FINANCIAL LEASING IN RUSSIA

MARKET SURVEY 2000-2001

MOSCOW
2001

With financial support from the Canadian International Development Agency (CIDA)
INTRODUCTION ...............................................................................................................5
LEASING MARKET: MARKET OVERVIEW .................................................................7
  Size of the Russian leasing market .................................................................7
  Methodology ....................................................................................................7
  Leasing as a percentage of capital investment ...............................................8
  Leasing as a percentage of machinery imports ...............................................9
  Leasing as a percentage of GDP .................................................................10
  Leasing market size - ‘reality check’ against survey results .........................10
  Future trends ................................................................................................11
  Number of leasing companies ....................................................................11
  Types/market niches of leasing companies ..............................................13
LEASING MARKET: RUSSIAN LEASING COMPANIES ........................................17
  Sources of financing ..................................................................................17
  Number of leases/company ....................................................................19
  Average deal size ....................................................................................20
  Types of equipment ................................................................................22
  Pricing and security ................................................................................23
  Problems and tax issues ........................................................................27
LEASING MARKET: LESSEES’ PERSPECTIVE ......................................................29
  Why leasing? ............................................................................................29
  Existing sources of credit ....................................................................29
  Existing banking relationships ............................................................30
  Problems/issues .....................................................................................31
    Availability of leasing and lack of capacity ...........................................31
    Legal problems ....................................................................................32
    Other problems ..................................................................................32
HISTORICAL PERSPECTIVE ...............................................................................33
  Early Period (late 1980’s to 1994) ............................................................33
  Initial Industry Development (1994-1998) .................................................33
  Post-Crisis Industry Consolidation (1999-2001) .....................................33
MACRO-ECONOMIC OVERVIEW AND IMPACT ON LEASING .................................35
  «Too Much Money» ................................................................................36
  Microeconomic Developments and the Macroeconomy ..........................37
  The Effects of Reform on the Leasing Industry ......................................38
  Remaining Obstacles to Development of the Leasing Industry ..........39
OVERVIEW OF THE RUSSIAN CREDIT MARKET (INCLUDING BANKS AND SUPPLIERS) .................................................................41
  How do companies (lessees/potential lessees) finance asset purchases .............41
  Appetite of suppliers (foreign and domestic) to finance equipment purchases ........................................42
  Projected annual capital requirements ......................................................43
  Credit available, credits to enterprises and loan terms ...................................44
  Non-commercial or mixed-source credit ..................................................46
  Banks’ attitude to leasing .......................................................................47
  Availability of two to three year money ...................................................48
The Civil Code of the Russian Federation (Article 665, RF CC) defines financial leasing as follows:

*A financial leasing contract is a contract in which the lessor pledges to acquire property specified by the lessee from a vendor defined by the lessee, and to provide this property to the lessee in return for payment for temporary use of the equipment for entrepreneurial purposes. In this case the lessor does not bear responsibility for the choice of the asset to be leased and the vendor. A financial leasing contract can stipulate that the choice of the vendor and acquired property should be made by the lessor.*

In keeping with this definition, for the remainder of this survey, the term «leasing» is used to refer to financial leasing according to the Russian Civil Code. In the general English use of this term, financial leasing refers to a leasing deal whereby the full value of the equipment is paid out over the term of the lease. Hence a financial lease is essentially a means of acquiring the equipment, or an alternative form of financing. In contrast, operating leases are generally used to acquire the use of an asset for a predetermined period of time, without acquiring the asset itself; the lessee thus avoids most equipment risk under an operating lease.

While the great majority of Russian leases are financial leases according to the generally accepted English definition, Russian law does not define a financial lease in this way. Some Russian leases may in fact correspond to operating leases - although in practice this will be rare until the industry develops further. Russian law further defines leasing as a specific form of rent.

The Russian leasing industry is currently growing quickly to a size we estimate at $1.2 billion in 2000, albeit from a low post-crisis base estimated at $400 million in 1999 (all figures are in US dollars or Russian rubles). We conservatively expect it to continue to grow rapidly to at least $2 billion in 2002. As the legal system and the economy stabilize and as much-needed reforms to the tax system and in crucial parts of the economy are enacted, the leasing market should continue to grow apace. While the limited credit markets in Russia are a hindrance to even more rapid growth and problems with the judicial system will not be resolved overnight, we believe leasing will play a crucial role in enabling the growth of small and medium-sized enterprises in the coming years.

