Construction Equipment Financing: innovative options in a tough market

Vinod Kothari

1012 Krishna
224 AJC Bose Road
Kolkata – 700017
Phone 033-22811276/ 22813742/ 22817715

601-C Neelkanth
98 Marine Drive
Mumbai- 400 002
Phone 022- 22817427

www.vinodkothari.com
Email: vinod@vinodkothari.com

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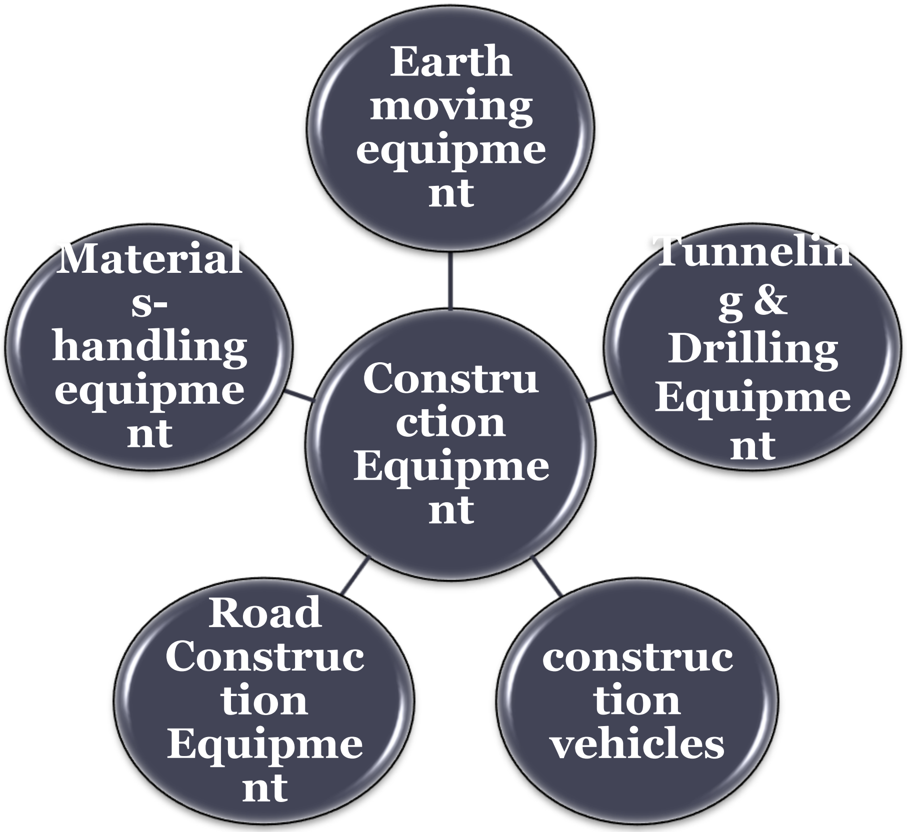
Construction equipment

- The present size of the market is approx $ 2.3 billion
  - Expected to grow to annual sales of $ 6.2 billion in 2014
    - IBEF ICE report, March 2013
    - In FY 2013, most financiers have reported 20% de-growth
- The construction equipment sector comprises five major segments:



Market de-growth

BHL	*JAN-SEPT*			*APR-SEPT*		
MANUFACTURER	**2012**	**2013**	**%**	**2012**	**2013**	**%**
JCB	16092	13996	-13%	9427	8210	-13%
CNH	2236	1869	-16%	1329	1112	-16%
TEREX	1107	834	-25%	679	514	-24%
TELCON	965	657	-32%	542	390	-28%
ESCORTS	830	651	-22%	457	369	-19%
CAT	1136	1081	-5%	735	653	-11%
M&M	666	725	9%	345	478	39%
ACE	291	213	-27%	127	117	-8%
ALJD	448	830	85%	302	486	61%

EXCAVATOR	*JAN-SEPT*			*APR-SEPT*		
MANUFACTURER	**2012**	**2013**	**%**	**2012**	**2013**	**%**
TELCON	3582	2670	-25%	1972	1566	-21%
L&T KOMATSU	2346	1358	-42%	1374	695	-49%
HYUNDAI	1845	1349	-27%	1204	881	-27%
JCB	982	1011	3%	609	623	2%
VOLVO	788	564	-28%	520	346	-33%
KOBELCO	643	571	-11%	399	371	-7%
DOOSAN	200	197	-2%	113	141	25%
CAT	121	101	-17%	64	80	25%
SANY	158	190	20%	101	136	35%

CE finance market

FY (Fig in Cr)	09-10	Market Share	10-11	Market Share	11-12	Market Share	12-13 (H1)	Market Share
SREI BNP	5500	32%	7824	33%		29%	2246	27%
HDFC	2350	14%	3000	13%		13%	896	11%
L&T	1450	9%	1900	8%		9%	496	6%
TATA	1425	8%	1800	8%		7%	781	9%
MAGMA	1415	8%	1200	5%		6%	481	6%
KOTAK	675	4%	1250	5%		4%	158	2%
INDUSIND	575	3%	1150	5%		9%	707	8%
RELIANCE	450	3%	600	3%		2%	267	3%
CITI	400	2%	300	1%		3%	355	4%
RELIGARE	300	2%	500	2%				
SHRIRAM			700	3%		8%	780	9%
BAJAJ			700	3%		2%	88	1%
ICICI			750	3%		4%	454	5%
SUNDARAM						3%	505	6%
HDB							225	3%
OTHERS		15%		8%				

Acquiring construction equipment

- Owning option
  - Own with equity
    - CE business is capital intensive – substantial investment needed in both fixed assets and working capital
    - If equity is invested, equity quickly gets blocked in business, leaving business dry of working capital
    - Hence, leverage is well accepted norm in the business
  - Borrowing option
- Medium term rental option
- Short term rental option
- Leasing option

