Construction Equipment Financing: innovative options in a tough market

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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

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### EXCAVATOR

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## CE finance market

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Acquiring construction equipment

- **Owing 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 relevant
- 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

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<th>RVs derived from formula</th>
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<tr>
<td>7</td>
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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 may be difficult to mitigate but on a pool basis, it may
Cordonning 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