Leasing is an important source of medium-term financing of enterprises in many countries, regardless of their size or stage of development. In developing economies and countries with economies in transition, leasing is an economically efficient solution to the problem of asset acquisition for all parties to a lease transaction. It is particularly important in providing finance to small and medium-sized enterprises and start-ups, which play a key role in introducing innovation and competition into the economy and in job creation.
International experience shows that financial leasing is the first leasing market to develop, followed by a broadening and deepening of the market to include operating leases. With limited financial resources, the lessee can acquire equipment that increases their productive capacity and their ability to generate revenue. For lessees, leasing is more accessible than bank loans, as they are not required to demonstrate a lengthy credit history, but rather must demonstrate the ability to generate adequate cash flows to cover the lease payments.

From the equipment supplier's point of view, leasing is a means of selling equipment. As many enterprises are cash poor and do not have access to bank loans, leasing is one of the only means of getting equipment to the end user.

Due to the fact that leasing has special features, it is an alternative to traditional bank loans that is attractive to certain types of clients in certain circumstances. In this sense, leasing is not so much a competitor to bank financing but a complement.

Leasing is playing an important role in stimulating economic growth in Russia. A healthy leasing industry will result in increased flows of financing to the productive sector of the economy, facilitating an increase in domestic production, a rise in sales of capital assets in Russia, and a wider choice of financing options available to Russian enterprises.

Our survey results show that the leasing industry, while still relatively small in comparison to OECD countries, is growing rapidly and is playing an important role in supplying credit for equipment acquisition. Russia's leasing market is relatively advanced compared to other countries of the former Soviet Union. In the countries of Central Europe, there are considerable differences between each market.

Leasing in Russia is playing a growing role in supplying credit to small and medium-sized enterprises. Challenges remain, including improving the legal base, more widespread appreciation of the effectiveness of leasing, and particularly repossession in cases of default, but there has been considerable improvement to date.

This survey first presents information about the size and structure of the Russian leasing market based on our own analyses and questionnaires sent to Russian leasing companies. The survey then presents the lessees' perspective on leasing, a short history of the industry in Russia, the macro-economic and political situation in Russia and its relation to leasing, and an overview of the Russian credit markets. The report then provides a summary of the legal, regulatory, tax and accounting environment, as well as an introduction to the nature of international lease deals in Russia.
SIZE OF THE RUSSIAN LEASING MARKET

There is, unfortunately, no definitive figure on the size of the leasing market in Russia. Although all leasing companies must register to undertake leasing activities, there is no requirement that leasing deals be registered with government bodies, and data collection from industry is poor. Nonetheless, Goskomstat (the State Statistics Committee) estimates the size of the leasing market at 5.8 billion rubles for 2000, or roughly $200 million.

Unfortunately, we believe Goskomstat’s estimate to be a significant underestimation, since our own direct survey of leasing companies - which does not cover the entire leasing industry, and is based on purely voluntary responses - includes almost this amount of leasing activity in the same period. Further, one company - RTC Leasing - puts the value of its own leasing deals in the same period at over 5 billion rubles. Respectfully, we believe Goskomstat’s estimate is almost an order of magnitude away from a reasonable estimate. The IFC Leasing Development Group’s conservative point estimate places the size of the market at $1.2 billion in 2000. As detailed below, we expect the market to grow to $1.5 billion in 2001 and $2 billion in 2002.

If the number of leasing companies continues to grow as dramatically as has been the case in recent months, as noted below, and if they prove able to attract financing, the industry could grow considerably more rapidly.

