A Trucking Fleet Owners Guide to Improving Business Value

Executive Summary

The purpose of this white paper is to provide fleet owners, executives and their financial advisors with an understanding of how recent technological changes, as well as recent IRS regulatory changes regarding the use of IRC Section 1031, can enhance key financial metrics for trucking companies:

1. Financial benefits:
    a. Reduction in financing costs for equipment results in increased cash flow and overall lower debt, improving debt to equity ratio;
    b. Reduction in financing costs for equipment results in incrementally improving debt coverage ratios, improving financial efficiency ratios;
    c. Improved key financial metrics provide cash and/or leverage capacity to acquire new and/or better assets or technology sooner, resulting in total lower operating costs, with higher earnings over time; and
    d. Higher earnings (EBITDA), drives higher business valuation; results in more value for exiting the business or financial flexibility for future acquisitions.
2. Tax benefits:
    a. Taxes deferred have no repayment schedule or on-going reduction, and do not bear any interest rate if/when finally paid;
    b. Depending on business structure, taxes currently deferred may be eliminated in the future through proper planning and execution; and
    c. Allows for the accelerated deduction of taxable losses without taxable gains to reduce or eliminate those losses.
3. Process benefits:
    a. Replacement equipment purchased prior to disposal of old equipment does not qualify for trade or barter deferral, thus all gains are fully taxable;
    b. Financial flexibility and tax deferral is gained when assets are
        i. Disposed later in order to obtain more value, or
        ii. Disposed later, and used to generate additional income for up to 6 months, or
        iii. Purchased and sold intermittently over a period up to 360 days.
4. Technological benefits:

a. Recently developed modeling tools allow for analysis and comparison of alternatives, based on individual needs and current business metrics;
b. Strategic plans, developed or validated using output from these tools, can be executed together by the firm, its financial advisors and the provider of the tools; and
c. Turn-key solutions from the provider offer execution and implementation to eliminate errors or mistakes that can be the result of lack of experience or supervision.

The balance of this paper will look at factors involved with the replacement process, the current state of the equipment replacement process within the trucking industry and how those factors and current industry state interact for most fleet owners. Note that purchasing assets outright as well as capital leases qualify for Section 1031 exchanges. Finally, three examples using data from actual business operations will illustrate the effects of transitioning over time from a current taxable or trade strategy to one utilizing the 1031 exchange benefits listed above.

Overview

Since 1921, the Section 1031 exchange process has helped investors, developers and business owners defer income taxes as they replace current assets with similar or like kind assets. Beginning in 1990, then in 2000, and most recently in 2010, the IRS has expanded Section 1031 to provide equipment owners with more flexible rules relative to the equipment exchange process. These offer the ability to purchase a replacement asset first, mix and match purchase and sale transactions, simultaneously utilize the purchased asset as well as the asset to be sold for a term not to exceed 180 days, and finally, can extend the period of time to identify and match assets. The value to any fleet owner of transitioning to this tried and true process will be an increase in the economic value of the business as compared to continuing its current replacement strategy.

The business strategy for replacing tangible business assets has three common factors. Those factors are:

- **Structure** – Assets are replaced by either selling or trading the current asset at a specified economic value.
- **Timing** – The longer the current asset is held, the less value it provides upon disposition and the more it will cost to operate.
- **Financing** – The owner will acquire the asset with either its own funds, such as operating cash flow; or the funds of another, such as a loan or a lease arrangement.

Each of these three factors works together to provide value to the business entity, based on the how they are combined. The goal is to combine them in the most efficient and productive manner, given the unique needs of the business, its owners and any others that may need to be considered in the replacement process.

Assumptions in the Fleet Replacement Process

1. Most fleet vehicle dispositions are treated as taxable. Whereas an estimated 75% of investment grade real estate is exchanged, less than 25% of fleet equipment is exchanged, due to the fact that a majority of fleet managers and advisors are not familiar with the enhanced flexibility Section 1031 equipment exchange options.

