro-dollar centres makes it possible to obtain deposits in minutes. The inter-bank market does serve as a lender of last resort to an individual Euro-bank. Virtually every Euro-bank's asset portfolio contains some call or sight deposits with other Euro-banks.

#### Limitation of Borrowings in New Zealand by Overseas Persons

Before going into the various forms of off-shore borrowings, which is today's topic of discussion, it may be worthwhile to mention that the Overseas Investment Act and Regulations stipulate that any overseas person is limited in its domestic borrowings and must make an application for consent before borrowings in New Zealand dollars are allowed. (An overseas person is defined as a company which is 25% or more overseas owned or controlled. This is a simplified statement, because the actual definition is more complicated.)

In other words, when the financing needs of an overseas person exceed its domestic availability, that person must arrange off-shore financing for the excess.

Exempt from the Regulations are local borrowings up to a total of NZ\$300,000 and consent to borrow up to that amount is not required.

The Overseas Investment Commission (OIC) closely linked with the Reserve Bank of New Zealand, has given the following guidelines which are currently applicable.

The restrictions with regard to the amount of domestic borrowings come into force when the foreign ownership is 50% or greater. When the company is predominantly New Zealand owned and controlled, there are no restrictions, but prior approval has to be obtained.

There is a limitation, however, when the company is 50% or more overseas owned or controlled. In that case the domestic borrowings may never exceed the sum of 15% of total turnover in the previous financial year, plus an additional 20% on export sales therein. If a company is less than 75% overseas owned or controlled, additional borrowings are permitted as long as an amount proportionate to their overseas ownership or control is also raised overseas, for instance, if a company is 60% foreign owned it may increase its local borrowings by \$4.00 for every \$6.00 raised overseas.

When a company is exactly 50-50 New Zealand/Overseas owned and controlled, their local borrowings may raise even further, namely with \$3.00 for every \$1.00 raised overseas.

This OIC regulation clearly outlines the need for foreign subsidiaries to have offshore borrowings available.

Conversely, the general rule of the Reserve Bank of New Zealand is that without the consent of the OIC, no person shall borrow any money outside New Zealand. The Reserve Bank regulation is that whenever a person requires approval for off-shore borrowings, it will be given only, and then subject to specific conditions relating to the transaction, when the repayment is due after 12 months.

The principal exemption from this regulation is when the money borrowed shall be used for the purpose of financing exports from New Zealand or imports into New Zealand by that company and that the term of the borrowing will be less than 12 months.

The following types of offshore borrowings will be discussed:

Eurocurrency loans

Eurobonds

Bankers Acceptances

### Eurocurrency Loans

This can be divided into two sections, namely -

1. short term transactions, and
2. medium term credit.

The short term transactions are for commitments by a Euro-bank for one year or less, while medium term credit is for a period between one year and ten years. In both cases the borrower arranges a facility with his bank, the lender, to raise funds from the Euromarket at a pre-arranged margin over the inter-bank offered rate (that can be London, Singapore, or Hong Kong or even any other major international money market etc) or in some cases pre-arranged margin over the costs of funds of the lender.

1. For short term transactions, the loan is, as the name already indicates, a one-off transaction. This means that there is no interest review and no rollover.
2. Medium Term Credits can be divided into two principal types of Medium Term Euro-dollar credits, namely -
  - (a) revolving credits, and
  - (b) term loans.

A revolving Euro-currency commitment is a confirmed line of credit beyond one year, whereby the bank enters into a firm commitment to make available to the borrowing company a fixed amount for an agreed period. This form of credit is frequently used by

the borrowing company as a reserve line of credit to cover unforeseen needs. The funds are drawn down by the borrower in the form of short term renewable advances, usually against 90 days or 180 day notes. Under such revolving credit arrangements, the amounts outstanding can fluctuate with the needs of the borrower. Quite often a revolving credit is converted into a term loan by simply eliminating the revolving feature and setting up an appropriate repayment schedule. The rate adjustments are normally every 180 days. In exceptional cases the bank is prepared to make fixed rate loans available, but that is only the case when the bank can finance the loan with a matched deposit.

Both revolving credits and term loans have quite often a multi-currency option in the agreement. This means that the borrower can at the interest review date convert his borrowings from one currency into another. This multi-currency option enables the borrower to take advantage of the interest rate differences between the various currencies as well as the relative weaknesses of the currencies involved.

(Below I will refer to the exchange risk and what to do to avoid those).

#### Euro-Bonds

Flotations in the Euro-bond market involve a number of special problems for prospective borrowers. For instance, choice of currency denomination can become an important element in the borrowing company's long term foreign risk exposure. International composition of Euro-bond underwriting syndicates complicates preparation of new issues.

Tax and regulatory considerations have led companies to issue Euro-bonds through financing subsidiaries, often created solely for the purpose of floating an international bond. The tax consideration is quite often the withholding tax, namely that the country of the borrower charges withholding tax on interest to be paid. The financing subsidiary is established in tax friendly countries such as the Netherlands, Antilles or Luxembourg. The normal function of such financing subsidiaries is to re-lend the funds derived from a Euro-bond issue to operating affiliates of its parent company. Since the financing subsidiary usually possesses too low a capitalisation to provide an acceptable credit risk for investors in the Euro-bond market, the payment of interest and principal is almost uniformly guaranteed by the parent corporation.

