A closing window

VASGEN EDWARDS DISCUSSES AN OPPORTUNITY FOR BUSINESSES TO ENJOY MATERIAL COST SAVINGS THROUGH FINANCE LEASING.

Lloyds TSB | Corporate Markets

Corporate treasurers are familiar with the benefits of leasing as just one of the financing tools available to maximise the efficiency of the corporate balance sheet and as part of the overall mix of appropriate financing solutions. They will also be aware of the impact of the Finance Act 2006 on finance leasing generally and in particular, unless specific criteria are met, that the availability of capital allowances passes from a Finance Lessor to the Lessee for what are termed long-funding leases. The most recent Budget also saw an unexpected reduction in Capital Allowances from 25% to 20% on non-long life assets, the first wholesale change in this arena since 1986.

In conjunction with the reduction in the rate of writing down allowances corporation tax will fall from 30% to 28%. Both changes will be implemented from April 2008.

Clearly there is a short window in which new financings can be put in place under the existing regime before rates change next year.

The 2006 Finance Act determined that leasing company groups could only have one year end in which they could enjoy the full capital allowances rather than capitalise upon separate companies' year ends. As such the specific timing of this opportunity will vary depending on the characteristics of each leasing provider and the timing of their group financial year end. Lloyds TSB Bank plc, for example, has a year end of 31 December.

SO WHO CAN BENEFIT FROM THIS? While many companies already use lease financing, the benefits are particularly attractive to companies who are not paying tax at the full rate, including companies with carried forward losses, or marginal tax payers who have relatively high capital expenditure incurred each year. However, benefits can still accrue, but may be more modest, where the corporate is a full tax payer, and for these corporates an analysis of pre- and post-tax cost of funds will highlight whether it is an appropriate tool.

Like many other financing tools the benefits become more material where there are sizable amounts of assets to be funded, with the advantage being significant on facilities over £20m. As such finance leases can be seen as a useful tool within investment grade corporate borrower's capital structure, supplementing other routes of financing such as bonds or syndicated debt.

Lloyds TSB have modelled the potential benefits which might flow through for transactions funded in December 2007. The table and the diagram illustrate the potential Internal Rate of Return (IRR) for finance leasing, both pre and post April 2008, versus other traditional forms of financing.

Of course the eventual solution will vary according to each corporate's requirements, but the figures below are a very good indication of why there is a renewed interest in finance leasing products.

	TERM	AAA	AA	A	BBB
Debt / Bank loan	5 yrs	12.5	17.5	25	45
Bonds issued	5 yrs	0	15	28	43
Finance lease (drawn Dec 07)	5 yrs	-20	-16	-11	-7
Finance lease (drawn Dec 08)	5 yrs	21	26	31	35

Notes to the above: All figures are for illustrative purposes only; All figures quoted are basis points (on top of cost of funds); Bonds and debt figures may vary between industrial sectors; Terms and conditions of all products (bonds, debt or lease) vary from client to client; Bank debt based on rate over LIBOR; Leasing based on assets over £20m with annual payments in advance compounded annually; All figures quoted are before taxation treatment (pre-tax) and exclude any fees associated with the establishment of the associated finance.

As is demonstrated by the table and diagram, this financing proposition becomes more compelling the closer you get to your lease provider's financial year, with leases taken out with Lloyds TSB in December 2007, for example, providing the most attractive IRR for its customers.

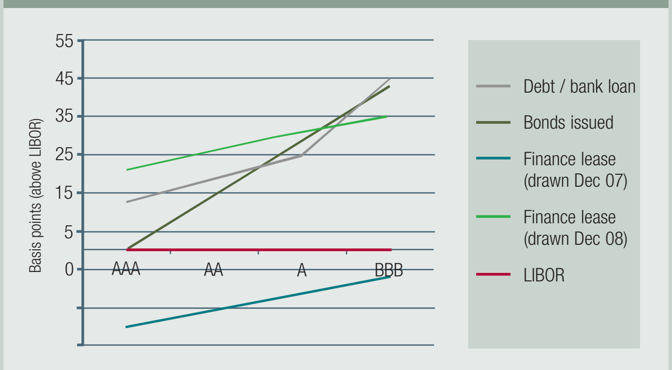
It can also be seen from the diagram on the following page how much less attractive finance leasing might become post 2007.