2. Approximately 7%[i] of all class 8 semi-tractors are acquired new, then disposed prior to when major repairs must be made in order to minimize operating costs. The value of these assets at that point in time is relatively high.
3. Most companies purchase used fleet vehicles, and they are operated until the cost of operation and maintenance exceeds the benefit of continued ownership. The value of these assets may be average to marginal at this point.
4. Some fleet assets are acquired, and then used "until the tires fall off". The value of the assets at this point is time is low.
5. Most companies finance the acquisition of assets by external means, requiring adherence to financial and operational covenants, as well as repayment terms, which may constrain and/or limit growth if not met.

Typical Disposition Decision Process

Fleet owners do not follow a set pattern as to which of the factors is considered first in their replacement/ disposition process. For the purposes of this paper, the timing factor will be considered first. Which of these is combined in the disposition decision process will ultimately determine the amount of value, if any, to be realized by the business in the execution of that decision.

Typical Timing Factors:

1. The "look" of the asset as an advertisement of the firm.
2. The number of times the asset has broken down and not been in service.
3. "The wheels (or whatever else there is) fall off."
4. Mileage as an indicator for replacement.
5. An ownership cycle in a set number of years.

Typical Structural Factors:

1. Sale of the asset while it retains some marketable economic value.
2. Trade the asset to a dealer, less commission/profit expected by the dealer.
3. Scrap the asset for little or no value.

Typical Financing Factors:

1. Internal, using cash on hand, either in the business account or the account of the owner.

2. External, using cash of a financial intermediary, such as a bank or leasing company.
3. Financing restrictions;
    a. In both internal and external financing, businesses must recover their costs through the use of depreciation and successful business operations.
    b. In the case of external financing, in addition to the recovery of cost noted above, businesses must also comply with a lender's financial covenants and restrictions, designed to ensure repayment of the debt, such as debt service coverage ratios and distribution of cash restrictions.

Putting it All Together

Once the decision is made to dispose of an asset, most fleet owners seek optimum value in either the sale and/or trade of that asset. In the case of the sale, it usually occurs after the purchase of the new asset. This is due to the operational need to get the new asset on the road prior to releasing the older asset, and the time to obtain maximum value. This transaction is by definition a taxable sale, and the tax due as such will impact the cost of financing the new asset.

In the case of the trade, federal tax law requires the trade to be completed on the same business day to qualify for tax deferral treatment. The trade is essentially a one day 1031 exchange. The convenience of the trade must be balanced by its cost to the taxpayer (dealer discount for commission/profit) and the lack of flexibility (one day requirement). Depending on the asset to be traded and then later resold, trade discounts of 15-25% off current retail value are common in the industry. In comparison, current exchange costs on the sale of assets would be a fraction of that cost.

Once the disposition decision is made, the 1031 exchange process allows the fleet owner to realize the highest value (sell at market), while obtaining the tax deferral of any taxable gain. The proceeds from the sale of the old asset reduce debt on the new asset, resulting in lower financing costs and better financial efficiency than possible under either the taxable sale scenario or the trade scenario.

This improved efficiency attributable to the 1031 exchange process can enhance other growth strategies to increase earnings, such as;

- Reducing the sales cycle to replace newer and/or better assets sooner.
- Utilizing financial leverage to acquire more fixed assets than otherwise possible

- Reinvesting additional cash flow into technology to reduce operating costs.

In turn, the effect of more earnings from operations to pay down debt can result in:

- Lower debt service coverage ratio over time,
- Potentially expanded debt capacity, and
- Leverage to seek better financing terms.

The value of the exchange process should not be discounted, because it creates a cyclic affect that over time will create significant value for the fleet owner. That value extends to all depreciable assets, so trailers are also exchangeable, as are straight trucks and other pieces of equipment found in many fleet operations today. However, because of the nature of the regulations, separate models must be developed for each separate class of asset.

