Leasing in Emerging Markets

A potent instrument for financing small business?

The owner of a small, three-year-old road maintenance company in Ghana has secured his first big break: a contract to maintain local roads for three years. But he needs to double his truck fleet from two to four. His bank manager, though sympathetic, points out that he has only two years of accounts and has already mortgaged his house to buy one of his trucks. So the owner approaches a leasing company for a financial lease—a contractual arrangement that allows the road contractor (lessee) to use trucks owned by the leasing company (lessor) in exchange for "rental" payments. Concluding that the firm's projected cash flow will easily cover the lease payments, and after receiving a 20 percent down payment, the leasing company supplies the trucks within two weeks under a three-year lease.

In another part of the world, a Romanian chemist wants to set up a private laboratory to conduct tests for several local hospitals. The equipment she needs must be imported from Germany. She has twenty-five years of experience and contacts in the local medical community. But she has limited personal savings, no fixed assets to collateralize, and no corporate sponsor. Several banks suggest that they might consider a loan after two to three years of successful operation. But on the basis of her business plan, the manager of a leasing company concludes that she will be able to service lease payments. So the leasing company imports the equipment and gives it to the chemist under a two-year lease.

These are typical leasing transactions. The leasing company, unlike a bank, focuses on the lessee's ability to generate cash flow to service lease payments, rather than relying on its credit history, assets, or capital base. This particularly suits new or small enterprises without historical financial statements. The asset itself provides security for the transaction, and so separating legal ownership (retained by the leasing company) and use of the asset (held by the lessee) is critical for the lease instrument to work. Over the lease term, the lease payments typically amortize the lessor's purchasing costs as well as cover interest costs and some profit.

The investment experience of the International Finance Corporation (IFC) suggests that leasing can be a significant source of finance for small firms wanting to invest in equipment. In 1994 alone, sixteen leasing companies in which the IFC had invested (and that had been in operation for at least two years) financed over 10,000 leases, worth more than US$2 billion. Relatively little "seed" capital was involved: the IFC had invested just US$13 million of equity in these firms and extended US$150 million in loans to them. The small size of the leases—ranging from US$18,000 to US$580,000—suggests that many went to relatively small firms. Many of these firms were in low-income countries considered high risk by foreign investors.

**Edge over loans**

The success of leasing is due mostly to the relative simplicity of the transaction. Because the leasing company retains ownership of the asset, leasing transactions generally require a less rigorous legal and regulatory environment than do bank loans. Often, leasing requires no collateral beyond the security of the leased asset, and it allows simpler repossession procedures because ownership of the asset already lies with the lessor.
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A DYNAMIC BUSINESS

Over the past forty years, leasing has evolved from a manufacturer's selling technique into a specialized financial service. The first independent leasing company was set up in 1952 in the United States. In the 1960s, the industry extended to Europe and Japan, and it has since been spreading through developing countries. By 1994, leasing had been established in more than eighty countries, including over fifty developing economies. In that year, leasing financed more than US$350 billion of new vehicles, machinery, and equipment worldwide, accounting for about an eighth of private investment. The industry is now mature in most OECD countries, where up to a third of private investment is financed through leasing. And it is most dynamic in developing countries—even those once considered high risk by investors. Between 1988 and 1994, new leases increased from US$15 billion to US$44 billion in developing countries, and leasing's share of private investment more than doubled in both middle-income and low-income countries. While the United States, with 40 percent of the market, still dominates, Asia's share of the market (more than 28 percent in 1993) has overtaken that of Europe.

LEASING IN DEVELOPING COUNTRIES, 1988–94

![Bar chart showing leasing volume and market share in developing countries from 1988 to 1994.]


