

This case demonstrates that in dealing with Off Balance Sheet activities, useful information can be obtained by going beyond footnote data. Information about Texaco's affiliate Caltex can be estimated from Texaco's footnotes. However, by examining Caltex's own financial statements, a more accurate measure of Caltex's debt can be obtained. More importantly, by examining the affiliate's financial statements, a "grandfather" situation can be analyzed. That is, the Off Balance Sheet debt of Caltex's affiliates can be added to Caltex's debt and consequently added to Texaco's share of the Off Balance Sheet debt of its affiliates.

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## 1 Texaco Capitalization Table and Selected Ratios

Capitalization, December 31,	1999	1998	1997
Current portion of debt	1,041	939	
Long-term debt & Capital leases	6,606	6,352	Average
Total Debt	7,647	7,291	7,469
Total Liabilities	16,930	16,737	
Stockholder's equity	12,042	11,833	
Total Capitalization	19,689	19,124	
Total Assets	28,972	28,570	28,570
Average Assets	28,771	28,570	
Pretax income as reported	1,779	701	
Interest expense	504	480	
EBIT	2,283	1,181	
Total liability/equity	1.406	1.414	
Total Debt/equity	0.635	0.616	
ROA (EBIT/Average Assets)	7.94%	4.13%	
Times interest earned	4.530	2.460	

Based on information provided in exhibit 11-7, adjustments to Texaco's liabilities (and assets) must be made in the following areas

- |                                   |                            |
|-----------------------------------|----------------------------|
| (i) share of affiliate debt       | (iii) guarantees           |
| (ii) operating leases             | (iv) throughput agreements |
| (iii) redeemable preferred shares |                            |

As the discussion will indicate, a number of assumptions are needed to make appropriate calculations.

### N1 Share of affiliate debt:

Note 5 in the annual report provides information on an aggregate basis as to the composition of the balance sheets of Texaco's affiliates. However, the portion of current and noncurrent liabilities which is debt is not provided. We will assume that the noncurrent liabilities are (primarily) debt.

### N2 *See the last two pages of this report for lease analysis.*

Operating leases (Note 10): From the capital lease payments we find an implicit interest rate of approximately 4.41%. We will assume 5% rate throughout.

**Texaco Adjusted Capitalization and Debt / Equity**

Capitalization, December 31,	1999	1998	
Current portion of debt	1,041	939	
Long-term debt & Capital leases	6,606	6,352	Average
Total debt as reported	7,647	7,291	7,469
N1 Share of affiliates debt	2,638	2,142	2,390
N2 PV of operating leases	854	975	915
N3 Redeemable preferred shares	602	602	602
N4 Guarantees	336	387	362
N5 Throughput agreements	173	195	184
<b>Total Adjustments to debt</b>	<b>4,603</b>	<b>4,301</b>	
Total adjusted debt	12,250	11,592	
Total Liabilities as reported	16,930	16,737	
Redeemable preferred shares	(602)	(602)	
Total Adjustments to debt	4,603	4,301	
Share of affiliates liabilities	4,916	3,924	
	25,847	24,360	
Stockholders, equity as reported	12,042	11,833	
Adjustment to Equity	15		
Adjusted Equity	12,057	11,833	
Total adjusted Capitalization	24,308	23,425	
Adjusted Debt/equity	<b>1.016</b>	<b>0.980</b>	

N4 Guarantees: Note 15

N5 Throughput agreements: Note 15

However, based on our right of counterclaim against Equilon and unaffiliated third parties in the event of non-performance, our net exposure was estimated to be \$173 million and \$195 million at December 31, 1999 and 1998.

**Texaco Adjusted Times Interest earned**

The Off Balance Sheet debt carries with it an implied interest cost which must be computed to better measure the times interest earned ratio. For example, the affiliates must pay interest on their debt. The reported times interest earned ratio ignores that interest; it does, however, include Texaco's share of affiliate income in the numerator, thus biasing the ratio. Other than for leases, we do not know the rate of interest to apply to the debt. One possibility is:

Interest expense			504		
/ Total Debt	Average	/	7,469	=	6.75%

**Texaco: Adjusted Times Interest Earned**

	1999
EBIT as reported	2,283
Adjustment to interest for debt other than leases	178
Adjustment for leases	72
Adjusted EBIT	2,533
Interest expense reported	504
Affiliate interest expense	6.75% x 2,638 = 178
Operating lease interest	5.00% x 975 = 49

