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RESTRUCTURING A FINANCE LEASE AGREEMENT

A Four Step Guide to Success

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The COVID-19 pandemic affects the health of not only the population but businesses as well, especially small and medium-sized entities. Quarantine restrictions have led to production downtime and drops in market demand, causing changes in cash inflows. In this situation, access to new funding has become even more difficult.

Debt restructuring will help overcome financial difficulties in fulfilling contractual obligations. This booklet provides important information for successful negotiations with the lessor regarding lease debt restructuring.

STEP #1

First, assess the terms and conditions of your finance lease agreement, specifically:

- Review your obligations under the lease agreement (payment terms and consequences of late payments).
- Assess your ability to honor the terms of the agreement.
- Review the terms of a finance lease agreement: are there any additional requirements (e.g., a fee for changing the terms of the agreement, time limits)?

IMPORTANT INFORMATION

Before moving to Step 2, get familiar with the **types of restructuring:**

Lease currency change (foreign or domestic). Changing from a lease denominated in foreign currency to one in national currency can help avoid currency risks, but finance lease servicing will be more expensive. Conversely, if a company has foreign currency revenues, a foreign currency lease might significantly reduce the costs under the lease agreement (bear in mind that a foreign currency lease is possible only if you have foreign currency revenues sufficient to cover lease payments). Also bear in mind that exchange rates fluctuate.

Lessor fee reduction. Reducing a fee rate will allow you to have additional liquidity. For example, if your company has lost several major regular customers, which resulted in a revenue decrease, but your fixed costs remain unchanged, the reduction of the lessor's fee will help increase your liquidity and allow you to settle your obligations in a timely manner.

Finance lease extension. Extending the finance lease for a certain period of time may help you keep going or re-start operations. For example, the major debtor of your company notified you that it would be able to settle its debt 3 to 4 months later than due. Thus, your cash flow does not allow you to make finance lease payments in a timely manner. A lease extension will help resume operations, manage your cash flow, to pay off your debt when it falls due and avoid penalties.

Debt reduction (such as late payment penalties / fines). This type of restructuring is most often available to companies that have a good long-term partner relationship with the lessor. In order to keep such a customer, the lessor may be willing to give up some profits and support the partner in financial difficulty.

Repayment holiday, i.e. obtaining temporary relief from the obligation to make financial lease payments in general, or on payments covering some part of the cost of the leased item and/or lessor's fee and deferring them to future periods, so that it is possible to resume business operations. For example, some of your harvest is destroyed by unfavorable weather or the price for your harvested crop is low but, according to some trusted sources, can significantly go up in a certain period of time. A repayment holiday for this period will solve the settlement issue.

STEP #2

Try to forecast the **company's financial capacity:**

- Develop a financial plan/forecast of your company that projects cash flows for the period (length of time) you expect problems in business, and for the subsequent recovery.
- In the forecast, separately describe the scenario in the event of restructuring. To do this, choose the expected type of restructuring.
- The forecast should include detailed information about: the problem that led to the need for restructuring (e.g., production difficulties, source of revenue/sales, collection of accounts receivable, changes in the product line, etc.) and about costs associated with such solutions (additional jobs, etc.).

STEP #3

If after the first two steps you are convinced that restructuring is good option for you, then it is time to prepare documents to apply to the lessor. Generally, it is necessary to prepare the following package of documents:

- **An application for restructuring** that should include the restructuring proposal and its justification.
- **Financial statements** (balance sheet, income statement) of the lessee and the consolidated statements of the group of companies (if such a group exists) as of the most recent reporting date, with a detailed breakdown of some line items of the financial statements (at the lessor's request).
- **Management/consolidated statements.**
- Documents that confirm the debtor's **financial forecasts** regarding debt repayment.
- For an investment project, **changes in the production start-up schedule, changes in the design documentation**, etc.
- **Bank statements from all the servicing banks for the last three months** and information about the existence or absence of overdue debt (e.g., debt on loans and/or finance leases) and the debt servicing.

IT IS IMPORTANT TO UNDERSTAND HOW THE LESSOR WILL ASSESS THE POSSIBILITY OF RESTRUCTURING:

A. LESSEE BUSINESS REPUTATION ASSESSMENT CRITERIA

The lessor will assess the reputation, credit history of you and your company

1. Credit history of the company / its owners

It is recommended to keep a good credit history and pay debts under other obligations. The lessee should check the owner's and the company's credit history at several credit history bureaus (this can be done by any individual for a fee but, once a year, this information can be received free of charge); the most active credit history bureaus in Ukraine are: ПВБКІ, УБКІ, МБКІ)

2. Criminal/court cases, facts of dishonest participation in the bidding process, facts of fraud, application of criminal liability, failure to pay taxes

It is advisable to have clean records and not be involved in lots of litigation. Check the Comprehensive State Register of Court Decisions (by the EDRPOU code of the company / group of companies); if there are litigations, explanations regarding their history and prospects should be prepared.

Taxes payable can be checked on the website of the State Tax Service of Ukraine.

3. Distortion of information in financial documents (inconsistencies in the financial statements, discrepancies between breakdowns and official records for which the client cannot give a clear explanation)

Make sure that your financial statements are accurate and verifiable. Statements provided to the lessor should be consistent with reports filed with the statistics authorities and/or the tax service. Breakdowns of line items in the financial statements should be consistent with the final data in the reports.

B. FINANCIAL CAPACITY ASSESSMENT CRITERIA

1. Requested restructuring terms should be consistent with the forecast sales volume

Lessors are generally willing to make changes to the agreement for the purpose of restructuring if it is justified and there is no other way to pay off debt in a timely manner. It is important to channel some forecast revenue of the lessee not only into current operations but to pay off debts as well.

2. Loan debt burden of the company: the operating income + depreciation (ebitda) to total debt (with guarantees and letters of credit received) ratio

Most lessors will allow this ratio to be no more than 4. This means that the operating income generated by the company can be used to pay off all its loans within 4 years. It should be noted that this indicator can be higher for some companies if their loan portfolio consists of long-term (over 3 years) loans.

3. Adequate business capitalization

The equity to total assets ratio shows the resilience of the company, its ability to withstand adverse unforeseen conditions in business. A company is considered adequately capitalized if its equity level is over 20%. But there are certain exceptions – e.g., for trading companies, this number can be lower, given the specific nature of their business.

STEP #4

FINAL STEP

1. Read the entire agreement on making changes (on restructuring) before signing, as well as all the documents referred to in the agreement.
2. Before signing the changes to the finance lease agreement, check the following terms and conditions:
   - A new lease term.
   - New amounts, payment procedure and lease payments schedule.
   - Fees for the revision of terms.
   - Rights and obligations of the parties. Pay attention to the lessee's obligations (reporting requirements and other obligations of the borrower) and liability in the event of a delay in payments.

Restructuring is a temporary solution for short-term financial problems to ensure business rehabilitation in the long term.

Additional information about finance leases can be found on the website of the Ukrainian Union of Lessors Association https://uul.com.ua/informatsiya-dlya-lizyngootrymuvacha/

This information is not intended as specific legal or financial advice. It is recommended that any lessee (or lessor) consider seeking professional advice as part of the restructuring process.

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