Subject:

Fundamentals of Alternative Financing: Mechanisms and Appropriate Applications

Examples of Creative Financing Approaches

From: Saulsbury Hill Financial, LLC: Mr. David J. Clamage, Managing Director

303-629-8777 x102; davidc@saulhill.com; or, www.saulhill.com

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Overview

The goal of this outline and related discussion is to provide a synopsis of the common…and *not* so common tools used today in the financing of Mechanical Systems across all industry and US Federal, State and Local Government customer types; learn their application for any particular purpose or customer; and, explore the pros and cons of their individual use.

Federal Leasing – LTOP, LWOP or FEMP

The United States Federal Government is able to access 3, (Three), basic forms of finance common in the business of mechanical system finance:

LTOP: Lease To Own Plan

Essentially a fully amortizing loan with termination for convenience.

LWOP: Lease With Option Plan

A rental vs. intent to own.

FEMP: Federal Energy Management Program, (http://www.eere.energy.gov/femp/)

A fully amortizing loan funding a guaranteed performance contract; with termination for convenience; and, a "termination liability schedule".

- Pros
    - There are established methodologies, (FAR, DFAR, GSA, etc.[1]), for process and law
    - Legal guidelines are clear as to documentation
- Cons
    - Limited number of funders
        - Term and location
    - No tax benefits – fully taxable to the Lessor/Lender

Creative Examples

- As the parameters for Federal Government Finance are clearly defined, there exists rather limited creativity as to the form of finance you can offer your customer, i.e. the US Government.
- Chauffage™/Outsourcing is one of the few models that "*might*" apply, but we are unaware of this application save for in "build to suit" applications of real property leases.
- Variable cash flow is permitted per the attached "theme": "Scaled Funding"

Municipal "Muni" Leasing

The term municipal or "muni" leasing is generically applied to "State governments and the political subdivision of states, i.e. States and all agencies and authorities of States, i.e. State "higher education", prisons, agencies; Counties and Cities and their subdivisions, i.e. county hospitals, sports authorities; Public School Districts; Special Authorities and Enterprises, i.e. airport authorities, water and sewer districts; and, under special conditions commonly referred to as the "conduit process", IRS designated 501(c)(3) – "*not for profit corporations*", i.e. certain hospitals, higher education.

The basic characteristics are, while structured as a traditional loan or fully amortizing instrument with payments comprising of components of principal and interest, the "muni lease", is:

- Cancellable for non-appropriation
- Pre-payable
- Has a "nominal" end of term purchase option.
- The interest component of the payment is generally exempt from Federal and State income tax for the lender.

- Pros
    - As the interest is exempt from taxation for the Lessor/Lender, the interest rates are lower.
    - There is a very fluid market of buyers for this form of finance.
    - Pre-payment permissions allow muni-leases to bridge the periods in between bonds.
- Cons
    - Very defined methodologies under tax and "state by state" law.

[1] Federal Acquisition Regulations; Department of Defense Federal Acquisition Regulations; General Services Administration

- Legal issues
    - Lessee and Lessor counsel; interpretations; and, “other[1]”.
- Authorizations
    - Lessee
        - Opinion of Counsel
        - Governing Body
    - Lessor
        - Tax Opinion

Creative Examples

- Chauffage™/Outsourcing applies
- Variable cash flow is permitted per the attached “theme”: “<u>Scaled Funding</u>”

Capital Lease

A Capital Lease is a “*Note and Security*”, i.e. each payment has components of principal and interest; the lease is a capital obligation; depreciation and interest deductions are for the account of the Lessee; and, the lease may be terminated and fully paid at the end of term for $1.

And, the following key points would apply:

- The payments may, for the purposes of the Lessee, (US Rules), be a rental or operating expense but, are typically a Capital Expense.
- All depreciation and interest expense are for the account of the Lessee.
- The “*end of term purchase option*” is $1
- Subject to the above parameters, this obligation would be both an asset, (based on the acquisition cost), and liability, (the lease balance), to the Lessee
- Title is with the Lessee

- Pros
    - Simplest form of commercial finance
    - Maximum control vested with the Lessee
    - Potentially lowest cost – rate only
- Cons
    - Title with the Lessee minimizes creativity in structure
    - Mortgagee Waivers