Size of the Russian Leasing Market - IFC LDG Estimate

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>$ billion</td>
<td>2.5</td>
<td>1.4</td>
<td>0.4</td>
<td>1.2</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Ruble billion</td>
<td>14.4</td>
<td>14.4</td>
<td>10.6</td>
<td>35.2</td>
<td>44.1</td>
<td>62.6</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group; dollar/ruble rates based on Economist Intelligence Unit estimates

Methodology

The IFC Leasing Development Group has estimated the size of the leasing market (leasing activity) defined as the value of equipment financed in that year. These figures exclude real estate leasing and apply only to financial leasing under the Russian definition, not to rent or ‘operating leases.’

It should be noted that the size of the leasing ‘lending’ market - that is, the total value of outstanding lease portfolios or lease payments due to leasing companies -

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1 Any estimate of this type more accurately describes a range of likely values than a specific figure. Our methodology indicates that the likely size of the market in 2000 was between $1 and $2.5 billion, while this range may seem wide, as noted our approach is to use a conservative value close to the low end of this range.
will be larger than the value of new equipment obtained in any one year, since most leases have terms of longer than one year. It follows that revenue from leasing activity is also larger than the value of new equipment acquired, since payments continue to be made on leasing deals from previous years.

LDG takes a conservative approach, estimating leasing activity as a percentage of investment, of machinery imports and of national GDP. For example, we have estimated that leasing in Russia - as in other countries - is primarily related to investment in fixed assets. While in OECD countries leasing is usually between 15-30% of GDP, in developing countries and transition economies the figure is usually from 3-15%. We used 3% to estimate the size of the Russian leasing market. Similar approaches were used for leasing as a percentage of machinery imports and GDP.

In each case, we also provide figures for leasing at different penetration levels. For example, we also checked the size of the leasing market at the 1.5% and 4% of fixed investment levels to derive a likely range of figures.

We then double-checked the estimates derived in this fashion against our own survey of leasing companies and other published data; the survey data provides considerable support to our analytical estimates. Using this approach, the leasing market in 2000 represented some $1.2 billion of investment. These different methods tend to converge around the figures estimated above.

We used the same methodology to provide projected figures for 2001 and 2002. These projections are based on a conservative approach, which assumes that there are no dramatic changes in the regulatory environment or credit industry significantly affecting the leasing industry. We have also not attempted to account for the number of leasing companies registered, their retained earnings, their ability to attract outside financing or other factors that would increase the importance of leasing as part of the domestic credit and equipment market in the coming years.

In other words, these estimates make no assumptions about the share of leasing in domestic investment growing, nor of a growing share in machinery imports. If the share of leasing in domestic equipment finance changes quickly, the size of the leasing market will grow far more rapidly. Conversely, we have not allowed for any drastic economic crash, as happened in 1998; we defer to sources such as the Economist Intelligence Unit’s risk assessments for these judgments.

**Leasing as a Percentage of Capital Investment**

OECD countries consistently report between 15% to 30% of capital expenditure being funded by leasing operations. Developing countries, with less developed leasing industries, finance between 3-15% of capital investment through leasing. In order to use this method for estimating the size of the leasing market, an assumption was made that 3% of capital investment in 2000 was directed through leasing.

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2 The two figures are, of course, related. The total leasing portfolio should equal the sum of the company's new lending for all previous years minus lease payments and redemptions. Or, alternatively, the portfolio equals the portfolio from the previous year, plus new leasing activity, minus lease payments and redemptions in the current year.
We estimated that only 1.5% of financing was directed through leasing in 1999 due to the post-crisis lack of available credit funds throughout the credit and banking industry, but we believe it rebounded to a minimal level in 2000. This assumption is intended to be conservative and reflect the continued scarcity of financing in 2000, despite the significant improvement over 1999.

**Size of Leasing Market**

<table>
<thead>
<tr>
<th>As % of Fixed Investment</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Investment</td>
<td>$41.4</td>
<td>$57.6</td>
<td>$66.3</td>
</tr>
<tr>
<td>1.5%</td>
<td>$0.6</td>
<td>$0.9</td>
<td>$1.0</td>
</tr>
<tr>
<td>3.0%</td>
<td>$1.2</td>
<td>$1.7</td>
<td>$2.0</td>
</tr>
<tr>
<td>3.5%</td>
<td>$1.4</td>
<td>$2.0</td>
<td>$2.3</td>
</tr>
<tr>
<td>4.0%</td>
<td>$1.7</td>
<td>$2.3</td>
<td>$2.7</td>
</tr>
</tbody>
</table>

*Source: Economist Intelligence Unit, IFC Leasing Development Group*

At 3% of total fixed investment in 2000, Russia's leasing market is estimated at $1.2 billion

We have also projected a size for the market in 2001 and 2002 based on estimates of the likely growth in the Russian economy. We show a range of values here to show the potential size of the market in dollar terms if leasing were to grow in its share of fixed investment, but have used our low-end estimates. Note the range in estimated market sizes: it is entirely possible that the market is considerably larger than our estimate.