Redeemable preferred shares	6.75%	x	602	41
Guarantees	6.75%	x	362	24
Throughput agreements	6.75%	x	184	12
Adjusted interest expense				<u>808</u>

Adjusted Times interest earned **3.135**

### Adjusted ROA

The off-balance sheet data also imply adjustments to Texaco's assets. Taking the present value of leases implies capitalizing the operating leases; similarly for the throughput agreements. Finally, just as we recognize Texaco's share of its affiliates, debt, we should also reflect Texaco's share of its affiliates, total assets as these assets generated Texaco's share of affiliate income; at present Texaco is only carrying (its share of) the net assets of these affiliates (under the equity method).

<b>Texaco: Adjusted ROA</b>		<b>1999</b>	<b>1998</b>
Total Assets on Balance sheet		28,972	28,570
Adjustments:	Operating lease assets	878	975
	Guarantees	336	387
	Throughput agreements	173	195
	Deferred taxes		
Affiliates:	Current assets	3,796	2,769
	Noncurrent Assets	9,321	9,313
	less net assets	<u>(5,563)</u>	<u>(6,016)</u>
		7,554	6,066
Adjusted Assets		<u>37,913</u>	<u>36,193</u>
Average Adjusted Assets		37,053	
Total liabilities and equity as reported		28,972	28,570
Total Adjustments to debt		4,603	4,301
Redeemable preferred shares		(602)	(602)
Adjustment to Equity		15	
Deferred tax liability		8	
Current liabilities in subsidiary companies		4,916	3,924
Adjusted liabilities and equity as reported		<u>37,913</u>	<u>36,193</u>
Adjusted EBIT		2,533	
Adjusted ROA (pretax)		<b>6.84%</b>	

Texaco's reported and adjusted ratios for 1994 are reported below:

<b>Texaco Ratios 1998</b>	Reported	Adjusted for Off Balance Sheet items
Debt/equity	0.635	1.016
Times Interest earned	4.530	3.135
Return On Assets	7.94%	6.84%

Taking into consideration Texaco's Off Balance Sheet debt raises the debt/equity ratio by 60% from about 0.635 to 1.017. The adjustments to interest expense (added to both numerator and denominator) reduce the times interest earned ratio. ROA declined slightly as the increase in assets

was offset for the most part by the increase in EBIT.

## 2 Caltex Capitalization Table & Selected Ratios

Capitalization, December 31,	1999	1998
Short-term debt \$	1,588	1,475
Long-term debt	1,054	930
Total Debt	2,642	2,405
Stockholder's equity	4,275	4,398
Total Capitalization	6,917	6,803
Total Assets	10,309	9,658
Average Assets	9,984	
Pretax income	780	
Interest expense	152	
EBIT	932	
Total Debt/equity	0.618	0.547
Return On Assets (EBIT/Average Assets)	9.34%	
Times Interest Earned	6.13	

**3a** The adjustments for Caltex's Off Balance Sheet activities are similar to those of Texaco.

- (i) Share of Affiliate Debt: We assume that the other liabilities are primarily long-term debt
- (ii) Operating leases
- (iii) Purchase commitment (similar to throughput agreement): The present value of these payments of \$700 million per year through 2007 (discounted at 6%) is \$3,585 million.

## Caltex Adjusted Capitalization Table

Capitalization, December 31,	1999	1998
Total debt as reported	2,642	2,405
(i) Share of affiliates debt	937	1,866
(ii) PV of operating leases	169	267
(iii) Purchase commitments	3,585	3,585
Total adjusted debt	7,333	8,123
Stockholder's equity	4,275	4,398
Total adjusted Capitalization	11,608	12,521
Reported Debt/Equity	0.618	
3 b. Adjusted Debt/equity	1.715	

**Caltex Adjusted Ratio: Times Interest Earned**

<b>Adjustments for interest</b>				<b>1999</b>
Affiliate interest expense	5.00%	x	1,866 =	93
Operating lease interest	5.00%	x	267 =	13
Purchase commitments	5.00%	x	3,585 =	179
Interest expense reported				<u>152</u>
Adjusted interest expense				438
EBIT as reported				932
Affiliate interest expense				93
Purchase commitments				179
Adjustment for leases				<u>72</u>
Adjusted EBIT				<u>1,276</u>
Adjusted Times interest earned				<u>2.915</u>

