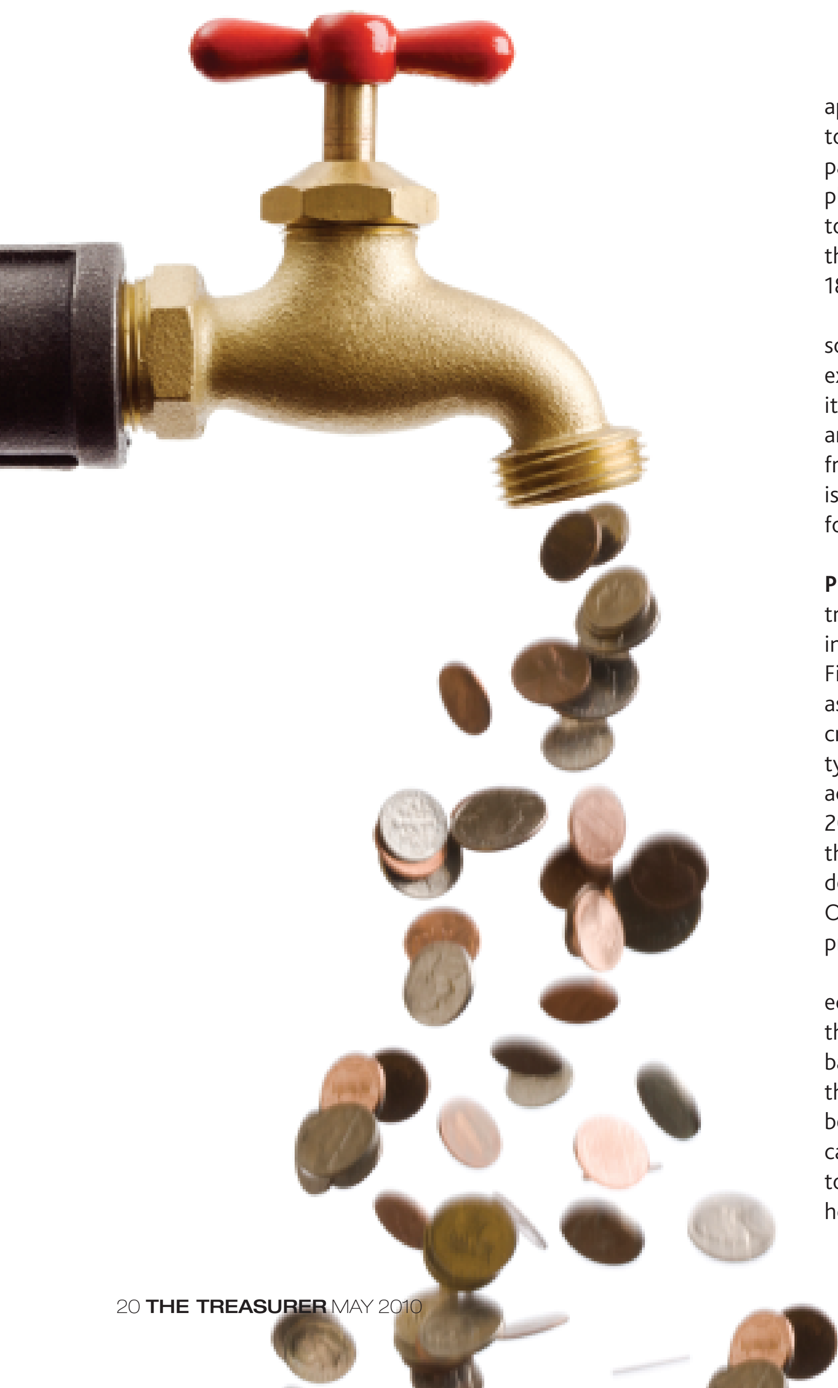
Tapping the capex line

AS RECOVERY GRADUALLY RESTARTS, TREASURERS ARE WEIGHING UP ASSET FINANCE OPTIONS THAT CAN FIRE UP THEIR CAPITAL EXPENDITURE PROGRAMMES. **RICHARD WATERS** EXPLAINS THE IMPORTANCE OF ASSET-SPECIFIC ISSUES IN CHOOSING THE MOST SUITABLE PRODUCTS.