**Leasing as a Percentage of Machinery Imports**

As with domestic fixed investment, in developed markets leasing accounts for 20-30% of capital asset imports (machinery and equipment). In 1999, we estimated this proportion to be no more than 7.5% given the lack of availability of dollar financing for leasing deals. We have shown figures at the 10% level, since we have seen a notable return to the leasing market for imported equipment, and likewise projected these figures for 2001 and 2002. The table shows the range that estimates of lease financing as a percentage of machinery and equipment imports give at each estimated level. In 1998 we used a figure of 15%, which, if applied in 2000, would give a much larger market and shows the potential for growth. This share of leasing might reasonably be expected to change, but we have used 10% as a conservative estimate.

**Size of Leasing Market**

<table>
<thead>
<tr>
<th>As % of machinery imports</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery Imports</td>
<td>$14.1</td>
<td>$16.2</td>
<td>$18.5</td>
</tr>
<tr>
<td>10%</td>
<td>$1.4</td>
<td>$1.6</td>
<td>$1.8</td>
</tr>
<tr>
<td>15%</td>
<td>$2.1</td>
<td>$2.4</td>
<td>$2.8</td>
</tr>
<tr>
<td>20%</td>
<td>$2.8</td>
<td>$3.2</td>
<td>$3.7</td>
</tr>
</tbody>
</table>

*Source: Economist Intelligence Unit, IFC Leasing Development Group*

At 10% of machinery imports, Russia's leasing market is estimated at $1.4 billion in 2000
**Leasing as a Percentage of GDP**

Leasing as a percentage of GDP is, methodologically, not much different than using leasing as a percentage of investment or of machinery imports in a country with relatively stable levels of investment and imports. We have chosen to show this calculation, however, since the percentage-of-GDP approach is less dependent on investment (which may change quickly in Russia due to the size of investments needed) and imports (which could change depending on the exchange rate and monetary policy). In other words, this approach may be a better estimate, or at least more stable, particularly in ruble terms.

As the graph and tables show, our estimate of the size of the leasing market implies that leasing as a percentage of GDP is between 0.5-1%, an assumption that seems reasonable - albeit conservative - compared to figures in developed countries of between 2% and 5%. We believe that this demonstrates that our approach and methodology are unlikely to have over-estimated the size of the market.

### Size of Leasing Market

<table>
<thead>
<tr>
<th>As % of GDP</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>$251.1</td>
<td>$306.6</td>
<td>$345.1</td>
</tr>
<tr>
<td>0.50%</td>
<td>$1.3</td>
<td>$1.5</td>
<td>$1.7</td>
</tr>
<tr>
<td>0.75%</td>
<td>$1.9</td>
<td>$2.3</td>
<td>$2.6</td>
</tr>
<tr>
<td>1.00%</td>
<td>$2.5</td>
<td>$3.1</td>
<td>$3.5</td>
</tr>
<tr>
<td>1.50%</td>
<td>$3.8</td>
<td>$4.6</td>
<td>$5.2</td>
</tr>
</tbody>
</table>