Even though leasing is a higher-spread business than bank lending, in many developing countries bank loans can turn out to be more expensive—or even simply unavailable—for small firms. Typically, developing countries have weak collateral laws, and so loans can involve high costs in assigning collateral, in documentation, and in processing time. Other advantages for the lessee are that leasing can finance a higher percentage of the capital cost of equipment than bank borrowing, often with only a small down payment, and contracts can be structured to meet the cash flow needs of the lessee. While some governments have offered tax benefits for leasing to encourage investment by small and medium-size enterprises, leasing has flourished in many environments without tax benefits.

From the leasing company's perspective, ownership of the asset provides strong security. So does the dedicated use of funds: the lessor purchases the equipment directly from the supplier, so the lessee has no opportunity to use the funds for other purposes. Relatively simple documentation allows leasing companies to achieve high leasing volumes efficiently. And because leasing companies usually are not retail deposit takers, they tend to be less tightly regulated than banks, which enhances their flexibility.

The IFC's portfolio

Because leasing is proving to be so effective in catalyzing small business finance, the IFC often takes initiatives to promote the leasing industry in countries where it does not yet exist, providing advice to government on proper regulation for all leasing companies. When the IFC helps set up a leasing company, it frequently brings in other investors, mobilizes funding, and sits on the board. The idea is to promote well-managed, successful "demonstrator" companies. The IFC also tends to promote specialized, independent leasing companies rather than encourage existing financial institutions to expand into leasing. Managers of specialized financial institutions are likely to be more focused in their business strategies, resulting in operations that are easier to monitor than those of multipurpose institutions.

Exposure

Between 1977 and June 1995, the IFC's board approved US$523 million in 120 transactions with 63 leasing companies in 36 countries. The IFC has invested equity in most of these companies, although only about US$500,000 per transaction. On average, the IFC takes a 15 percent equity share in the leasing companies it
helps to establish. Initial equity investments may be followed by a loan. For example, the IFC invested US$0.6 million in Ghana's first independent leasing company in 1991, invested US$0.15 million more in 1993, and provided a US$5 million loan in mid-1993 to help the company expand its foreign currency lease portfolio. The IFC's strategy is to give guarantees or direct loans in particular to new leasing companies that have not yet established credit histories that would allow them to borrow locally.

The IFC has invested in leasing companies in more than half the developing countries that now have a leasing industry—often these investments are in the first leasing company to be set up in a country. By volume, it has directed nearly half its commitments to leasing companies in Asia (table 1). The average size of its investments in Africa has been quite small, reflecting the fact that they are mostly in start-up ventures. And in the past few years, it has accelerated its leasing activities in Eastern Europe and the former Soviet republics. Leasing has proved a particularly appropriate financing source for the emerging private sector in transition economies, where firms have a limited track record, legal difficulties often restrict the use of collateral, and many banks are undergoing restructuring.

**Financial returns**

The financial results have been impressive. Returns on equity have averaged more than 20 percent. Since the IFC made its first loan to a leasing company in 1977, there have been no defaults—and no loans have shown arrears. The companies have lower provisioning rates than bank lending, suggesting that leasing is less vulnerable to default. And average debt-equity ratios of about 5 to 1 suggest that many of the firms are conservatively leveraged. This average may be slightly lower than what might be efficient for a mature leasing company, because many of the companies are still young and have not yet mobilized much debt, and others have evolved from pure spread leasing firms into companies offering a wider range of financial products, which typically reduces leverage.

### Lessons

Access to term finance and expertise have proved to be the two biggest challenges facing the leasing industry.

**Term finance and convertibility**

Leasing companies have to broadly match their lease terms to the financing they can secure. But mobilizing domestic term financing is often difficult, and many lessees are unwilling to take the foreign exchange risk associated with foreign currency leases. Moreover, stand-alone leasing firms can be at a disadvantage when competing with leasing subsidiaries of commercial banks, which can tap low-cost depositors’ funding.