The sudden economic downturn of 2008 and 2009 forced corporate treasurers to make some urgent decisions. Maintaining maximum liquidity was critical and reducing levels of working capital was the in-house solution. Typical approaches included cutting inventory and stock levels, negotiating to respectively extend and reduce the payment terms for accounts payable and accounts receivable, and deferring or even cancelling planned capital expenditure. Increased attention also had to be given to core banking relationships, with discussions sought to ensure that the refinancing of core facilities due to mature within the next 12 to 18 months would be well received.

A year or so later and with the economy doing its best to recover some of the lost ground, the realisation is dawning that capital expenditure cannot be postponed indefinitely (see Figure 1). Whether it is to replace older life-expired assets, invest in new lines of plant and machinery, or increase cost-effectiveness and environmental friendliness by acquiring more energy and process-efficient assets, it is time to get to grips with the importance of capex as a key driver for both market competitiveness and organic growth.

PRODUCT SUITABILITY But what options are available to corporate treasurers in best funding this capex? Certainty of funding is critical in order to ensure that relationships with suppliers remain good. Financial product "suitability" is the key in the endeavour to match assets with liabilities. Tapping into the scarce resource of revolving credit facilities is often a first call, but the tenor of the facilities will typically be far shorter than the useful life of the assets being acquired. Similarly, bond issuance, a core route to new money in 2009 and likely 2010, typically produces tenors with bullet profiles that may be suitable for very long-lived assets; but as the assets depreciate in value, so the debt to asset ratio will worsen over time. Ostensibly there is asymmetry between asset lives and funding profiles that creates a strip risk of uncovered liabilities.

Matching the funding requirement and profile to the inherent economic value in the underlying assets being acquired is therefore the optimal solution. Treasurers need to be confident that a bank-based asset lender will have a full understanding and appreciation of the value curve over time. This will enable an amortisation profile to be constructed that takes account of both the income generating capability of the asset and the likely resale values achievable in a sale to a third-party purchaser. Equally important is that the lender knows how critical the assets are to the borrower's business.

The ability to assess these factors will ensure that the inherent asset value is taken into account in maximising the lender's risk-weighted capital efficiency when applying Basel II capital adequacy accord rules to the loan. This in turn will ensure that the most competitive pricing is made available to the client. Whereas once the lender was potentially able to price accelerated tax depreciation benefits into a lease, now the allocation and pricing of regulatory capital and the simplicity of documentation make asset finance an attractive alternative medium-to-long-term funding source.

BE PREPARED Prior to signing purchase orders, treasurers should be looking to enter into a capex facility with an availability period that covers the expected asset delivery profile. For discrete assets a repayment schedule can be established for each drawdown, while for a factory fit-out or project-style asset a single repayment schedule can be calculated which commences at the completion of the asset build, thus matching liabilities with income generation. Funding options can be similarly flexible with floating rate throughout, floating through drawdown with a prefixed rate take-out, or a fixed rate for both drawdown and take-out phases based on an expected drawdown schedule. Multicurrency options for assets located in different jurisdictions can also be incorporated.