*Source: Economist Intelligence Unit, IFC Leasing Development Group*

**At 0.5% of GDP, Russia's leasing market is estimated at $1.3 billion in 2000**

**Leasing Market Size - 'Reality Check' against Survey Results**

The IFC Leasing Development Group conducted a survey of approximately 75 Russian leasing companies between May and July 2001 (more detailed results of the survey begin on page 17). The questionnaires, and subsequent follow-up conversations, asked for both qualitative and quantitative information about the company, its leasing portfolio, and its policies and procedures. The LDG received just over 50 responses, or approximately 15% of the estimated 350 leasing companies active in Russia in 2000 (a number which has subsequently risen). Only approximately one-half of the companies responding (7.5% of those active in Russia in 2000) provided sufficiently detailed answers to include the data provided in the total outstanding portfolio value and new leasing activities figures. Nonetheless, the total portfolio of LDG surveyed companies was approximately $190 million in 2000, up from approximately $110 million reported by the same companies in 1999. The total value of contracts signed during 2000 amongst companies reporting was approximately $95 million.\(^3\)

Our estimate of market size, based on our own survey, projects that the market has grown three times over our post-crisis estimate of $400 million for 1999. Given that the figure has almost doubled for the companies surveyed - without

\(^3\) For these questions, there were between 26-28 companies responding for 1999, and 35-38 for 2000.
taking into account growth in the number of companies in the market, or those we are not aware of (because they are too new) - we believe that estimating three times growth is reasonable.

Given the known data shortages, extrapolating the survey data out to say that the total leasing market is approximately ten times that of the voluntarily reported figures we have summarized is, if anything, a conservative approach. Rosleasing, an industry association, undertakes a survey of its own members, which represent 70-odd leasing companies, or about 5% of the registered leasing companies and slightly less than one-fifth of those active in the market. About 40 of those companies responded to Rosleasing’s survey questions in its most recent survey. Rosleasing estimates the market at approximately $500 million, as reported by its members.

We note that because our survey respondents and Rosleasing members do not overlap much, and Rosleasing includes several of the largest leasing companies in the industry (two of which alone have portfolios worth well over $100 million). Comparing the figures, the noted lack of overlap between the two surveys, and the absence from either survey of several potentially large players (particularly leasing subsidiaries of foreign banks), we believe our estimate of $1.2 billion for the leasing market is both conservative and sensible.

**Future Trends**

In real terms, the absolute size of the market is less important than the trend of market development. The trend is clearly one of strong growth, with a number of leasing companies showing significantly increasing demand and supply. Just as importantly, we note a significant trend toward the establishment of small, specialized leasing companies. Increasingly, these companies are founded with the intention of working in the leasing industry on a long-term basis, with relatively fewer companies founded now in order to carry out one-off deals. These new companies tend to have very high growth rates.

As with any new enterprise, a large proportion of these companies will probably not be successful in the long term, and many may not survive. Nonetheless, the trend is positive, as it indicates that there are an increasing number of industry specialists that understand the advantages of leasing, and this should result in increased competition - albeit beginning from a very low base.

In terms of the effect on the Russian economy, it is worth noting that leasing appears to be playing its expected role in terms of providing increased access to financing for start-ups and small and medium-sized enterprises. The growth in the lending portfolios of existing companies, as well as the rapid growth in the number of companies, appears to be occurring without any significant change in the minimum sizes of lease deals available.

**NUMBER OF LEASING COMPANIES**

The number of licensed leasing companies has grown significantly in the period covered by this report (that is, to January 2001) from 1279 to 1662. From January to July 2001, approximately 500 more companies were registered.
While these numbers include a large number of companies that are not actively involved in leasing (and may include a number that received licenses for one leasing deal), based on LDG research into active leasing companies, we estimate that this means that approximately 500 leasing companies are active throughout Russia as of mid-2001 and approximately 350 companies were active throughout 2000.4

<table>
<thead>
<tr>
<th>Number of Leasing Companies</th>
</tr>
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<tbody>
<tr>
<td>2500</td>
</tr>
<tr>
<td>2000</td>
</tr>
<tr>
<td>1500</td>
</tr>
<tr>
<td>1000</td>
</tr>
<tr>
<td>500</td>
</tr>
<tr>
<td>0</td>
</tr>
</tbody>
</table>

Sources: Leasing Development Group, Ministry of Economic Development and Trade Figures for the first half of 2001 are unofficial.