The market of Euro-bonds is quite extensive and it has been increasing due to its reliance on no single city or stock exchange. Both the London and Luxembourg stock exchanges - which are the most frequently used for Euro-bonds - have requirements for quotations, but they have no difficult registration procedures, onerous disclosure or continuing reporting requirements. Both normally require a suitable summary of audit figures of the borrower and guarantor.

The market is operated by a large number of commercial banks and investment banks, but the role is mostly as a broker between a borrower and the ultimate investor. A common characteristic of private and corporate investors is that they frequently have offshore funds outside the jurisdiction of their countries, either because they find opportunities more attractive outside their own countries or because they are reluctant to repatriate the funds. The tax free bearer nature and consequent anonymity of Euro-bonds is an essential element which attracts their investment.



Bankers Acceptances

An Acceptance is a promise by the drawee of a draft or bill of exchange that the instrument will be honoured at maturity. Where the drawee is a merchant, the instrument is known as a 'trade acceptance'; where the drawee is a bank, it is known as a 'bankers acceptance'. The principal purpose of a bankers acceptance is to provide current financing; it permits one person to use the credit of another person - being the bank - to raise a financing. Historically, the credit of a bank has been preferred to that of merchants, with a consequence that the market for bankers acceptances has developed virtually independently from the market in which mercantile obligations are traded and entirely distinct from the securities market. There is a well established market for the acceptances, which, in the USA, is stimulated and a large measure regulated by the Federal Reserve system. Acceptances can readily be sold to dealers or actually to the bank which has accepted. Since the US\$ is still the major international currency it is attractive to know that the bankers acceptance creates an efficient and relatively easy means of utilising the US capital market. Also important to know is that the acceptance financing need not be limited to trade transactions with the US. Important for the saleability of bankers acceptances in the US market is that they should be accepted by "Prime Name" US Banks. The acceptance stamp of a "Prime Name" bank is known to all major US market brokers and without such a stamp it becomes less saleable paper. The mechanics for arranging a bankers acceptance finance are as follows:

- The company negotiates a facility in US dollars with an American bank and opens an account with that bank.
- That company will sign in blank a parcel of numbered bills of exchange to be held in safe custody by that US bank.

Whenever the company intends to utilise the facility it informs the American bank

- a) description of the goods being exported
- b) the value of the goods being shipped and financed
- c) the port of origin and destination of the shipment
- d) the date of shipment, which must be within three days of planned acceptance and discount of draft
- e) the date on which the draft should be accepted and discounted by the American bank,
- f) the tenor of the drafts which must be for a minimum of 30 and a maximum of 180 days

#### FOREIGN EXCHANGE EXPOSURE MANAGEMENT

An extremely important factor in off-shore borrowings is the foreign exchange exposure and what means are available to avoid, or at least minimise your foreign currency exposure risk.

An important consideration, of course, on deciding to protect a company against the risk of foreign exchange exposure is the cost involved i.e. the cost of hedging must be measured against the foreseen loss due to a given currency exchange rate change.

There are a number of alternatives available to protect, or at least partially protect, against foreign exchange changes.

The one which comes to everybody's immediate mind is to take out a forward contract. If a company borrows, for instance, US dollars it sells those dollars in the spot market, but at the same time negotiates the contract to buy them back at a future date at a pre-determined exchange rate. In this situation the borrower knows exactly how much this US borrowing will cost him. Namely, the interest charge of borrowing the US dollars plus or minus the forward cover costs. This type of foreign exchange protection is ideal for a so-called transaction exposure, which means that the company needs the funds only for a limited period, which can be entirely covered by a forward contract. Effectively this means that the offshore borrowing should not be longer than 12 months, because that is in practice the maximum period one can arrange a forward contract.

When borrowings for longer periods are arranged forward contracts also protect the borrower against foreign exchange fluctuations, but only partly. The reason is that at the maturity date of a forward contract generally a new forward contract has to be arranged and it is most likely that there will be a difference between the contract forward rate and the spot rate at the time the contract matures. In New Zealand it is the Reserve Bank which stipulates that forward contracts are limited to one year. In other countries contracts for longer periods can be arranged, but that depends on the currencies involved.

Another alternative to actual hedging is to create a foreign exchange reserve.

The amount of the reserve is determined by the Company Treasurer's view on the fluctuation of the currency they deal in. As an example, one can base the amount of the reserve on the average percentage monthly change of that currency or currencies.

Other alternatives to protect against foreign exchange exposure involve third parties, but they can be equally adequate and possibly less expensive. The three alternatives involving third parties are:

parallel and back to back loans

currency swaps

simulated currency loans

#### Parallel and Back to Back Loans

Those loans involve two entities with headquarters in different countries and each having a subsidiary in the other's country.

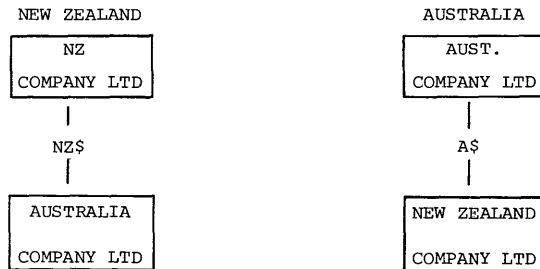
Suppose a New Zealand parent company, with a subsidiary in Australia, has a surplus of New Zealand dollars, but the Australian subsidiary would like to borrow Australian dollars. At the same time, there may be an Australian company which has surplus of Australian dollars with a New Zealand subsidiary which would like to borrow New Zealand dollars. These requirements can be met by either a back to back loan or a parallel loan in which the New Zealand company lends New Zealand dollars to the New Zealand subsidiary of the Australian company, and the Australian parent company does the same to the Australian subsidiary of the New Zealand company.