One way to reduce the risks associated with access to term debt is to involve local banks or institutional investors, such as pension funds and insurance companies, as shareholders in the leasing company. Such local partners have been involved in IFC ventures in the Czech Republic, Indonesia, Jordan, Slovenia, and Turkey, for example. Institutional investors often go unrecognized as a potentially good source of term finance. In West Africa, how-

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**TABLE 1 IFC COMMITMENTS BY REGION, 1977–JUNE 1995 (US$ millions)**

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of companies</th>
<th>Equity</th>
<th>Loans</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>18</td>
<td>22</td>
<td>156</td>
<td>177</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>5</td>
<td>2</td>
<td>58</td>
<td>60</td>
</tr>
<tr>
<td>Central Asia, Middle</td>
<td>11</td>
<td>2</td>
<td>92</td>
<td>94</td>
</tr>
<tr>
<td>East, and North Africa</td>
<td>8</td>
<td>3</td>
<td>18</td>
<td>21</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>7</td>
<td>3</td>
<td>19</td>
<td>22</td>
</tr>
<tr>
<td>Europe</td>
<td>49</td>
<td>32</td>
<td>342</td>
<td>374</td>
</tr>
</tbody>
</table>

Note: The difference between approvals (US$523 million) and commitments is largely explained by the projects approved in 1994/95, for which formal commitment agreements are still in progress. Data may not add to totals due to rounding.

Source: International Finance Corporation data.
ever, recent liberalization of insurance company regulations allowed the IFC to offer local currency guarantees to two leasing companies in Côte d’Ivoire so that they could borrow from local insurance companies.

This dependence on term funding means that leasing exposure tends to “unwind” if term financing dries up. So leasing companies are vulnerable to changes in the macroeconomic climate. Given their relatively high debt-equity ratios, it makes good sense for leasing companies to make an effort to remain attractive to lenders to help safeguard their access to term funding. One way to do so, often used in IFC agreements, is through security sharing agreements, which establish equal rights to a pool of collateral for senior lenders. Securitization is another way.

Another important issue for leasing companies is foreign exchange convertibility. Leasing companies in developing countries often require foreign exchange to buy imported equipment, but prefer to denominate their leases in local currency because of their client base. Without foreign exchange convertibility, leasing companies tend to write mostly foreign currency leases to match their loans for financing imported equipment, restricting the leasing market to exporters.

Marrying foreign and local partners

Many of the IFC’s leasing investments have been in joint ventures between a foreign leasing company and a local financial institution. This structure has been useful in addressing the mix of term finance and know-how risks involved in introducing leasing into a market. The local partners bring knowledge of local markets to the leasing venture, but the IFC’s experience suggests that it is also important to have an active, committed, and competent foreign partner to provide and nurture the requisite skills.

To succeed, leasing companies must keep high standards in cash-flow-based credit analysis, supervision of clients, follow-up, and equipment insurance. The foreign partner can establish and monitor these standards and procedures; train local staff; advise on lease pricing, marketing, and administration; and perhaps second the first general manager. To do this job well, foreign partners should have a substantial equity stake (20 to 40 percent). Partners with smaller shares have not always proved effective, whether because of unfamiliarity with the market, cultural differences, or lack of interest.

Dynamic effects

The leasing industry tends to grow rapidly as lessors gain experience and potential borrowers come to understand leasing. More competition in leasing markets stimulates new product development and sometimes reduced spreads. In Botswana, for example, where a new leasing company captured 25 percent of the market within its first year, leasing spreads fell from more than 10 percent in the late 1980s to less than 5 percent in 1994.

Leasing companies can also boost capital market development. Once they have established an operating history, they can tap and foster equity markets. Their demand for term debt broadens the term lending options for banks, finance houses, pension funds, and insurance companies. They can also issue bonds or other marketable instruments. For example, a 1989 bond issue by a Tunisian leasing company was the first such issue by a local firm, and it helped reduce the company’s cost of funds by 2 percent. Finally, leasing companies can securitize their lease receivables, taking some assets off balance sheet to achieve higher leverage and better returns—and adding another tradable instrument to local capital markets.

This Note is based on a longer paper, Leasing in Emerging Markets (International Finance Corporation, Washington, DC, 1996).

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