This growth in one year is tremendous, particularly considering the fact that for approximately six months, the Russian authorities were not issuing new licenses at all. While, as noted, we believe that many of the companies registered are not actively pursuing leasing deals, the fact remains that almost one-third of the existing total of companies were newly registered in 2000, despite the fact that some licenses would also have expired during the year. Perhaps surprisingly, the 1998 financial crisis did not appear to have an influence on the number of registered companies, despite the fact that leasing is not advantageous when companies are unprofitable.5

Further, the pace of growth in licensing new companies appears to be accelerating. Unofficial sources say that over 520 licenses were issued between February and July of 2001, when the licensing system was transferred to the Ministry of Economic Development and Trade. This clearly represents strong growth in the industry, and cannot but lead to more competition in the lending industry throughout the country.

As far as physical location, more than one-third of the companies registered as of January 2001 are based in Moscow (at least officially), another third in European

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4 See the IFC Leasing Development Group’s Market Survey for 1998-1999. At that time, we estimated that approximately 30% of registered companies were active. For the purposes of this year’s survey, we estimate that 25% of companies are active.
Russia excluding Moscow, with one-fifth in the Urals and Western Siberia. Slightly less than one hundred, or less than 10%, are found in the Russian Far East. This breakdown roughly follows the population distribution, with the exception of the high concentration in Moscow.

The founders of the Russian leasing companies are predominantly - almost two-thirds - companies or individuals. Approximately 200 (or 15%) were founded by banks or by government bodies, with another 100 founded by foreign companies. The percentage of leasing companies founded by foreign companies has not significantly changed over the years.

**TYPES/MARKET NICHES OF LEASING COMPANIES**

Broadly speaking, there are several types of leasing companies, although the lines between each type are far from clearly drawn and some overlap is to be expected.

- Independent, universal leasing companies
- Bank-linked leasing companies
- Regional leasing companies
- Supplier-linked leasing companies
- Industry-specific leasing companies
- Government-linked leasing companies

**Independent, universal leasing companies**

In this rubric we place only a few companies. We exclude companies that are focused on one or two regions (oblasts), although a few of the companies focus on a larger geographic region (such as the Northwest of Russia). We also exclude from this group companies that are tightly linked to commercial banks, which also reduces the number, and those that may focus on particular industries. Two of the companies that we identify as being universal leasing companies are Delta Leasing and Deutsche Leasing Vostok. Due to the sheer physical size of Russia, there are no universal leasing companies that achieve market reach throughout the country. Note that even universal leasing companies may have their own market niches; Delta Leasing, for example, tends to focus on smaller businesses.

**Bank-linked leasing companies**

A number of banks have leasing subsidiaries or leasing affiliates. In some cases, these leasing companies are treated more as a part of the bank's regular lending activities, and may have little more than a skeleton staff. Credit analysis may be done by the bank's own credit department, with the lease agreement considered as simply an alternate type of loan. In many cases, however, bank-controlled leasing companies and subsidiaries begin to pursue their own business separate from the bank, although the bank generally remains the principal source of funding. Some of these bank-linked leasing companies are growing larger; Sberbank in particular has the potential to build on the saving bank's enormous network but has been slow to emphasize leasing to date. One banker told us that the banking industry's approach to leasing is likely to be cautious «as it is to most ‘new’ activ-

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5 Profitability amongst Russian companies fell dramatically in the wake of the ruble devaluation, although this trend has since reversed.
ities». Examples of leasing companies linked to fairly large banks include Alfa-Leasing, Raiffeisen Leasing, ING-Leasing, Baltisky Leasing and Sberbank's related leasing companies. Since Russian banks are comparatively quite small and foreign banks have not wholeheartedly jumped into the market, the bank-linked leasing companies have considerable room for growth. Leasing companies linked to foreign banks appear to be focusing their efforts primarily on larger projects, from $500,000 to $1 million and up.

**Regional leasing companies**

We define regional leasing companies as those primarily focused on a specific geographic region, usually a single oblast, territory or even city. Examples include the Krasnodar-based Municipal Investment Company, the Irkutsky Business Park, the Sakhalin Leasing Company and the Volkhov Mikrolizing Center. Note that we are drawing a distinction between leasing companies focused on one or two oblasts to those that may cover several; the latter are of course also geographically focused, but due to the physical size of Russia, the approach is more similar to that of a universal company.