Parallel loans differ from back to back loans only in that parallel loans do not include a right of offset, or cross collateralisation between loans.

Interest rates on these type of loans are usually set at a fixed rate corresponding to commercial rates prevailing for each currency at the time of closing, and are subject to local governmental regulations. Since two multinational companies are involved, only the actual difference in rate is of importance, and therefore, both lending companies can agree to charge the borrower a below market interest rate.

The maturities of these loans vary between six months and ten years.

The below example illustrates the back to back or parallel loan.



There are three main steps to be taken by a company which wishes to enter into a back to back loan,

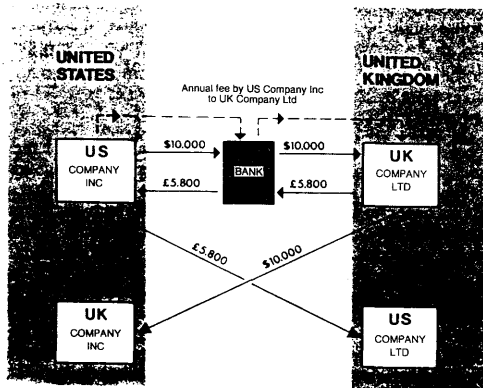
- a) search for a partner: quite often an intermediary, in most cases a bank with many contacts inside and outside New Zealand, will arrange for finding the missing party abroad.
- b) Negotiation of terms: loan agreements must be prepared, parties must agree on the periods, amounts and interest rate etc.
- c) Application for consents and permissions: OIC approval and possibly Reserve Bank approval in the other country have to be obtained. Also here an intermediary can be of assistance in obtaining the required permissions on behalf of both parties.

With regard to interest the importance is actually the differential being the difference in rates between the two loans

With regard to the agreement it is important to know that back-to-back loan is normally evident by two separate loan agreements, but the provisions of each being so interlinked that the borrower from one country has an effective right to set off should the borrower from the other country default in his obligation to repay.

Currency Swaps

Also this involves two different parent companies with subsidiaries in the other's country, and also both agree to arrange the others subsidiary's needs for financing, but not in the form of a loan to that subsidiary, but rather the two parent companies agree to sell to each other their respective currencies, with an agreement to reverse this sale in the future by a forward exchange contract. The parent company then immediately lends his subsidiary the amount they have purchased in the subsidiary's currency. The interest rate must be in accordance with the relevant country's regulations. The parent companies pay a negotiated annual fee in case there is an interest differential between the two currencies involved. For instance, if the interest charge in New Zealand is 20% while it is in Australia 18% then the New Zealand parent will pay the 2% per annum interest to the Australian parent company. The following example outlines a currency swap with a bank intermediating.



U.S Company Inc and UK Company Ltd enter into a spot exchange transaction at current exchange rates (e.g  $\$1.72 = \pounds 1.00$ ); US Company Inc thus buys 5,800,000 against payment of \$10,000,000. Simultaneous with the spot exchange transaction, the same parties enter into a forward exchange agreement which will exactly reverse the swap made above at the same rate after 10 years. US Company Inc immediately lends to its UK subsidiary the 5,800,000 purchased. The interest rate on this loan must conform to relevant exchange control and tax regulations of both countries. UK Company Ltd also immediately lends to its subsidiary the dollars it received in the swap. As in the above case, an annual interest rate must be in accord with appropriate regulations. US Company Inc pays UK Company Ltd a negotiated annual fee in sterling approximating the interest differential between sterling & dollars of the same maturity (ie. the interest differential between sterling & dollars if the transaction had been accomplished as a parallel loan).

A parallel loan transaction and a currency swap are quite similar techniques to achieve the same objectives. However, four main differences should be noted which might influence a company's choice between parallel loans or a currency swap.

1. Accountants differ on how parallel and back-to-back loans should be reported by the parent company on its balance sheet. Even if there exists a right of offset, some accountants feel that both loans should appear in the balance sheet rather than being treated as off-balance sheet items. Such treatment inflates the company's balance sheet, may produce adverse consequences under outstanding indentures and may therefore make a currency swap preferable.
2. In a parallel loan transaction, each borrower has an unambiguous tax-deductible interest expense and each lender taxable interest income. In a currency swap, the annual fee paid by one party to the other (representing the interest differential between the long term rates in the respective currencies) may or may not be tax-deductible depending upon local law. Either a parallel loan transaction or a currency swap might be preferable depending upon the tax position of each counterparty.
3. An implied right of offset often exists in the case of a currency swap, whereas no such right exists between parallel loans. If this right of offset is important as a credit matter, a currency swap or back-to-back loan might be preferable.
4. If one counterparty is a trust, its trust instrument may permit it to enter into a parallel loan but not to engage in a currency swap.