Key features of construction equipment financing needs

- Medium term financing
  - pay-back period for most equipment would be 3-5 years
  - Generally speaking, an operator earns from the asset to pay for it
    - Asset-backed financing with cash outflows connected with cashflows from the asset is the norm in the business
- Disposal of assets after a few years
- In case of small operators, advisory support on choice of equipment may also be necessary

Providers of CE financing

- Banks
- NBFCs
  - Asset finance companies
  - Infrastructure finance companies
- Leasing companies
- Equipment renting companies
- External commercial lenders
  - Supplier's credit
  - Buyer's credit
  - ECB
- Cross border leasing option
  - Operating lease from out of India
  - Financial lease from out of India

Forms of financing

- End-to-end solution providers
  - From acquisition, to provision, to training, to maintenance, to buyback of used equipment
  - Ideal for leading suppliers/vendors
- Term loan
- Hire purchase
- Financial lease
- Operating lease
- Conditional sale
- Equipment rental
  - Presently only about 2-5% of the market, but expected to grow significantly
  - Lots of small and medium players in equipment rental market
- Supplier's credit
- Buyer's credit

Devising a proper funding plan

- Do understand that default is very costly
- Therefore, the funding plan should ensure the cashflows from the asset will be sufficient to pay the instalments
- Other free cashflows is often a myth
  - Hence, cashflows from the asset most relenvat
- Two important parameters for every funding plan
  - LTV ratio
    - Yes, it is important to conserve equity, but a higher LTV ratio means more EMIs, putting burden on the DSCR ratio
  - Debt service coverage ratio
    - Function of
      - LTV ratio
      - Funding tenure
    - Don’t agree to aggressive payback periods –ensure at least a DSCR of 1.33 -1.25

Typical structure of a loan product

- Down payment 10-20%
- Tenure 3-4 years
- Full payout product
- Problems in a typical full payout loan contract:
  - EMIs are too high for the present market scenario
  - Collateral deficit in the initial few months; collateral surplus in the later part of the contract

RV function of a CE equipment

- Based on RV data, we derive the following equation for residual values of a standard CE (say, JCB)
- $y = 24e^{-0.297x}$
- Where Y is the value
- X is the no of years the asset has been used

Life	Expected RVs	RVs derived from formula
0	24	24
1	18	17.8330563
2	14	13.2507457
3	11	9.84588725
4	8	7.31592757
5	6	5.43605618
6	4	4.03922899
7	3	3.00132492

RV risk as a crucial parameter in structuring of any innovative product

- Therefore, there have to be effective ways of mitigating/transferring such risk
  - Vendor/reseller buy back
    - If vendors give a buyback guarantee, it may lead to issues on revenue recognition
      - However, resellers may provide buyback assurances
    - Vendor may do a financial lease and assign receivables to NBFCs
  - Third party/RV players
    - Eventually, in most cases, NBFCs take exposure on (a) credit risk; and (b) residual value risk
      - If these two elements can be unbundled, it should not be difficult for an NBFC to take exposure on asset values
      - And make its spread income by simply providing forwards on asset values
  - RV risk on a pool basis
    - Single asset risk ma y be difficult to mitigate but on a pool basis, it may

Cordoning off of cashflows

- There are essentially 2 elements in taking a purely asset-based risk
  - Cashflows from the asset
  - Residual value of the asset
- How does a lender cordon off the cashflows from the asset:
  - Escrow
    - Escrow is only a payment mechanism
      - Payee does not get any right against the debtor
      - Detailed ruling of Delhi High court in GTI Ltd vs IFCI
  - Assignment of receivables
  - Factoring of receivables
    - NBFCs are defined as "factors" under the Factoring Regulation Act and may take advantage of the law
    - Sec 26 of the Act grants a non-obstante right on assignment of any receivables from an assignor to a factor
    - Law covers future receivables as well
    - The only compliance requirement may be registration of the assignment with the Central Registry
  - Therefore, factoring is clearly the most preferred way

Regulatory incentives/disincentives in leasing transactions

- RBI has specifically recognised infrastructure leasing for utilisation of ECBs:
  - Available to AFCs for infrastructure equipment for leasing to infrastructure projects
    - Lessee must be infrastructure project
    - Equipment must be infra equipment
  - Maturity 5 years
  - Upto 75% of the NOF of the AFC, or max $ 200 million per financial year, whichever is lower
  - Current cost of forward cover may not make it viable on a fully hedged basis
  - However, practically, ECBs may be used for general corporate funding
    - Since there is no matching between repayment of rentals and repayment of the ECB

Incentives/disincentives for leasing

- Allowability of depreciation on finance leases continues to be in controversy
  - Ruling of SC in ICDS, and Madras High court in First Leasing support claim of depreciation by lessor
  - However, several factual decisions have disallowed
  - We strongly suggest that if the lessor intends to claim depreciation, the should preferably be structured as an operating lease
- VAT
  - Some states continue to deny benefit of input tax credit in case of lease transactions
    - Maharashtra
      - Amendment effective 1st May 2013 limit ITC in case of cars held as capital goods
      - However, unlikely to affect leasing companies
    - UP
    - Kerala
      - Lower tax rate of 5%
    - Gujarat
    - Madhya Pradesh
- Service tax
  - We continue to hold the view that service tax is not applicable to any lease transaction
    - What is a "sale" cannot be charged to service tax

Incentives/disincentives for leasing

- No need to make use of SARFAESI Act for repossessions
- Rental expenditure qualifies as an operating expense
  - If the client goes for CDR, rentals will get priority as operating expense in the T&RA