Show Me: Three Case Studies[ii]

Modeling assumptions: *Most financial models are historic in nature, using a period of years in the past to model against some current financial position. Based on an implicit assumption of wholesale change in some action at the start of the chosen period, that change is projected forward using historical data to the current time as a hypothetical value. The hypothetical is compared to the current, and from that financials and/or percentages are drawn to illustrate the value of the advice being proffered.*

The modeling tools used in the following case studies are designed to illustrate a different scenario; the future impact (10 years out) to a business of transitioning over some cyclic period from its current non-exchange strategy to an exchange strategy. However, because assets purchased in the past have by nature both current and future effects, some way to reconcile the past with the future was needed. The modeling techniques used, which were internally designed and externally validated, provide a realistic method to compare the differences in certain key business areas of staying the current course or transitioning over time to a new course of action.

Case Study One

1. Current Facts:
    a. Company owns 33 used class 8 semi-tractors, average replacement cost of $65,000. Current replacement strategy is to hold for 5 years, then purchase a replacement,

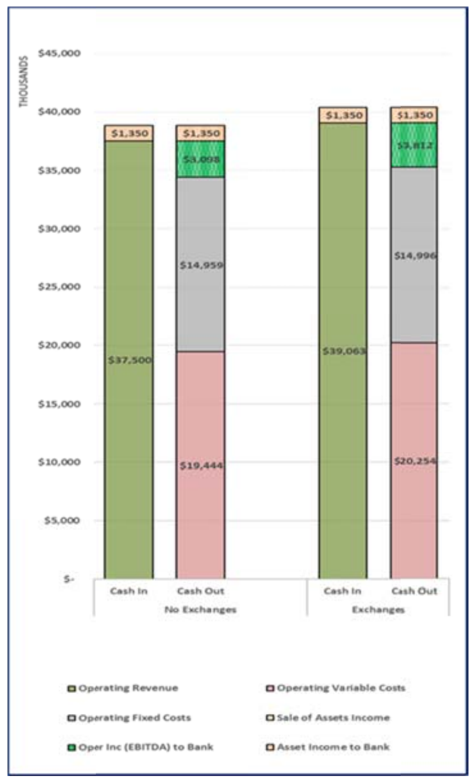
financing 100% of cost at 4 ¼ % over 4-year term. The old tractor is later sold for an average price of $22,500, and proceeds are added as working capital.

   b. Company is flow-thru entity owned by husband and wife, with marginal federal tax rate of 28 % and state of 4%. Annual gross revenue per unit is $125,000, with pre-tax profit of 8.26%. Current cash on hand averages $185,000.

2. Future Issues:
   a. Company would like to increase fleet size by 15% (5 trucks) over next 10 years, based on projected customer demand.
   b. Current debt service coverage ratio below bank standards, with no strategy to change; bank not willing to advance funds for new acquisition under current circumstances.

3. Possible Solutions:
   a. Use 100% of cash balance to satisfy lender limits; temporary solution, but bank hesitant may not resolve over long-term.
   b. Transition to 1031 exchange, showing bank how use of sale proceeds to reduce debt will resolve ratio issue, with continued improvement over time.

4. 10 Year Projections, Revenue (to right):
   a. The value from the disposal of old assets over time has not changed.
   b. Exchange allows 5 trucks to be purchased as desired, increasing net income by 4.17%.
   c. Despite variable and fixed cost increases, pre-tax profit is up 18.16%, from a projected 8.26% now to 9.76%.



5. 10 Year Projections, Net Cash (top left, next page):
   a. More total cash is available for financing, taxes, fees and distribution.
   b. Financing costs are up 9.02% due to increased number of assets financed.
   c. Taxes are up 223.44% due to increased earnings from increased assets.
   d. Exchange fees of $24,000 provide value, but are an increased cost.

e. Net of these increases, projected net cash available for possible distribution and/or for other business or personal needs is up 121.32%.