#### Simulated Currency Loans

A simulated currency loan is a loan given in a certain currency whereby the interest charged and the amount of repayment is expressed in the terms of a second currency. These types of loans can be of interest to companies which have subsidiaries in countries, such as Spain, where limitations exist with regard to re-exporting of profits made. For example, a US multinational company has a successful subsidiary in Spain, which had blocked Spanish pesetas while a second US multinational would like to invest additional dollars into its Spanish subsidiary. A simulated dollar loan from the first subsidiary to the second would be denominated in pesetas, be repayable at maturity in pesetas in an amount equal to the original

dollar equivalent of the loan, and at a negotiated interest rate close to the London interbank offered rate for dollars. The interest can be payable either in pesetas or in dollars.

Simulated currency loans offer good opportunities to both the lender and the borrower. For the lender it converts an asset denominated in one currency into an asset in a second currency; in this case peseta balances were effectively converted into dollar receivable, and also it enables a company to actually use otherwise unused funds.

Also for the borrower it has interesting alternatives, for instance, the actual interest rate is lower than market rate, and also that the parent company of the subsidiary which is borrowing pesetas, which they otherwise had to transfer to Spain with a risk that they can never be reexported.

#### Taxation

Of paramount importance in the decision making process of hedging, borrowing or lending is the tax consequence of such a transaction. The tax becomes a factor in the timing, the amount, for how long, and where a loan or hedge should be lodged.

This taxation is something to be looked at on a case by case basis.

In 1975 with a deteriorating balance of payments and a contraction in the growth of money supply, it became necessary for New Zealand companies to raise funds offshore, on a scale much greater than in the past. This coincided with an increase in overseas interest rates to levels far greater than those prevailing on the local market. Official Government policy was to encourage the private sector to borrow offshore so as to increase capital inflows with a consequent benefit to the country's balance of payment figures. Government accordingly announced that, as a matter of policy, it would give an exemption from withholding tax on interest paid under offshore loans which met certain requirements. The exemption will not be given if the borrowings were used for, on-lending in consumer credit transactions or if the borrower and lender are associated persons. The reason for these two restrictions was first the desire not to stimulate consumer spending (which would inevitably result in increased imports) and the desire not to give exemption from withholding tax to subsidiaries of overseas companies on their "inter-group" financing.

PAPER 3

**LEVERAGED LEASING AND  
PROJECT FINANCING**

by

**B.J. McWILLIAMS,**

Partner — Russell McVeagh McKenzie Bartleet & Co.



LEGAL RESEARCH FOUNDATIONLEVERAGED LEASING AND PROJECT FINANCINGB.J. McWilliams

The terms "leveraged leasing" and "project financing" are very trendy and it is de rigueur for financiers and aspiring sophisticates to casually drop them, however slight the excuse. The purpose of my paper is to attempt to explain these financial techniques in general terms with particular regard to the benefits which they may confer. The term "project financing" is a general term encompassing a number of financing methods including, in the view of some, leverage leasing. Although it does not have a precise meaning, it is generally accepted that it means more than the mere financing of projects. It refers to a financing arrangement under which the financier looks to the assets and cash flow of the project rather than the personal covenant of the owner or sponsor of the project. In its pure theoretical form the lender looks solely to the project for repayment. In practice it is not non-recourse lending but limited recourse lending as there are some risks which the financier will not assume. The sponsor may have only limited liability to the lender or in some cases no liability beyond its interest in the project with the financier obtaining credit support from other parties who are directly or indirectly involved in the project.

Project financing including leveraged leasing developed over the '60s and '70s primarily in the United States and to a lesser extent in the United Kingdom as means of financing major projects. The typical situation where a leveraged lease is used is in relation to financing major items of equipment such as aircraft, ships, railway rolling stock or industrial plant. Other types of project financing are most commonly

used in relation to major oil and mineral projects and major industrial plants where the capital required often exceeds the credit-worthiness of the actual sponsors of the project. Some of you may be questioning the relevance of this type of financing to your own practices as the size of the projects and the very limited number of projects where these techniques will be applied in New Zealand mean that most of us will not become involved in either setting up such a transaction or advising in relation to it. Apart from curiosity to find out what these damned terms are which everyone keeps dropping, I believe that we can all obtain some benefit by understanding the techniques, and the benefits which are achieved through the use of these techniques, and applying them to more normal transactions. While you may not use the total package, there are a number of angles which I believe can be usefully applied in other situations to achieve benefits for clients wishing to raise funds or for financier clients.

Although the financing techniques and the documentation often become very sophisticated I will attempt to explain them in general terms without getting too involved in unnecessary detail but rather, attempt to emphasise the basic principles and objectives. Project financing does not involve set structures and there is a high degree of flexibility in using a number of means to obtain the most appropriate financial structure for a particular project. The exception is leveraged leasing where the structure is quite well settled. We will consider this first and then look at some of the other types of techniques used in other project financing proposals.

### LEVERAGED LEASING

The basic principle of leveraged leasing is quite simple. The transaction is a financial lease under which the owners only put up a minority of the cost of the equipment being financed. The principal benefit of any form of financial leasing is that the lessor obtains the taxation advantages of depreciation. Under a leveraged lease the lessor only contributes part of the

price of the equipment and thus leverages or gears up the depreciation benefits. It may put up only 20% of the price but will be claiming depreciation on 100% of the price. You may ask what is so clever about this as any lessor can achieve the same result by merely borrowing. The difference is that under a leveraged lease transaction it is customary for the financiers who are providing the bulk of the finance - who are called the debt parties - to have no personal covenant from the lessor other than perhaps an undertaking that the lessor will put up its agreed equity contribution. Thus, the owner or owners - who are called the equity participants - obtain the benefit of the leveraging but without liability for repayment of the loan.