Many regions, particularly the poorer regions, have no more than a single local commercial leasing company, which relies primarily on its strong local connections and knowledge to develop its client base, or a handful of very small companies. Some regions have effectively no active leasing companies. In real terms, many of these regional leasing companies are effectively industry focused, since the local economy may lack diversification. In some regions in which we have done research, leasing activity is severely underdeveloped, with insignificant numbers of leasing deals concluded.

There are a number of regional leasing companies that have some connection with the local government and could be classified as government-linked (see below). There is no clear line that can be drawn here, but some companies clearly have a more ‘commercial’ bent than others. We exclude companies from this group that appear to have a primary goal other than profit such as supporting local small businesses, implementation of agricultural credits, etc. This is a subjective definition, and some companies may have a more or less commercial approach.

**Supplier (or Financial-Industrial Group) linked leasing companies**

Some suppliers (for example, John Deere Russia, Hewlett Packard and others) have subsidiaries or affiliated companies that provide leasing to their customers, effectively as part of a payment plan or credit arrangement. This approach is under-utilized in Russia. A number of reasons could be identified as contributors to this under-development. First, geographic reality is such that monitoring leasing deals is not practical at long distances. Hence, a supplier with an office in Moscow may have little or no advantage at providing a leasing deal in (for example) Krasnoyarsk, at over 3000 km distant. Second, many suppliers are either short of cash themselves or unwilling to expose themselves to additional purchaser risk. The former usually applies to Russian companies, while the latter to foreign companies active in Russia. For suppliers that insist on up-front cash payment - a substantial portion of Russian equipment purchases - a lease provided by a subsidiary provides no practical advantage to the parent company unless the subsidiary has independent sources of credit and capital. While this market should develop further, it is likely to be slow; judging by LDG surveys and interviews, it appears that
many suppliers would prefer to find a well-run leasing company to work with and to negotiate risk-sharing arrangements with the leasing company rather than establish their own leasing company and bear most of the risk.

**Buyer-linked companies**

Less frequently, some (relatively) cash-rich companies have founded leasing companies to provide them with some of the cash management and taxation benefits of leasing when acquiring new equipment; this is particularly true of the oil and gas and telecom industries. In a few cases, these companies have gone on to develop their own leasing business independent of the parent - particularly where the parent may sell equipment to other companies. A former subsidiary of Rostelecom (the national long-distance monopoly) is a case in point: the subsidiary, RTC-Leasing, is now raising funds on the market to finance lease deals with regional telecommunications companies. (Rostelecom's parent holding company, Svyazinvest, also owns majority shares in most of the regional telecoms).

While we expect this business to develop slowly as well, there may be increased on-lending from buyer-linked companies to affiliated companies, client companies and suppliers. These leasing companies could potentially become a profit center for the cash-rich companies, since they may have sufficient access to management of potential lessees to reduce their own lending risk well below what any comparable company would be able to achieve. This will be particularly true as some new vertically-consolidated companies are created through mergers and acquisitions.

As an analogy, think of General Motors Acceptance lending to a company that makes one product: car seats for General Motors. The car giant may know better than even the borrower - and certainly better than any outside company - what risks the company may face. There is considerable potential for such financing arrangements in Russia, given the vertical dependence of many companies on others since the break-up of the Soviet-era industrial giants. To date, such arrangements have more frequently been organized using battles for control of related companies. In many cases, these battles for control may represent an inefficient use of funds, and arranging borrowing or leasing would be more effective, given the ability to reduce lending risk within these organizations.

**Industry-specific leasing companies**

Industry-specific leasing companies make use of their superior knowledge of a particular industry or type of equipment to reduce their own equipment risk. They also tend to be geographically focused only to the extent a particular industry or sector is, and may have only a 'virtual' office. Most of the actual leasing activity takes place 'in the field', and the head office location is less important.