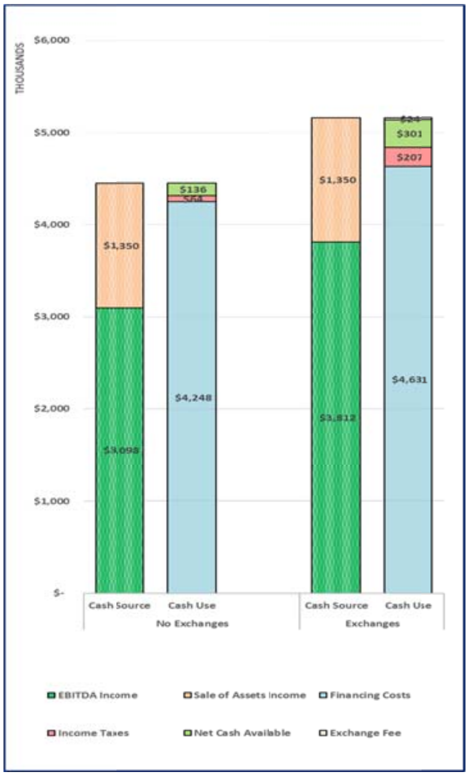
6. 10 Year Projections, Future Value (top right, next page):

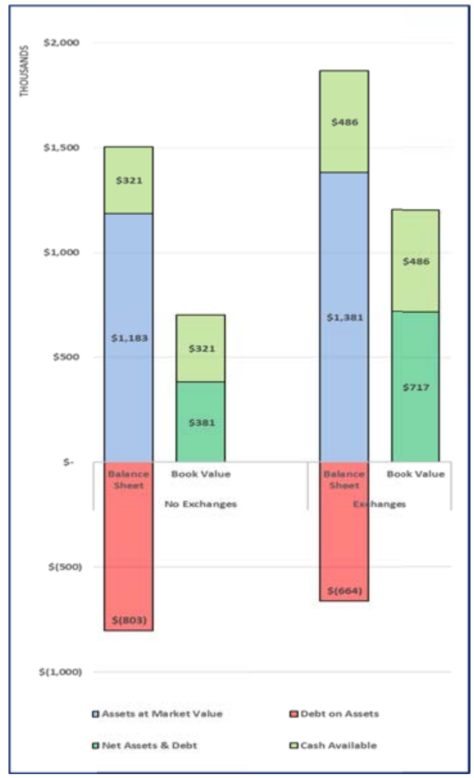
a. Additional assets acquired result in higher book value for those assets.

b. Higher cash applied to debt results in lower overall debt on the books.

c. Higher earnings, net of all financing costs and taxes, results in more cash.

d. The combination of changes results in 71.37% increase in net equity.





7. Conclusions:

a. The 1031 process can offer more value than just tax deferral.

b. The exchange process is unique in that one, some or all assets replaced in a cycle can be included.

c. The exchange process can be started and stopped, should business warrant such changes.

d. The impact of the exchange process can introduce options, not considered in the past, for future plans.

Case Study Two (values only):

1. Current Facts:

a. Company owns 63 class 8 semi-tractors, purchased new at average cost of $128,500. Tractors are traded every 4 years, with trade value roughly 35% of original cost. Net value is financed at 4.125% for 3 years.

b. Company is single member LLC, taxed in total at highest marginal rate of 45.6%. Annual gross revenue per unit is $147,500, with 51.13% variable costs and 31.35% fixed for pre-tax profit of 17.52%. Based on receivables, bank requires cash not fall below $500,000. Current cash on hand is at 98.71% of required.

