SESSION 8
Paper (d)

METHODS OF FINANCING LOGGING MACHINERY

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INTRODUCTION

This paper will attempt to illustrate some of the methods of financing logging equipment.

We leave the choice of equipment to the purchaser to decide and at the time the approach to us is made for finance we consider the requirements under four basic headings.

These are:-

1. HISTORY

What is the borrower's past repayment history? Has he been successful? Bank and credit reports are obtained particularly in the case of a new connection. These reports give us the ability to determine whether or not the borrower is the type of person which we would be prepared to become involved with.

We obviously like to ensure that the borrower has an equity in the plant being purchased. Minimum deposit requirements are for new, 25% and higher for second hand and can be made up with either cash or equity in a trade-in or a combination of both. If the deposit is entirely by way of cash we want to know where it is coming from. In the case of new operators we find that a lot of proposals come to us which show that, in effect, the new operation is being financed 100%, usually by way of a combination of a loan from a member of the family together with finance from a finance house. That type of proposal is rarely approved.

2. CASH FLOW

Do the funds available from the proposed or existing operation provide sufficient monies, after operating expenses, and contractors remuneration to pay both proposed and existing commitments?

...2/

We like to restrict the advance to a three year period, however, under today's conditions, considering the high cost of gear, it is becoming more common for lending proposals to be for a term of up to five years.

3. SECURITY

It is essential that the machine being purchased provides the lender with adequate security. We are obviously concerned that should the purchaser not pay instalments and repossession occurs, that the sale of the security will provide sufficient funds to repay the balances outstanding.

It is a standard requirement of UDC these days to obtain guarantees from the major shareholders in the Company. Therefore if the sale of the security is insufficient to repay the borrowings, the guarantors are then expected to make up the difference.

4. FINANCIAL

A copy of the latest financial accounts is usually required. The accounts provide considerable information such as the shareholding structure of the Company or the net worth of the individual borrower. They also divulge whether or not the borrower is making a profit on his existing enterprise and whether or not he has sufficient working capital.

If the borrower is to operate on his own account for the first time, we will require a budget and cash-flow. As previously shown above, that information enables us to check that there will be sufficient money to:-

i) Repay all borrowing commitments <u>and</u>

ii) Show the return which the operator expects to receive on his capital.

Money lenders are inclined to be cautious people and when considering a proposal obviously wish to ensure that there is a return to both parties in the transaction.

There are four methods of financing the purchase of logging equipment. These are:-

1. HIRE PURCHASE OR CONDITIONAL PURCHASE AGREEMENT

A Hire Purchase Agreement is a contract whereby the purchaser requests the finance house to purchase a particular machine or machines from a third party. He then contracts to pay the amount of the purchase price, less any deposit plus a finance charge, back to the finance company. Any such transactions are covered by the Hire Purchase Act 1971. That Act gives both the client and the finance company certain rights. Very briefly, the Act

...3/

specified the form in which the agreement is to take, if the type of forms which must be used should repossession action take place, who is liable for repairs and maintenance to the security etc. etc.

In order that a comparison may be made between the cost of purchasing by way of Hire Purchase or Leasing I have attached a set of calculations to this paper which shows the all up costs to the borrower. It should be noted that I have not made any allowance for tax as each individual's tax situation is different from the next.

Hire Purchase is the most common form of documentation used for financing and the rights explicit in terms of the Hire Purchase Act give the user far more rights than under a Lease Agreement.

2. LEASING

From a lender's point of view, the same credit appraisal criteria applies to a Leasing transaction as to a Hire Purchase transaction. A Lease Agreement, like a Hire Purchase Agreement is still a basic contract between two or more parties. A Lease Agreement achieves the same purpose as a Hire Purchase Agreement and is a somewhat recent innovation (comparatively speaking) in today's conditions. Some pertinent points as regards to Leasing are as follows:-

a) Leasing is off balance sheet borrowing and does not create a charge over unencumbered assets, preserving margins in existing borrowing channels.

b) Unlike some forms of borrowing, such as bank overdraft, Leasing is not subject to recall at short notice, as it is for a fixed term, although can normally be terminated at the lessee's request.

c) If advance rentals are required, they are normally tax deductable at the time of payment. This can sometimes result in a deferrment of tax.

d) Lease rentals are a charge against revenue not capital expenditure, and as such, under most circumstances, are eligible for full tax deductions.