Creative Examples

- Chauffage™/Outsourcing applies
- Variable cash flow is permitted per the attached “theme”: “<u>Scaled Funding</u>”

[1] WILLIAM SHAKESPEARE, Henry VI, part II, act IV, scene ii, lines 83-84

True Lease

A hybrid between the Capital and Operating Lease, the True Lease does provide for a purchase "*option*", but that option is typically fixed and thus is not truly an operating lease. However, the Lessee may expense the payments as rental payments with title remaining with the Lessor. In the most widespread model a 10%, (10% of the original cost), purchase option is used but other options can be structured with the proportionate adjustment in the payment terms. The increase in this residual or Future Value will serve to lower the periodic payment but, imparts certain future risk to the Lessor.

Comparable to the Capital Lease, some of the features of a True Lease are:

- The payments may, for the purposes of the Lessee, (US Rules), be a rental or operating expense.
- All depreciation and interest expense may be for the account of the Lessee or the Lessor with the selection made at Lease Inception.
- The "*end of term purchase option*" is *x*% of the original cost.
- Subject to the above parameters, this obligation may be both an asset, (based on the acquisition cost), and liability, (the lease balance), to the Lessee
- Title is optionally with the Lessee or the Lessor subject to the above depreciation election.

- Pros
    - 2nd simplest form of commercial finance
    - Maximum control vested with the Lessee
    - Potentially lowest cost – rate only
- Cons
    - Title with the Lessee minimizes creativity in structure
    - Mortgagee Waivers

Creative Examples

- Chauffage™/Outsourcing applies
- Variable cash flow is permitted per the attached "theme": "Scaled Funding"
- Residual Management
    - Higher residuals result in lower payments

Off Balance Sheet Financing

The goals of an Off Balance Sheet Financing are many:

- Protect the Balance Sheet of the Borrower/Lessee, (the Lessee), from the underlying debt

- Provide for an Operating vs. Capital Expense for purchasing authority guidelines, i.e. authority exists for a defined operating budget vs. a capped or limited capital expense budget.
- Use Operating vs. Capital Expense accounting for tax benefit, i.e. AMT[1] problems facing the Lessee/Borrower

The tools then available are Operating Lease and Chauffage™/Outsourcing.

Operating Lease

As defined in GAAP, IRS[2] and FASB[3], an Operating Lease may permit the Lessee, (the Lessee), treat the debt as off balance sheet and the lease payments as an operating vs. capital expense of the following tests are met:

1. Ownership of the property is not transferred to the Lessee by the end of the lease term.
2. The leased assets may be purchased at the end of the lease term by the Lessee for only the "*then fair market value*".
3. The lease term, at inception, is not equal to or greater than 75% of the estimated economic life of the leased property, i.e. 10-year assets may not generally have an operating lease term greater than 7.5 years.
4. The present value of the minimum lease payments at the beginning of the lease term is greater than 90% of the equipment costs when that present value is determined by using the "*Lessees incremental borrowing rate, (IBR)*", i.e. "The IBR[4] Test".

As with all Operating Leases, the following key points apply:

- The payments may, for the accounting purposes of the Lessee, (US Rules), be a rental or operating expense.
- All depreciation is for the account of the Lessor.
- The "*end of term purchase option*" is Fair Market Value
- Subject to the above parameters, this obligation may be "off balance sheet" for the Lessee
- Title is with the Lessor

- Pros
    - Defined "off balance sheet" GAAP[5], FASB[6] and like models

[1] Alternative Minimum Tax

[2] Internal Revenue Service, (US)

[3] Financial Accounting Standards Board, (US)

[4] This is defined as "the rate at which the Lessee would borrow money today, on like terms, to purchase the leased property" and *not* the historical average cost of funds; line of credit borrowings; or, other non-comparable financings.