**Caltex Adjusted Ratios -- ROA**

		<b>1999</b>	<b>1998</b>
Total Assets on Balance Sheet		10,309	9,658
Adjustments:	PV of operating leases	241	267
	Purchase commitments	3,585	3,585
Affiliates	Current assets	1,535	1,855
	Noncurrent Assets	3,287	4,004
	less net assets	<u>(2,069)</u>	<u>(2,198)</u>
Adjusted Assets		16,888	17,171
Average Adjusted Assets		17,030	
Total liabilities and equity as reported		10,309	9,658
Total Adjustments to debt		4,691	5,718
Adjustment to Equity		47	
Deferred tax liability		25	
Current liabilities in subsidiary companies		<u>1,816</u>	<u>1,795</u>
		16,888	17,171
Adjusted EBIT		1,276	
Adjusted ROA		7.50%	

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Texaco's share of Caltex		Debt		Interest Expense	Assets	
		1999	1998	1999	1999	1998
1	Texaco balance sheet only	none	none	not explicitly	not explicitly	not explicitly
2	Texaco footnotes only	2,639 50%	2,421 50%	1,211 6.75%	10,309 50%	9,658 50%
		1,320	1,211	82	5,155	4,829
3	50% of Caltex reported data	2,642 50%	2,405 50%	152 50%	same	same
	Average	1,321	1,203	76	5,155 4,992	4,829
4	50% of Caltex after adjusting for Caltex's Off Balance Sheet activities	7,333 50%	8,123 50%	438 50%	16,888 50%	17,171 50%
	Average	3,666	4,062	219	8,444 8,515	8,586

As our information about Caltex becomes more refined our estimate of Caltex's debt and assets increase larger. We can now compare Texaco's ratios using the various levels of Off Balance Sheet information available. For comparative purposes we also show Texaco's ratios as reported ignoring all Off Balance Sheet activities:

<b>Debt to equity:</b>		Debt /		Equity	
Texaco balance sheet only		7,647	/	12,042	= 0.635
Texaco footnotes only		12,250	/	12,057	= 1.016
(from part 3) using Caltex's financials:					
add increase in Caltex debt	1,321 -	1,320	=	<u>2</u>	
				12,252 /	12,057 = 1.016
(from part 4) including Caltex's Off Balance Sheet:					
add increase in Caltex debt	3,666 -	1,321	=	<u>2,345</u>	
				14,597 /	12,057 = 1.211

The debt/equity steadily deteriorates as we explore (Texaco's and) Caltex's Off Balance Sheet activities.

<b>Times Interest Earned:</b>		EBIT /		Interest	
(from part-1) as reported ignoring Off Balance Sheet :		2,283	/	504	= 4.530
(from part 2) using Texaco's footnotes :		2,533	/	808	= 3.135
(from part 3) using Caltex's financials:					
adjust for change in Caltex interest	76 -	82	=	<u>(6)</u> / <u>(6)</u>	
				2,528 /	803 = 3.150
(from part 4) including Caltex's Off Balance Sheet:					
adjust for increase in Caltex interest	219 -	76	=	<u>143</u> / <u>143</u>	
				2,671 /	945 = 2.825

Overall the times interest earned ratio also declines as we add Off Balance Sheet debt.

<b>Return On Assets</b>		EBIT /		Assets	
(from part 1) as reported ignoring Off Balance Sheet :		2,283	/	28,771	= 7.94%
(from part 2) using Texaco's footnotes :		2,533	/	37,053	= 6.84%
(from part 3) using Caltex's financials:					
	76 -	82	=	<u>(6)</u>	
				2,528 /	37,053 = 6.82%
(from part 4) including Caltex's Off Balance Sheet:					
adjust for increase in Caltex interest	219 -	76	=	<u>143</u>	
adjust for increase in Caltex Assets	8,515 -	4,992	=	<u>3,523</u>	
				2,671 /	40,576 = 6.58%

At each level, ROA declines.

- 5** It would be useful to know whether Caltex's affiliates, in turn, have their own off-balance-sheet liabilities. It would also be helpful to know more about transactions with Texaco (and with the other 50%- stockholder, Chevron) to -obtain a better idea of the role that Caltex plays. Caltex appears to be more than an investment; how much more we cannot tell from the data provided.