e) The net proceeds on the sale of equipment are refunded to you at the end of the contract.

f) A residual value or terminal adjustment is paid at the end of the Lease and it is the predetermined amount that the equipment is required to realise at the end of the Lease period. The Lease provides that the lessee indemnifies the lessor for the residual value. Should the equipment on eventual sale not realise that figure then the lessee pays the lessor the difference. On the other hand, should

...4/

the equipment realise in excess of the residual value, then the net proceeds are refundable direct to the lessee. The residual value varies according to the nature of the equipment, the rate at which the depreciation is calculated in the Lease and to a lesser extent the use to which the equipment is put.

g) A Lease does not confer on a lessee any option to purchase the equipment subject to lease as in the case of a Hire Purchase Agreement. However, at the end of the Lease (with the exception of Motor Cars) UDC is free to consider an offer from the lessee for the equipment by separate agreement independant of the Lease Agreement. Alternatively the equipment can be returned to UDC for sale purposes or refinanced for a further period at a reduced rental.

h) In most cases no additional form of security is required. However in cases where the lessee is a private company, once again the personal guarantee of the Directors or principal shareholders is normally required. In most cases, a deposit or what is known in our jargon as a good performance bond, is required to be paid on signature of the Lease, the amount of which is similar to that required with Hire Purchase.

3. NIL DEPOSIT TRANSACTIONS - INSTRUMENTS BY WAY OF SECURITY

Instruments by Way of Security are used where the borrower does not have sufficient cash to enable the transaction to be done by way of Hire Purchase or Lease. In place of a cash deposit a charge is taken over the machine being purchased together with another piece of unencumbered equipment. Once again the basic idea of this transaction from the lender's point of view, is to obtain a margin between the amount lent and the resale value of the equipment. The basic difference between an Instrument by Way of Security and Hire Purchase and Leasing is that with an Instrument, the borrower at the time the advance is made is the owner of the items secured, whereas under a Hire Purchase or Lease transaction the financier retains ownership until all the terms of the contract have been met. In other words, when either the final instalment or residual value has been paid.

4. MORTGAGES AND DEBENTURES

Other forms of financing which are used sometimes, are those involving mortgages over freehold property and advances secured by a Debenture over the Company's assets and undertakings. That type of transaction is not common in my experience and in view of the legal cost and the preparation of such securities, will obviously increase the cost of borrowing.

...5/

CREDIT CONTRACTS ACT 1981

This Act came into force on the 1st June, 1982 and amends part of the Hire Purchase Act 1971 and also repeals the archaic Money Lenders Act 1908. This new Act applies to all lenders and was passed in order to:-

a) Prevent oppressive contracts and conduct.

b) Ensure that all the terms of the contracts are disclosed to the borrowers before they come irrevocably committed to them.

c) To ensure that the cost of credit is disclosed on a uniform basis in order to prevent deceptions and encourage competition.

d) To prevent misleading credit advertisements.

Without wishing to dwell on the far reaching effects which this Act will have on all lending transactions one advantage is that it will at least give you a short period of time in which to ensure you are aware of the full terms and conditions of the document which you are about to sign.

CONCLUSION

Whilst some of our requirements may seen onerous, they are based on our lending experience acquired over many years. It is obviously in the interests of both parties, that throughout the course of the transaction neither is going to lose money and careful thought and research prior to the start of the deal can avoid problems later.

From what I have told you; you will appreciate that the various options available for financing equipment can be somewhat complicated. Therefore, I do not intend to make any generalised observations as to which is the best method of financing. But I do recommend that, because of the large amounts of money involved in your industry, it would be prudent to seek independent advice from your tax consultants to ensure that you are getting the best after tax deal available in the market place, and also to ensure that the project which you are about to embark on is going to be profitable and worthwhile considering the long hours and hard work involved.

It should also be remembered that, from a lender's point of view, the risk of losing money is the same no matter which of the above forms of financing is used.

L.I.R.A. 1982 LOGGING MACHINERY SEMINAR

Hire Purchase & Lease Examples Based on a unit cost of $1,000

HIRE PURCHASE

36 Months

Amount Financed	$1,000.00
Finance Charge	$ 412.28
Balance Payable	$1,412.28
36 Monthly instalments of	$ 39.23

LEASE

Cost Price	$1,000.00
Residual Value	$ 480.00
Total Rental Payable	$1,080.00
36 Monthly rentals of	$ 30.00