[5] Generally Accepted Accounting Principles

[6] Financial Accounting Standards Board

    - Maximum control vested with the Lessee
    - Potentially lowest "payment" cost – rate only
- Cons
    - Post "Sarbanes Oxley", etc. markets are very circumspect and cautious about this form of finance
    - Long Depreciation/Useful Lives of mechanical system assets preclude this form of finance in many cases with respect to the 75% rule.
    - Fair Market Value end of term purchase option
        - May force high…
            - Lessee Value
            - Lessor Risk
    - Mortgagee Waivers

Creative Examples

- Chauffage™/Outsourcing applies
- Variable cash flow is permitted per the attached "theme": "Scaled Funding"
- Short term application for a major manufacturer
    - IBR Compliance

Chauffage™/Outsourcing

In Europe, Chauffage™ or Outsourcing is a very common methodology for all – not just municipal – users to acquire large scale HVAC, (Heating Ventilating and Air Conditioning), and related systems for their facilities. And, in the United States, this technique is growing in favor. This form of acquisition has many advantages for users such as the Lessee. Essentially the ESCO or Vendor not only designs, engineers, installs and commissions the facility, but either on their own or in conjunction with the Customer's staff, they operate the plant and sell to you the output, i.e. System Automation, Lighting, Steam and Chilled Water, and so on. The results can be many and profound:

1. The costs are clearly Operational vs. Capital as the Customer is purchasing a commodity vs. amortizing a debt.
2. The ESCO or Vendor is positioned to take some or all of both the operational responsibilities and performance guaranties.
3. The transaction is taxable to the ESCO and their investors and thus, there are not typically restrictions as to the use, i.e. commercial and/or "for profit" customers.

Basically the cost of the plant is amortized over an agreed upon contract term; the cost of that amortization is converted into a commodity rate by dividing your unit of total usage into the periodic amortization:

$1,000 of Payment / 100 Tons of Chilled Water = $10 per Ton of Chilled Water

Clearly there are many variables to be applied to this equation, i.e. indirect costs such as the underlying utility rates, (gas, electricity, water, etc.); base and expandable usage of the commodity; insurance; taxation; operating costs, i.e. all ESCO vs. all the Lessee vs. "hybrid"; and, other criteria.

In this form of acquisition, the finance provider would have their cost of capital fully taxable, but have the ability to lower current costs of that capital from a combination of retention of the tax benefits, i.e. depreciation and the residual or "future value" of the plant at the end of the initial contract term. Thus, there are "ranges" of costs associated with this form of finance.

However, the Chauffage™/Outsourcing model has virtually the same characteristics as an Operating Lease:

- The payments may, for the accounting purposes of the Lessee, (US Rules), be a rental or operating expense.
- All depreciation is for the account of the Lessor.
- There is "*technically*" no "*end of term purchase option*" as the Lessor is, via the creation of a "*special purpose corporation*", (SPC), is a Vendor of the commodity, i.e. chilled water, lighting, steam, etc.
- Subject to the above parameters, this obligation may be "off balance sheet" for the Lessee
- Title is with the Lessor/SPC

- Pros
    - Defined "off balance sheet" GAAP[1], FASB[2] and like models
    - Maximum control vested with the Lessee
    - Potentially lowest "payment" cost – rate only
    - Vendor/ESCO control of the customer
- Cons
    - Post "Sarbanes Oxley", etc. markets are very circumspect and cautious about this form of finance
    - No equity vesting with the Lessee/Purchaser
    - Mortgagee Waivers

Creative Examples

- Chauffage™/Outsourcing applies
- Variable cash flow is permitted per the attached "theme": "<u>Scaled Funding</u>"
- Major hospital
    - Off balance sheet
    - Vendor control – 15 years

Summary

There are a number of guidelines as to *"which product for which customer":*

[1] Generally Accepted Accounting Principles

[2] Financial Accounting Standards Board

Which Tool for Which Customer

Promissory Note/Note and Security

This is a conventional loan with components of principal and interest with each payment and it amortizes over time. The loan is capitalized on the books of the customer; they depreciate the equipment; and, deduct interest.

I. Commercial
II. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University

True Lease

This is a lease with a residual or balloon and where the Lessee, (Customer), makes payments while the Lessor, (Lender), holds title. There are no stated principal and interest components and the balloon is typically the “then fair market value”. The lease payments are typically expensed over the life of the financing.

I. Commercial
II. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University

Capital Lease

This is a lease with a residual or balloon and where the Lessee, (Customer), makes payments while the Lessor, (Lender), holds title. There are no stated principal and interest components and the balloon or residual is fixed at the beginning of the lease, i.e. 10% of original equipment cost. This lease must be capitalized on the books of the customer and they have the option of expensing the payment as a lease; or, depreciating the asset and deducting implied interest.