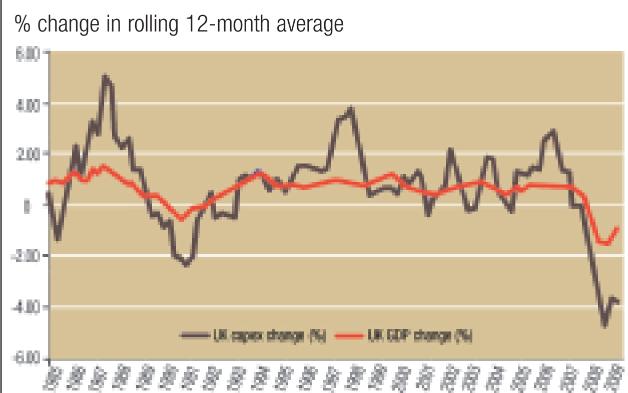
For certain assets that have wide-ranging alternative or secondary markets, a repayment profile can be structured that does not fully amortise the acquisition cost. Instead the borrower would have the right, typically subject to certain return conditions, to hand the asset back to the lender at the end of the term; the lender will then rely on the proceeds of disposal or release to complete the amortisation of its investment balance.

Solutions can be off the shelf or created specifically for the borrower and reflect the specific cycle in which the borrower finds themselves (see Figure 2). For new assets the use of vanilla hire purchase facilities can be employed so that the lender's security in the asset is obtained by virtue of its acquisition, with a conditional sale back to the borrower and a nominal purchase option exercisable at the end of the hire period. For tax and accounting purposes this would be treated as if the assets remained on the balance sheet of the borrower, enabling capital allowances to vest with the borrower.

HORSES FOR COURSES Corporate treasurers need to have access to lenders capable of managing the asset-specific issues above, while simultaneously demonstrating their understanding of the borrower's markets and existing financial commitments and covenants. This is best achieved by working with a bank's structured asset finance team closely aligned to the corporate relationship management team. This will ensure that asset-based transactions are structured using the principal terms drawn from existing loan agreements, and that important topics such as existing security arrangements and negative pledges are fully covered. Treasurers should leverage existing bank relationships to obtain introductions to the appropriate asset finance team, which will also ensure that the credit approval and documentation process is fully aligned.

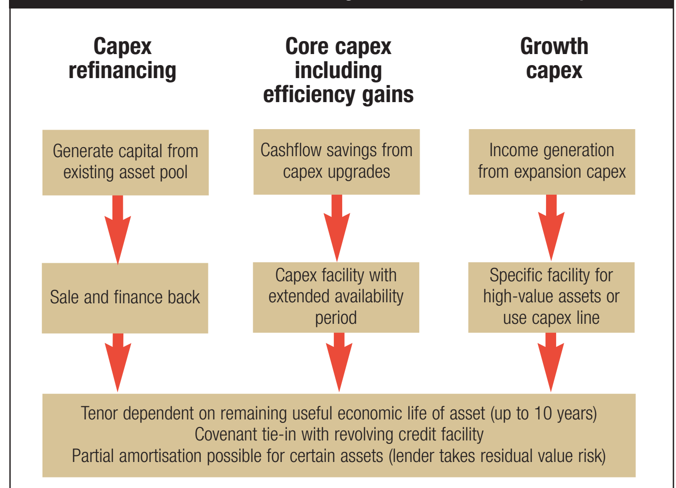
At Lloyds Banking Group, the Corporate Asset Finance team is in constant dialogue with the corporate relationship management teams, keeping them abreast of developments in the asset finance market and assisting them in offering suitable products to finance their clients' capital expenditure requirements. As a result Corporate

Figure 1: UK GDP v UK capex 1985-2009



Capex growth is closely linked to the wider economy growth trend but typically with accentuated highs and lows.

Figure 2: How asset financing fits the economic cycle



Asset Finance has delivered 30% growth in lending between 2006 and 2009, covering capex refinancing, core capex and in some markets growth capex facilities.

While the market has forced a change in capex pace, the value of matching funding products has come to the fore. Treasurers can create diversity in corporate facilities with products more suited to their business needs and thereby become less reliant on general working capital lines for their term asset financing, while spreading overall maturity and refinancing risk. With flexibility and simplicity at the heart of refinancing/capex lines, there is always an alternative.

Richard Waters is director of Corporate Asset Finance at Lloyds Banking Group.
richard.waters@lloydsbanking.com
www.lloydstsb.com/corporatemarkets

Lloyds TSB | Corporate Markets