The principal reason for the development of leveraged leasing is the lessening of cost by the utilization of taxation advantages. The equity participants get the full benefit of depreciation and the lessee is entitled to fully deduct as an expense all its rental payments so long as the residual value is not less than the tax depreciated value. There are incidental timing advantages from a tax point of view. First, if the equipment has to be constructed over a period falling in to two or more different tax years, depreciation can be claimed earlier by the equity participants than it could by the lessee. Depreciation can only be claimed when the equipment is being used. It would not be used by the lessee until it was delivered and actual physical use of the equipment commenced. However, the equity participant's use of the equipment is by leasing it so that as soon as it makes a payment and starts to receive rental it is able to claim depreciation. The second ancillary benefit is that arising from the timing of the incidence of receipts of rental from the lessee and payments of interest to the debt parties. It is usual to deduct interest on an accrual basis but to bring in rental on a receipts basis.

You will have had circulated to you a model illustrating the typical parties, documentation and cash flow under a leveraged lease of equipment. The circles represent the various parties

involved, the squares the documents required and the dotted lines the flow of funds. I will briefly comment on the functions of the various parties:

(a) Packager:

The packager is the merchant bank or other financial consultant who arranges the transaction. This person must have access to a suitable software programme to be able to calculate and adjust the financial details. These programmes are very sophisticated. The packager must be able to calculate the best method of structuring the transaction having regard to the return required by the equity participants, the prevailing taxation assumptions, the debt parties' required repayment programme and the cash flow available to the lessee to meet rental instalments. The packager first finds a client who wishes to finance a project and demonstrates to that client the advantages of financing the project by way of a leveraged lease. If the client indicates interest in this form of financing, the packager will then locate the equity participants and the debt parties and negotiate terms with the lessee, equity participants and debt parties which will produce a viable leveraged lease transaction. The degree of equity as opposed to debt will depend upon the various rates of return which each wishes to achieve. The packager optimises the financial details by adjusting the debt/equity ratio, duration and allocation of rental payments to make the transaction as cheap as possible for the lessee while still giving the other parties the return they require. As the packager brings all the parties together and has the computer programme upon which the financial details have been calculated and, is thus in a position to make any necessary adjustments should any of the assumptions prove to be incorrect, the packager usually continues to play a role in the transaction as manager. It enters into a management agreement with the equity participants under which it gets paid a management fee.

(b) Equity Participants:

It is possible to have either a single equity participant or a number of equity participants in partnership together. The equity participants must be people who have sufficient income from other sources to be able to fully utilise the tax benefits arising from depreciation. The equity participants are usually banks or other financial institutions whose expectation of a rate of return on funds invested is less than that of industrial companies. There would be no reason why the equity participants could not be individuals and this would produce a more beneficial effect because of their higher marginal tax rates. The equity participants set a rate of return which they wish to receive on the equity contribution they make. Part of this return is received by way of tax benefits so that the lessee does not effectively pay the equity participants their full investment plus interest - the amount of the rental which the equity participants may receive can be less than their equity contribution as they get part of their benefits from the cash flow advantage because of depreciation.

(c) Nominee Company:

It is usual for a nominee company to be formed for each transaction to act as a nominee and agent for the equity participants. This nominee enters into the various contracts with the supplier of the equipment, the lessee and the debt parties. It takes legal title to the equipment, leases it to the lessee and borrows the money from the debt parties giving security over the equipment and its rights under the lease. It would also assign to the debt parties the insurances and any performance bond or refund undertaking given in relation to the equipment construction. All of the payments other than the management fee go through the nominee company. Often the

manager will be responsible for the operation of the nominee's bank account and the collection and distribution of payments.

(d) Lessee:

This is the party which uses the equipment and is the party which is effectively financed by the whole transaction. The rental which it pays under the equipment lease services all the interest and loan repayments to the debt parties and produces the balance of the return to the equity participants. The payments which need to be made under the lease are calculated upon a number of tax and other assumptions which are clearly stated in the lease agreement. If any of these assumptions prove incorrect, the rental payments are adjusted accordingly so that the debt parties are serviced and the equity participant continues to receive the return which it had been promised. Where the debt parties are lending in foreign currencies this exchange risk is passed on to the lessee who is usually given the right to select the currency or require any currency switch under the loan agreement. If the equipment is not at a fixed price or if the debt parties have agreed to provide only a limited amount of funds in a foreign currency which, due to exchange rate movements, could result in there being a shortfall in available moneys to meet the cost of the equipment, the lessee would usually have an obligation to provide this shortfall.

(e) Debt Parties:

The debt parties are either local or more commonly off-shore lenders. They agree to make loans to the nominee without recourse to the equity participants. They lend against the credit-worthiness of the lessee and rely for their repayment on the rental paid under the lease agreement. The lessee is usually made a party to

loan agreements merely to give various covenants and acknowledgements but it does not guarantee the loan agreements. The debt parties may provide their loans under a single composite loan agreement, or under a number of separate loan agreements. These loans are secured by assignments by way of mortgage of the equipment and the equipment lease as well as any other ancillary documents such as a refund agreement or repayment rights under the equipment purchase agreement.