I. Commercial
II. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University

Operating Lease

This is a highly specialized form of lease that is used to keep the debt off the balance sheet of the customer. The lease payments are 100% expensed for the life of the lease and the end of term purchase option is <u>strictly</u> fair market value. There are complex tests that must be applied to the math of this financing to ensure that all accounting tests are met.

I. Commercial
II. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University

***Muni*[cipal] Lease**

This is a tax-exempt lease where the interest charged by the Lessor is exempt from State and Federal income tax. Thus, the effective rate is lower than a commercial financing. The lease payments have components of principal and interest and there is an end of term purchase option of $1. The lease must be cancelable for non-appropriation by the Lessee, i.e. they have insufficient monies for payments in subsequent years and the equipment must be returned.

I. State and Local Government
School Districts
Special Districts, i.e. Water, Sewer, Fire, etc.

Conduit Lease

This is a Lease and Sub-Lease and is structured as a municipal lease where it is a tax-exempt lease where the interest charged by the Lessor is exempt from State and Federal income tax. Thus, the effective rate is lower than a commercial financing. The lease payments have components of principal and interest and there is an end of term purchase option of $1. The lease must be cancelable for non-appropriation by the Lessee, i.e. they have insufficient monies for payments in subsequent years and the equipment must be returned. The Master Lease is to a State or Local Government or Authority and the Sub-Lease to a 501(c)(3)/Not For Profit entity.

I. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University

Chauffage™/Outsourcing

This is a purchase of the commodity underlying your system, i.e. steam, chilled water, lumens or control cycles. The customer, at no time, has an ownership interest in the asset but, purchases the output. We contract with the Vendor to purchase the asset; we further contract with the Vendor, or their designee, to provide for all Operations and Maintenance – complete with their normal "performance contract style guaranty; and, the commodity is sold to the customer. This may, in most cases, result in an "off balance sheet" obligation for the customer.

I. Commercial
II. 501(c)(3)/Not For Profit, i.e. Hospital, Private College or University
III. State and Local Government
School Districts
Special Districts, i.e. Water, Sewer, Fire, etc.

Abatement Lease

This is a form of tax-exempt lease where the interest charged by the Lessor is exempt from State and Federal income tax. Thus, the effective rate is lower than a commercial financing. The lease payments have components of principal and interest and there is an end of term purchase option of $1. The lease must be cancelable for non-appropriation by the Lessee, i.e. they have insufficient monies for payments in subsequent years and the equipment must be returned. The Abatement Lease is only used in the State of California.

I. State and Local Government
School Districts
Special Districts, i.e. Water, Sewer, Fire, etc.

Federal Government Lease

This is the assignment of a purchase order from a unit of the United States Federal Government - any branch or entity, i.e. IRS, Army, Department of Justice, etc. - where a purchase order is given to the Vendor specifying both the goods and services and the payment terms, i.e. Dollars per Month. This lease can be prepaid in whole or in part at any time and must be cancelable for convenience, i.e. at any time with the notice of the agency. It has an end of term purchase option of $1, (Lease To Own Plan, LTOP).

I. Federal Government Agencies.

Key: I. This indicates this is the PRIMARY candidate for this form of lease.
II. This is a SECONDARY candidate for this form of lease.

Note: If a customer type is not indicated, they are likely not a candidate for that form of finance.

Scaled Funding				
Lease Amount:		$ 1,000,000		
Interest Rate:		8.00%		
Term:		10	Years	
Mode:		Annual	Arrears	
		Annual Payments		
		Loading		
		Level	Front End	Back End
1		($149,029.49)	($193,738.34)	($104,320.64)
2		($149,029.49)	($193,738.34)	($104,320.64)
3		($149,029.49)	($193,738.34)	($104,320.64)
4		($149,029.49)	($149,029.49)	($149,029.49)
5		($149,029.49)	($149,029.49)	($149,029.49)
6		($149,029.49)	($149,029.49)	($149,029.49)
7		($149,029.49)	($93,826.85)	($204,232.12)
8		($149,029.49)	($93,826.85)	($204,232.12)
9		($149,029.49)	($93,826.85)	($204,232.12)
10		($149,029.49)	($93,826.85)	($204,232.12)
TOTAL:		($1,490,294.89)	($1,403,610.89)	($1,576,978.88)
Total Interest:		($490,294.89)	($403,610.89)	($576,978.88)