SEYFARTH SHAW LLP ATTORNEYS

Quick Takes

March 2006

No Equity? No Letter of Credit? No Problem!

Many of my *Quick Takes* articles, and a lot of my workshops, have focused on how you make a project financeable. There are two key issues- equity, and credit enhancement. After all, you can't even buy a house without putting some money into it. And many car loans would not have been made without someone co-signing the note (credit enhancement!).

Why should a $100 million (or $10 million, or $1 million) project be any different?

The "old school" answer is- it isn't. You always need equity. And if you want to finance your project with variable (floating) rate industrial development revenue bonds, you need credit enhancement through a letter of credit. (And not just any letter of credit. You need one that's investment grade rated from a commercial bank). The letter of credit is needed for floating rate bonds not just to make the bonds marketable- it serves other functions, as well.

Now, for some projects, at least, there's another option- "**Authority-Financed Structured Leases**." Authority-financed structured leases is a financing structure that always involves: (1) bonds issued by a development authority (or another type of public authority, depending on the project); (2) the authority's holding title to the project; (3) a lease of the project by the authority to the lessee; and (4) "structuring" (financial engineering) of the lease to the lessee. The lessee then chooses among the available additional features of this financing structure in order to get the financial and accounting results it wants. In qualified transactions, the lessee can choose to-

- Float the interest rate, without a letter of credit.
- Get 100% financing for the project- no equity required! And in terms of what it costs to get it, equity is the most expensive line-item in any project's balance sheet.
- Pay interest-only during the lease term. Or have only partial amortization of the debt. This strengthens the lessee's cash flow and cash on hand.
- Avoid rent that escalates during the lease term (rent escalators are typical of traditional developer leases).
- Finance all costs of issuance, rather than having to pay them out-of-pocket.
- Access "taxable" bond financing (better rates than conventional financing), if tax-exempt financing isn't available for the project.
- Sell the bonds privately (which is cheaper to do), rather than publicly.
- Raise as much capital as needed- there is virtually no upper limit on the size of these financings.
- Sign the type of lease the lessee wants- operating lease, or capital lease.
- Finance all types of fixed assets- land, buildings and/or machinery and equipment.
- Fund projects for non-profits, as well as for-profit industrial, office or other traditional

projects.
- Get incentives that aren't available without this structure.

Lessees can also "monetize" existing assets through a sale-leaseback using selected elements of this financing technique.

So, what's the catch? Well, I said there weren't any problems; I didn't say there weren't any qualifications. Here's what is required to access this financing structure-

- To avoid the letter of credit requirement, the lessee has to have very good credit- at or near investment grade. If not, the financing may still be possible, particularly if the lessee is a creditworthy privately owned business, even if it never has had its debt rated.
- If the lessee is financing machinery and equipment and isn't investing equity, the residual value of these assets is important.
- If the asset being financed without equity is land and buildings, the asset value is also important, but credit is even more important.

If the lessee wants the no-equity feature of this financing technique, this takes one of my favorite things- financial engineering! A financing normally requires equity. In formula terms: amount needed – amount of debt = equity. If borrowing 100% of the amount needed isn't possible or desirable, however, this financing structure provides you with a substitute for equity- residual value insurance. Because of the residual value insurance, you can get 100% of the funds you need, but only be personally liable to repay 90% or less of the principal amount you received. Here's how it works.

Take a typical bond-financed sale-leaseback structure, in which the authority holds title to the project and leases it to the company. The rent payments are equivalent to debt service; they are used to retire the bonds that the authority issued to a lender/bondholder to finance the project.

Assume that this is a no-equity deal, so the rent payments are not sufficient to pay off the bonds during the lease term. At the end of the lease term, if the company buys the project, its purchase price payment would be used to pay off the bonds.

But what if the company doesn't buy the project at the end of the lease term? The lender still expects to get paid, and it (or its trustee) would have a first priority security title to, and security interest in, the project to make sure that it does get paid. Problem is, lenders worry about what the project really is worth at the end of the lease term, and lenders don't like to have to resort to foreclosure in order to get paid.

Here's where the residual value insurance comes in. If the lender doesn't get paid any other way, the residual value insurer will pay off the lender. Simple as that.

Keep in mind that the financial engineering for a no-equity financing also has to deal with the amortization requirements of the Development Authorities Law, if this is a Georgia financing involving a "statutory" development authority.

This financing technique has more to it than just its no-equity feature. In fact, most authority-financed structured lease transactions do not involve residual value insurance. Doing without equity is optional. For example, the bonds can still be privately placed on a floating rate basis without a letter of credit. However, the lease structure is always needed if the lessee wants better economics for the financing or wants incentives for the project.

And, if the lessee provides the equity, the lessee's lease will be a capital lease, rather than an operating lease. What's the difference, you ask?

Well, a capital lease is a "finance" lease. It is fully amortizing, or "full pay-out." In other words, the mandatory rent payments will completely pay off the debt by the end of the lease term, and the lessee will own the project at that time. Because of this, the project and the debt are on the lessee's balance sheet for accounting purposes. This also means that, unless the lender actually loaned 100% of the amount needed, the lessee had to invest equity in the project. And remember, that equity is more expensive than debt!

On the other hand, an operating lease is a "true lease." It doesn't fully amortize the debt. So rental payments are lower (some operating leases are even interest-only during the lease term). If the lessee uses the no-equity feature of this financing structure, it does not have to pay for expensive equity to be invested by the lender/lessor. And since the lessee never invests equity in cases like these, the lessee conserves even more cash.

Operating leases are also off-balance sheet for the lessee for accounting purposes. Having title to the project vested in a development authority (or other public authority) satisfies one very important accounting rule in order to make that happen. This financing structure also has a number of other built-in features to satisfy the other accounting rules.

When a rating agency like Standard & Poor's determines how it will view the effect of an operating lease transaction on the lessee's financial situation, the "asset class" of the project is a determining factor in whether it will view the transaction as both off-balance sheet and "off-credit." Many times a rating agency may view the transaction as partially or fully "on credit" when looking at debt ratios for their listed public debt ratings. This determination is made promptly, based on a quick review of the project.

In Georgia, we are used to a development authority holding title to a project in a bond-financed sale-leaseback structure. This is so the development authority can provide a prospect with the incentives that it has negotiated, such as property tax abatement and cash and in-kind incentives. There are similar motivations in other states to use this structure; for example, to obtain the exemptions in Alabama and Mississippi from payment of the sales and use tax on building materials if the project is a local authority project.

This financing structure has made a lot of projects take place. They include an office, machining, manufacturing and distribution facility for a U.S. Navy supplier that (for reasons of federal procurement law) had to have an operating lease; a parking facility with retail space serving a corporate headquarters; hospital facilities for a non-profit qualified as a "501(c)(3) organization"; and manufacturing, warehousing and distribution space for a traditional manufacturer of injection-molded plastic packaging.

So, what's the conclusion? "No equity? No letter of credit? No problem!"

If you have any questions or comments about authority-financed structured leases, please let me know.

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February 24, 2006 interest rates on IDBs (variable rate demand bonds; AMT 7 day general markets; rates are market extracted and approximations):

Interest Rates:
tax-exempt 3.35%
taxable 4.66%

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General note: This issue of *Quick Takes* is a quick-reference guide for economic developers, participants in the real estate and financial industries, and company and public body directors, executives and managers and their advisors. The information in this issue is general in nature. Various points that could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case.

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