QUALIFYING REQUIREMENTS The specific modelling that Lloyds

Executive summary

- Recent changes announced in the 2007 Budget have created an opportunity to consider, or reconsider, finance leasing as part of a corporate borrower's capital structure. However, there are time limitations to exacting the greatest financial benefit and the close of this calendar year-end will present the lessee with the most meaningful upside, including sub-LIBOR financing.
- It is the combination of the reduction in the rate of writing down allowances and UK Corporation Tax rate (the kernel of the relevant changes announced in the Budget), that provide the requisite components for delivering to the corporate borrower a cost of debt that should be sub-LIBOR. These transactions should, in the main, be without the risks associated with more highly structured financing.
- The new rates take effect from April 2008 and the transition period between the old and new regimes will create an opportunity to finance assets with a useful life of 10 years or less, and by doing so deliver material cost savings to lessees.

Your Financing Suite



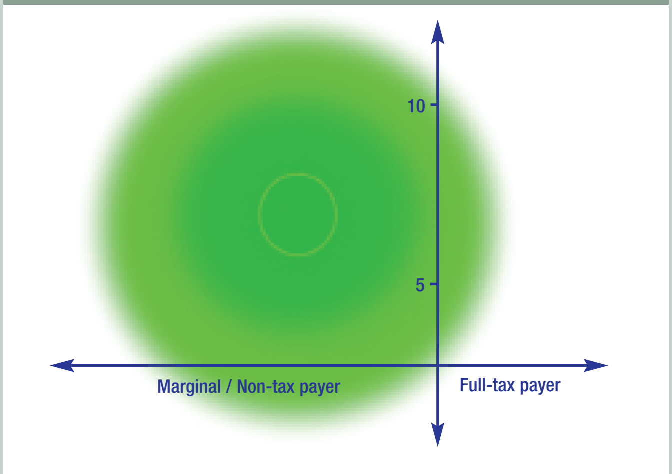
TSB itself has undertaken also reveals that only conventional finance leases can enjoy this attractive structure with other leases, such as operating leases, failing to meet certain key criteria.

This preferential structure is available for lease financing for any assets with a useful economic life below 10 years, providing an ideal solution for medium-term assets used generally within a business. Assets with an economic life over seven years may count as long funding leases rather than conventional finance leases, depending on certain criteria and would therefore not qualify for these tax benefits. (See November 2006 edition of *The Treasurer* for a fuller explanation of the new rules applying to long-funding lease rules.)

Assets fitting these criteria and financed through a straight-forward, low risk finance lease will enable investment grade corporate borrowers to enjoy significant cost savings, through sub-LIBOR financing.

Given the benefits that lease financing can provide over the coming months, we would expect many corporates to be looking quite seriously at their immediate capital funding requirements, and in particular to juxtapose a lease solution against existing non-tax debt-based facilities.

Sub-LIBOR financing



FLEXIBLE STRATEGY The increasing complexity in capital structures demands a flexible strategy to secure financing that offers the appropriate blend of risk- reward to the corporate. Finance leasing has consistently presented solutions that complement the borrowing suite and the opportunity that is presented today continues to reflect the need to balance marked financial benefits with measured risk.

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The opportunity in practice

Assumptions and Background

- BBB+ rated Corporate
- CapEx of £25million
- Marginal tax payer
- Drawn down prior to Calendar Year End
- Assets used within the business over next 5-7 years

Evaluation Process

- Compare all financing options including structured bank debt, hire purchase, etc
- Client decision-making based on;
- Simple NPV calculation
- Pre-Tax IRR
- Tactical view on the impact to taxable profits using various financing tools
- Risk of reduction in committed or stand-by facilities for other projects

Review and conclusion

- Using a finance lease given
- Margin difference in the cost of funds between debt and leasing of 45bp, resulting in an overall cash saving of £420,000 over the life of the lease
- Preserves the availability of the corporate's standby and committed debt facilities
- As a marginal tax payer, the company is happy for the leasing company to take the allowances, rather using the allowances to shelter its own profits.