(f) Supplier:

The supplier enters into an equipment purchase agreement with the nominee. It may require some guarantee of payment by the lessee. The passage of title to the nominee is of vital importance as it is the effective security of both the debt parties and the equity participants. Under major projects there are usually progress payments and great care needs to be taken to protect the position of the equity participants and debt parties in the event of the failure of the supplier. The supplier receives the price which is the total of the equity contributions and the loans made by the debt parties plus any short fall contribution which may need to be made by the lessee.

The structure is rather complicated and the documentation is involved. There needs to be careful interlocking of all the various documents with the approval of each of the parties being obtained to all of the documents. It usually requires a reasonably sizeable transaction to justify the expenses involved, as setting the transaction up involves a considerable amount of time on the part of the packager and the lawyers for the various parties. A crucial feature under the transaction is that the various taxation assumptions should always be fully disclosed to and approved by the Inland Revenue Department.

A leveraged lease may have the following benefits for the lessee:

1. Off balance sheet financing - the commitments under the lease agreement do not appear as a liability in the lessee's accounts.
2. Avoidance of borrowing restrictions and ratios under debenture trust deeds and loan agreements containing a negative pledge.
3. Ability to raise 100% of purchase price against the security of the assets.
4. Avoidance of borrowing restrictions in New Zealand if the lessee is an "overseas person" for the purposes of the Overseas Investment Regulations.
5. Lower cost, particularly in cases where the lessee is not in a position to fully utilise the depreciation on the equipment because it does not have sufficient taxable income.
6. Rental payments may be less than the cost of servicing borrowed funds for which the equipment was purchased thus giving a cash flow advantage to the lessee.
7. Flexibility in setting amounts of rental payments during particular years to tie in with lessee's cash flow.
8. Minimisation of effect on reported income - lease payments may be spread more uniformly over the period.
9. Incidental costs such as installation charges, interest accruing during construction and freight may be effectively capitalised and amortised as rental.

#### PROJECT FINANCING

A convenient starting point in analysing the structure of a project financing proposal is to identify the objectives of the



sponsor and the lender. The secret of a successful project financing arrangement is to devise a formula under which the sponsor minimises its liability and possibly obtains other benefits, and under which the lender receives direct or indirect undertakings from financially sound persons so that it is satisfied with the credit risk.

### LENDER'S OBJECTIVE

Although the pure form of project financing under which the lender relies solely on the cash flow from the project to service its loan has great appeal to the sponsor, it does not, except in extremely rare instances, have any appeal to lenders. Generally, lenders are not interested in taking equity risks. This is certainly the case with banks whose sole objective is to be repaid principal and interest - they do not wish to accept an equity risk even if the return is higher as their business is borrowing money and on lending at a margin.

A lender who is asked to provide project finance will analyse the risks and identify those risks which it is not prepared to assume. There are a wide variety of risks which will obviously vary from one project to another, but may include the following:

(a) Technical risk

This is the risk that the technology being used in relation to the project won't work properly or economically or that the technology will become obsolete.

(b) Financial risk

This covers the risk that the cost of the project will overrun estimates or that there will be revenue loss because of delays in completion of the project.

(c) Marketing risk

This is the risk of the product produced by the project not being required or being priced in excess of what the market is prepared to pay.

(d) Resource risk

The risk of lack of availability of suitable raw materials for the project.

(e) Operating risk

Whether the plant will operate to capacity and at an economic cost and whether there will be sufficient management and technical support to prevent or overcome problems.

(f) Political risk

This is the risk that there may be some intervention by Government or regulatory bodies for political, ecological or other reasons.

The lender's prime objective is to be repaid and it will need to be placed in a situation where it can rely either on the project, the sponsor or some interested third party. The objective in structuring the transaction will be to either mitigate the risks or to allocate the assumption of particular risks to other parties.

The objectives and potential benefits for the sponsor will be wide-ranging but may include the following:

1. The ability to raise the substantial capital which may be required for the project.
2. Segregation of the risk of the project from the sponsor's other activities - if the project fails it shouldn't bring the whole group down.

3. Preservation of the sponsor's capital for other uses.
4. Preservation of the sponsor's credit sources for other uses.
5. Preservation of the sponsor's credit standing.
6. Avoiding having the project appear in the sponsor's balance sheet.
7. Avoidance of debt restrictions under debenture trust deeds, loan agreements and other instruments.
8. Minimising the cost of financing after taking into account taxation considerations. Although the cost of financing is always important an increase in cost may be accepted by a sponsor in return for other benefits.
9. Relating the flow of funds both for construction and repayment of debt to the anticipated cash flow of the project.
10. Avoidance of borrowing restrictions where the sponsor is an "overseas person" under the Overseas Investment Regulations.

### STRUCTURE

Once the particular risks and the objectives of the sponsor are identified, the most appropriate form of financing is developed, usually using a combination of techniques. There are no hard and fast rules - the structure is created so that the end result is acceptable to the various parties involved. The structure of the project is built using various techniques including the following as "building blocks":

1. Isolation of project entity

In view of the magnitude of the funds involved or the higher risks involved a sponsor will usually wish to isolate the project into a distinct economic unit. This may be achieved by making the project entity either a subsidiary, a joint venture company, an unincorporated joint venture, a special partnership or a trust. The sponsor will seek to avoid generally guaranteeing the obligations of the project entity. The use of a joint venture company which is not a subsidiary of the sponsor assists in keeping the financing off the sponsor's balance sheet and avoiding trust deed or similar borrowing restrictions. A joint venture approach may be necessary to enable the funds to be raised because the sponsor is unable itself to provide the total equity contribution which is required. The prime disadvantage of a joint venture company is the lack of total control of the project by the sponsor. However, there are means whereby a reasonable degree of control can be obtained.