2. Current Issues:
    a. Company has unique opportunity to immediately add high profile route, with customer wanting long-term contract for services.
    b. Bank approves current replacements, but is not willing to finance additional new truck without changes in lending agreement and/or capital structure.
3. Possible Solutions:
    a. Modify lending agreement to satisfy bank and finance new truck.
    b. Bank requires significant capital infusion, not as debt, if business desires no changes in lending agreement with additional financing capacity.
    c. Utilize unique safe harbor concept under 1031 rules to realize immediately the value of opportunity without increasing debt for the additional truck.
4. Solution C Concerns:
    a. Contractual agreement may be required by bank and/or dealer as to asset(s) being traded in the future.
    b. Asset ownership, with ultimate disposal structure and timing, must meet requirements for taxation benefits.
    c. Reduction in asset value and added costs may negatively impact final realized value from opportunity.
    d. Safe harbor requires modification of replacement timing for 2-3 assets per year to meet needs of all parties.
5. 10 Year Projections, Revenue, Net Cash and Book Value:
    a. The ability to service the new route without debt increases revenue by 1.51%.
    b. Assets servicing the new route do not add fixed costs; pre-tax earnings are up 4.54%.
    c. No new assets are added, and disposal value on old assets is projected down 2.95%.
    d. Lower value for old assets increases book debt marginally by .04%.
    e. Net of taxes, financing costs and exchange fees, cash is up 9.86%.
    f. Net book equity increases 3.53% as result of new opportunity being serviced.

6. Other values:
    a. No modification of current lending agreement.
    b. No capital contribution as equity needed from owner.
    c. Conversation as to other ways to improve financial efficiency (see Case Study Three).

Case Study Three (additional options from above, values only):

1. Current Facts – same as above:
2. Optional Issues:
    a. Company wants to explore option to add two routes, rather than only the one currently being considered.
    b. Company wants to see value of selling assets rather than trading on overall financial efficiency and projected values.
3. Modeled Solution:
    a. Utilize unique safe harbor concept under 1031 rules to realize immediately the value of 2 distinct opportunities without increasing debt for the additional trucks.
    b. All assets not part of safe harbor program are held until sold for market value, with net proceeds reducing debt after sale.
4. 10 Year Projections, Revenue, Net Cash and Book Value:
    a. The ability to service the 2 potential new routes, without debt for those assets, doubles revenue improvement to 3.02%.
    b. Assets servicing the new route still do not add fixed costs; pre-tax earnings are up slightly more than double to 9.28%.
    c. Once again, no new assets are added, but disposal value on old assets is now projected to be up 9.27%.
    d. The higher value for old assets reduces projected debt on the books by 8.09%.
    e. Net of taxes, financing costs and exchange fees, projected cash is now up 38.97%.
    f. As a result of the proposed changes, net book equity is now up 19.48%, with 2 new routes being fully serviced.
5. Other values:
    a. Again, no modification of current lending agreement.
    b. Again, no capital contribution as equity needed from owner.

c. Immediate and continuing debt service coverage ratio improvement offers;
   i. Ability to renegotiate current and future bank lending terms.
   ii. Debt capacity for additional asset acquisitions.
   iii. Support for possible changes in exit and/or future acquisition strategies.

Conclusion

Fleet owners inevitably face the issue of replacing costly assets. Rather than seeing the process as just another necessary burden, owners and/or their financial advisors now have the ability to design its structure, timing and financing to obtain the maximum current and future value from the process, based on their business and personal needs.

By understanding how each part of the process interacts with the other, using tools to model various alternative combinations, then executing on proposed strategic changes, fleet owners can realize;

- Significant improvement in balance sheet and equity
- Increased capital for reinvestment or other uses
- Leverage capacity for acquisition, transition, and/or estate planning

Members of Women in Trucking have the distinct advantage of having a member firm offering these strategic modeling and planning services to them at no cost. In addition, that same firm can provide turn-key execution of a whatever plan is selected, at a reduced fee due to membership in WIT. To learn more, members can contact Steve Robison by email, steve@spe1031.com or Dave Chrestensen, dave@spe1031.com or they can be reached by phone at (513) 412-3481.

[i] 2015 new Class production for 2015 reached 325,000, while class 8 registrations reached 3.82 million units.
[ii] data from small fleet owners, showing the results of their current, as well as proposed replacement strategy projected out over ten years