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LEVERAGED LEASING AND PROJECT FINANCING

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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

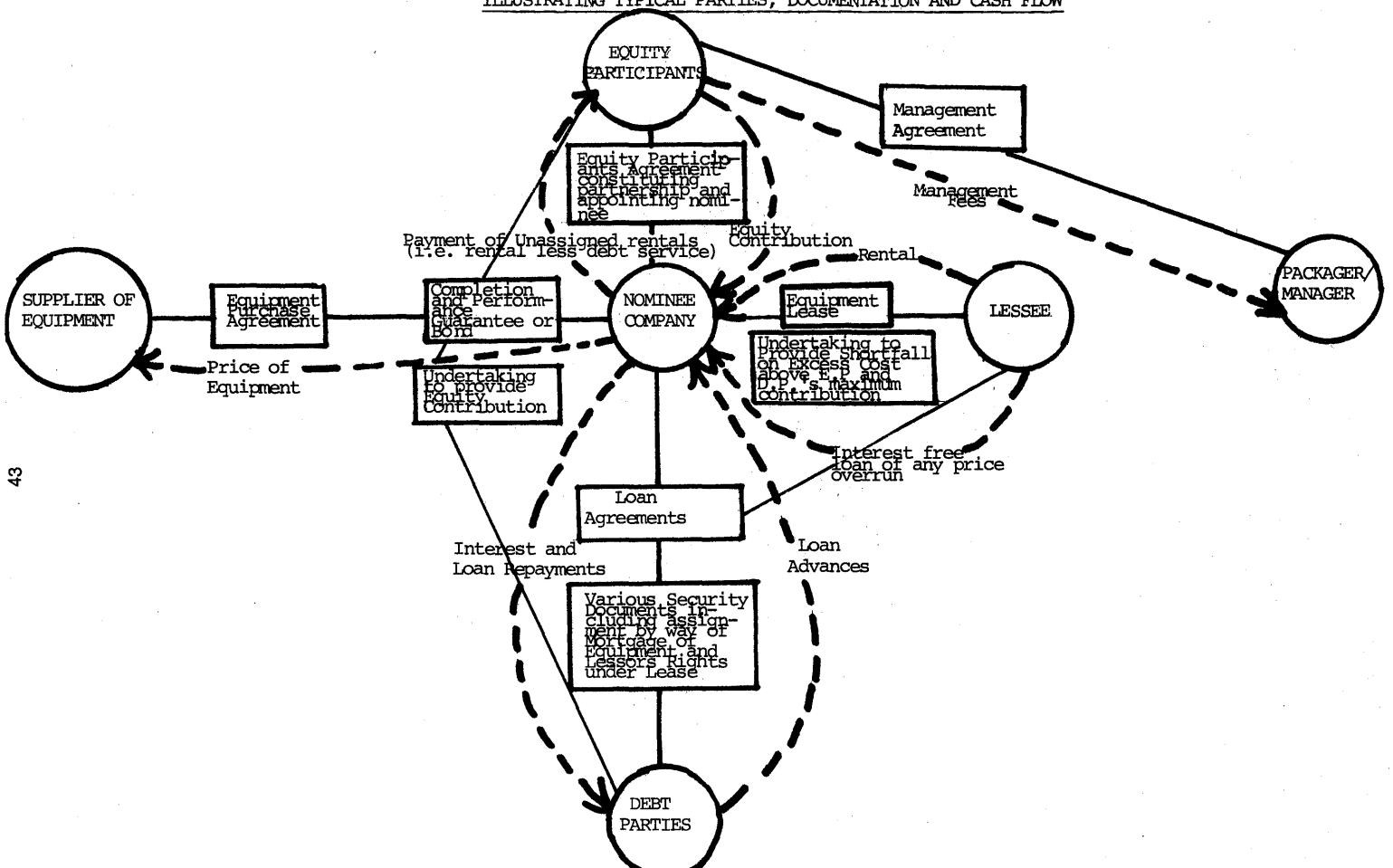
The sponsor could set up a company which was not a subsidiary to be the owner of the facility and to lease the facility to the sponsor. The lease would be of a "hell of high water" nature and would provide sufficient funds to service the debt and to meet expenses. The owner would raise the funds required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

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



MODEL OF PROJECT FINANCING OF INDUSTRIAL PLANT