2. Project entity to raise the finance

The project entity raises the funds from the financier either under a secured loan or a lease without the direct guarantee of the sponsor being required.

3. Customer support

Where the project involves the production of a commodity which is required by a single customer who has a strong need for that product, that customer can assume part of the credit risk by a number of different means in return for an assured source of supply:

- (a) The customer may provide guarantees of various sorts;

- (b) The customer may provide part of the funds required for the project on a subordinated loan basis. This injection of funds effectively provides a security buffer for the principal financier who has first security over the project assets.
- (c) Long term purchase contracts of a "take or pay" nature. This contract gives an assurance of a cash flow to service the debt and to cover operating expenses. It is essential that these obligations be unconditional and it is common for them to contain a "hell or high water" clause which requires the customer to pay, even if the facility is destroyed by act of God or other causes. There are a variety of means of treating these payments in relation to credits for future supplies. The customer would usually obtain the right to acquire the total project or the insurance proceeds if it was called upon to pay up in a disaster situation or even in the case of non-performance by the supplier. Where a take or pay contract exists, this would usually be assigned to the financier as security. The lender may be prepared to accept this security in lieu of any recourse against the supplier (i.e. the lender would rely upon the credit risk of the customer rather than the project operator). This structure can have a number of advantages for the supplier, both in terms of its balance sheet, debt restrictions and credit standing consequences. As far as the customer is concerned, the obligations under the take or pay contract would at most appear as a contingent liability on its balance sheet and would be less onerous than if it itself had developed the project. In some cases the customer will be a party to the joint venture or even the prime sponsor. The payments under the take or pay contract may be paid to a trustee to ensure that the lender receives its payments.

- (d) Advance payments to be repaid by subsequent supplies. The customer assists in funding the project and receives an assured source of supply. This a non-recourse borrowing, for the project operator, is off its balance sheet and enables it to meet development costs out of pre-tax income.
- (e) "Take if tendered" purchase undertakings pursuant to which the customer would be obliged to accept and pay for products as they are delivered. This is a watered down version of the take or pay contract as the customer need not pay if it does not receive the goods.

#### 4. Supplier undertakings

These are essentially the obverse of the customer obligations, i.e. in the case of a pipeline or refinery, an oil company may assume throughput obligations and be required to make minimum payments, even if the facility is not used.

#### 5. Completion assurance

- (a) The major period of risk under a project is the construction phase. The construction phase is usually understood as ending when the project is in full production. The lender will usually require some completion guarantee under which someone assumes the risk of this phase. This may relate not only to the completion of the project within a certain time but also to commencement of production at a stated rate or even maximum production costs. After the completion of this phase the lender may be prepared to rely on the cash flow from the project or on a take or pay contract.

- (b) The risk of construction is particularly significant as the project is exceptionally poor security if it is never completed or doesn't work upon completion.
- (c) A completion guarantee may be given either by the sponsor or by third parties. An obvious third party is the supplier or constructor of the plant. The project entity may purchase the plant under a "turnkey contract" pursuant to which the supplier has a total responsibility for ensuring that the plant is completed and operating satisfactorily before it becomes entitled to payment. As there may have been progress payments required to fund the construction, there may need to be a refund clause requiring repayment by the supplier or, where the supplier is not sufficiently substantial, bank performance guarantees or guarantees from other parties.
- (d) The contract could be a fixed price contract with liquidated damages or indemnity provisions to cover lost revenue because of delays.

## 6. Sponsor support

The sponsor may provide support which is less than a full guarantee by such means as:

### (a) Deficiency guarantees

A deficiency guarantee is a guarantee limited to the shortfall suffered by the financier in the event of a default resulting in a realisation of security by the financier. It is common for the deficiency guarantee to be subject to a limit expressed either as a monetary amount or as a percentage of the amount financed. A limited

deficiency guarantee may be reduced as the loan is amortised. The limitation on the liability under the guarantee may be beneficial to the guarantor both in relation to balance sheet footnotes and to its creditworthiness in respect of other transactions.

(b) Semi-guarantees

There are a number of ways in which the financier may obtain some support from the sponsor without a direct guarantee. These range from a mere comfort letter and cross-default clauses under other obligations through to deposits under which there will be a set-off to various forms of undertaking which will ensure that there is a cash flow to enable the financier to be paid.

7. Third party guarantees

There may be other persons who have a strong interest in the project proceeding and who are prepared to assume part of the risk. These would include either Governments or Governmental agencies who require the project to be completed as either part of national development or to provide employment opportunities or to ensure availability of the products or services deriving from the project. These guarantees may be either general unconditional guarantees or may relate to specific risks.