**Capital Lease Analysis - Texaco**

Later years: 2000 onwards total lease payments	14.00	x	7	=	2
Per year for 10 years	14.00	/	2	=	7.00

		Year	Value
			(46.00)
		2,000	9.00
		2,001	9.00
		2,002	8.00
		2,003	7.00
2000	9	2,004	7.00
2001	9	2,005	7.00
2002	8	2,006	7.00
2003	7	2,007	
2004	7	2,008	
Later years	14	2,009	
Total minimum payments	54	2,010	
Interest	(8)	2,011	
Present value of minimum payments	46	2,012	
		2,013	
		2,014	
			54.00
		Internal rate of return	4.419%

**Operating Lease Analysis - Texaco**

After 5 years: 315 / 54.0 = 5.833 Assume 8 years  
 Annual MLP 315 / 8.0 = 39.38

Rental commit.	Factor at 5.00%	Present Value	Present value of lease payments	
134	0.952	127.6	Annuity factor	6.463
93	0.907	84.4	Present value of	39.38
416	0.864	359.4	5 year present value factor	0.784
50	0.823	41.1	Total present value of minimum payments	854.17
54	0.784	42.3	1999 Lease payment	170.00
	Total	654.8	1998 Present value	0.952 x 1,024.17
				975.40

Entries	Fixed assets	975.40
end	Capital lease obligations - Current	121.23
1998	Capital lease obligations - long term	854.17
1999	Depreciation expense	10 years 97.54
	Accumulated depreciation	97.54
	Interest expense	5.00% x 975.40 = 48.77
	Capital lease obligations - Current	121.23
	Rental expense	170.00
End	Capital lease obligations - long term	91.29
1999	Capital lease obligations - Current	91.29
	134 - 5.00% x 854.17	

EBIT	More by	170.00 - 97.54 =	72.46
Interest Expense	More by		48.77
EBT	More by		23.69
Net income more by		65.00%	15.40
Deferred Tax liability more by			8.29

1999	<b>Cash flow from operations more by</b>	
	Net income	15.40
	Depreciation expense	97.54
	Deferred Tax liability	8.29
	<b>Cash flow from financing</b>	
	Reduction in Capital lease obligations	(121.23)

Balance sheet	End	1999	
Fixed assets	975.40	Capital lease obligations - long term	762.88
Accumulated depreciation	(97.54)	Capital lease obligations - Current	91.29
		Deferred Tax liability	8.29
		Retained Earnings	15.40
Total	877.86		877.86

**Operating Lease Analysis - Caltex**

After 5 years: 37 / 10.0 = 3.700 Assume 8 years  
 Annual MLP 37 / 8.0 = 4.63

Rental commit.	Factor at 5.00%	Present Value		
			Present value of lease payments	145.40
66	0.952	62.9	Annuity factor	6.463
42	0.907	38.1	Present value of	
30	0.864	25.9	4.63	29.89
13	0.823	10.7	5 year present value factor	0.784
10	0.784	7.8	Total present value of minimum payments	168.82
	Total	145.4	1999 Lease payment	112.00
				280.82
			1998 Present value	
			0.952 x	280.82
				267.45

<b>Entries</b>	Fixed assets		267.45	
End	Capital lease obligations - Current			98.63
1998	Capital lease obligations - long term			168.82
1999	Depreciation expense	10 years		26.74
	Accumulated depreciation			26.74
	Interest expense	5.00% x	267.45 =	13.37
	Capital lease obligations - Current			98.63
	Rental expense			112.00
End	Capital lease obligations - long term			57.56
1999	Capital lease obligations - Current			57.56
		66 -	5.00% x	168.82
EBIT	More by	112.00 -	26.74 =	85.26
Interest Expense	More by			13.37
EBT	More by			71.88
Net income more by			65.00%	46.72
Deferred Tax liability more by				25.16

<b>Cash flow from operations more by</b>			
Net income		46.72	
Depreciation expense		26.74	
Deferred Tax liability		25.16	98.63
<b>Cash flow from financing</b>			
Reduction in Capital lease obligations			(98.63)

**Balance sheet**

Fixed assets	267.45	Capital lease obligations - long term	111.26	
Accumulated depreciation	(26.74)	Capital lease obligations - Current	57.56	168.82
		Deferred Tax liability		25.16
		Retained Earnings		46.72
Total	240.70			240.70