8. Lease of project

The sponsor could set up a company which was not a subsidiary to be the owner of the facility and to lease the facility to the sponsor. The lease would be of a "hell of high water" nature and would provide sufficient funds to service the debt and to meet expenses. The owner would raise the funds required on the strength of

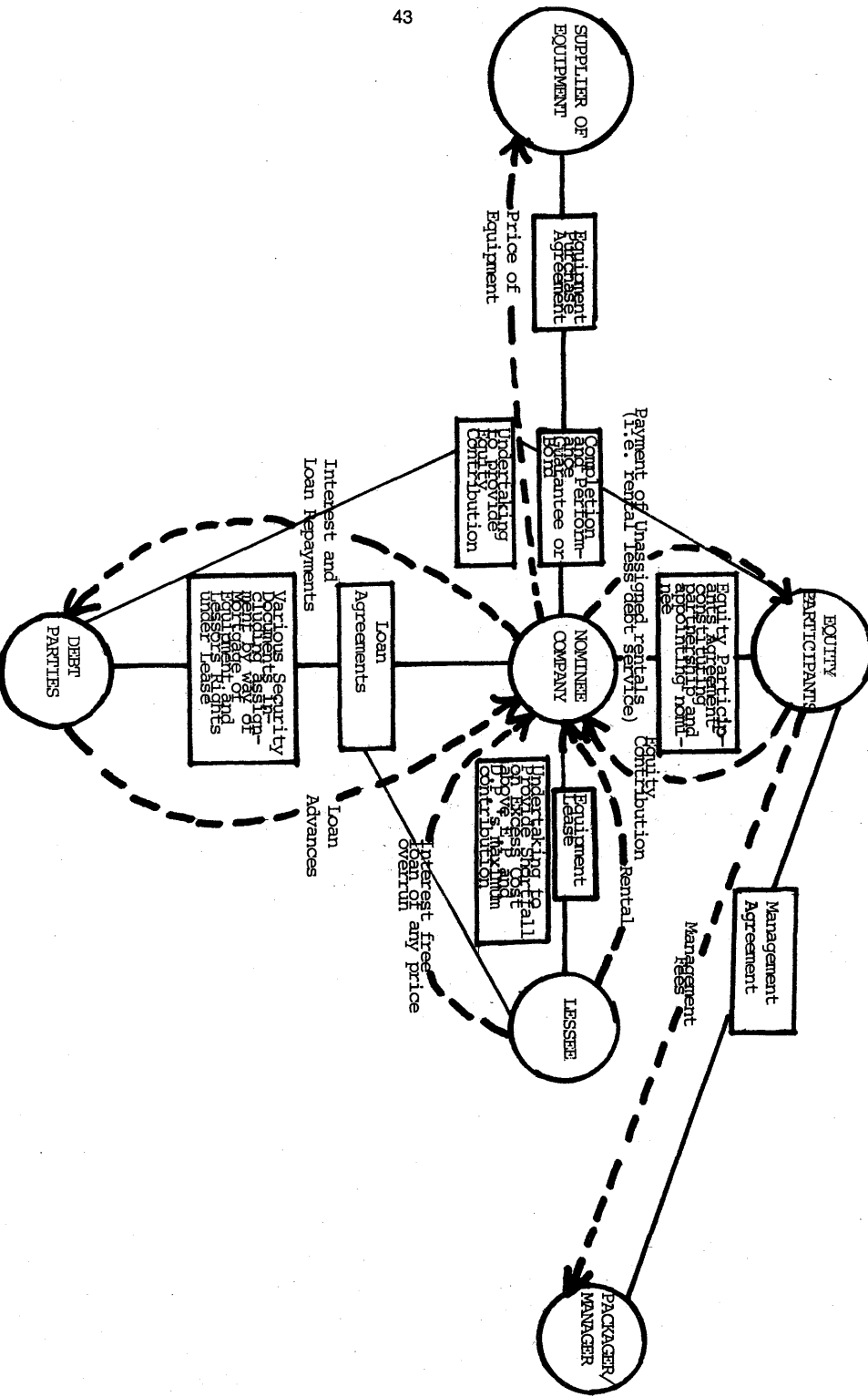


the sponsor's credit standing and payment obligations under the lease and the sponsor would obtain benefits such as avoiding the debt on its balance sheet and circumventing debt restrictions.

I have circulated a model of a project financing package involving a number of the foregoing aspects. While the overall project may be reasonably complicated, the individual techniques for spreading risk are relatively straightforward and can be used in relation to other transactions and, I suggest, could be used by most of you to assist your clients to raise funds or to obtain some of the benefits referred to previously. These techniques are valuable tools but the list is by no means exhaustive - there is still plenty of scope for an innovative approach to financing to meet the needs of the various parties involved. The practice in New Zealand has too often been for financing to be considered on the balance sheet of the borrower and with the lender automatically taking standard mortgage or debenture security. The time is coming when a bit more sophistication will be necessary as there are other benefits to borrowers in the arranging of a finance proposal than merely obtaining the funds required. Borrower should be aware of the additional price they are paying by granting excessive security - the cost is a restriction on future financing flexibility. Lenders can also benefit from the foregoing techniques as they provide means whereby their credit risk may be reduced.

Major projects have by their very size demanded a better appraisal of the objectives of the parties and risk allocation. The new techniques of project financing evolved as conventional financing did not meet the parties requirements. Project financing is a further example of what can be achieved by an innovative approach to solving legal and commercial problems.

MODEL OF LEVERAGED LEASE OF EQUIPMENT  
 ILLUSTRATING TYPICAL PARTIES, DOCUMENTATION AND CASH FLOW



MODEL OF PROJECT FINANCING OF INDUSTRIAL PLANT