This is perhaps one of the key characteristics of leasing in the West that is currently lacking in Russia. Given the severely under-developed secondary markets and the perceived need for on-site monitoring and control, this portion of the industry will take longer to develop - although this may be where some of the most interesting opportunities lie in the long term. At the moment, we know of only a handful of industry-specific leasing companies. The most important industry-focused leasing companies are in the agricultural machinery sector, but for reasons described below we would classify the vast majority of agricultural leasing companies as 'government-linked.'
Government-linked leasing companies

There are a wide range of leasing companies which could be classified as government-linked. We attempt to, wherever possible, distinguish between those that operate on a purely or largely commercial basis and those that operate on a non-commercial basis. In this analysis, the source of funds is less important than the use of those funds.

In many cases, some government-linked or owned leasing companies have received capital for lending programs, but lend on a primarily commercial basis, and we have excluded those companies from this section. An example here would be the Nizhny Novgorod Small Business Leasing Company, which receives some (limited) funding from the Oblast government but operates on a largely commercial basis.

There are a number of other leasing companies which appear to operate on principles that are primarily non-commercial: they exist primarily to provide credit to a particular enterprise, industry, or sector, and lease rates are more clearly subsidized. In the more extreme examples, there are a number of leasing companies that appear to have excessively low repayment rates, implying that ‘leasing’ is little more than a means of providing credits to enterprises (possibly using some of the tax advantages). This should not be surprising: these companies were often created precisely in order to provide ‘credits’ to these industries (or, as one observer put it, «their business plan does not currently include getting paid back»).

To a certain degree, we have witnessed some continuing evolution of these leasing companies towards operations that are increasingly commercial in nature. In effect, governments are recognizing that leasing may provide a reasonable tool that allows them to provide financing to successful producers - if they allow the leasing companies to make credit decisions based on the creditworthiness of the borrower. The fact that these funds, if invested properly, will also be available in future years for further lending (thus lessening the demand for outright subsidies from government budgets) is a strong incentive for governments to move towards more commercially-oriented lending.

The great hulking giant of these is Rosagrosnab and its affiliated leasing companies, which have a presence in all the subjects of the Federation. Rosagrosnab's current leasing portfolio is reported by Rosleasing at over $400 million. Rosagrosnab receives virtually all of its funding from the state, although little information is publicly available about the organization.

Rosselkhozleasing, the leasing branch of Rosselkhozbank, has been named the official government leasing company for agricultural equipment, and the government has allocated some 5 billion rubles to Rosselkhozleasing for these purposes. Rosselkhozleasing was chosen to ‘improve the effectiveness’ of government subsidies to the agricultural sector. It appears that the funds are caught in some sort of political dispute, however, and that the money has not been transferred. At any rate, Rosselkhozbank is still state-owned, and is expected to fulfill government orders in this area.
LEASING MARKET: 
RUSSIAN LEASING COMPANIES

IFC’s Leasing Development Group surveyed approximately 75 leasing companies, 52 of whom responded with sufficiently detailed responses for the purposes of our survey (although not for all questions on the survey). Unfortunately, some of Russia’s largest leasing companies did not respond to our survey.

Our results are therefore somewhat skewed towards smaller, independent companies, but we believe it is largely representative of this portion of the market and indicative of current and future trends. Approximately 20% of our survey respondents were entirely new to the leasing industry in 2000.

Concern over secrecy among the companies surveyed appears to still be sufficiently high that we had difficulty obtaining further information from many companies, roughly half of whom returned questionnaires that were either largely incomplete or lacking key information.

In addition, we have gathered information from a variety of publicly available sources about other significant companies, and encourage our readers to consult Rosleasing’s own annual survey, whose information complements our own.

To give just a few examples of significant market players about whom information is not included in our survey, RTC-Leasing (whose financial report is publicly available on the internet), the leasing subsidiary of Rostelecom, had a leasing portfolio of over 5 billion rubles (approximately $175 million) in 2000, and Rosagrosnab’s leasing portfolio has been estimated at over $400 million. Each of these companies alone, by our estimate, make up more than 10% of the Russian leasing market, although they represent very specific sub-sectors.

SOURCES OF FINANCING

Leasing companies surveyed by the LDG evidently derive a considerable portion of their financing from Russian banks (both parent banks and others), supplier credits, and internal resources (i.e., cash flows from operations and internal equity). 62% of those surveyed had received financing from third-party banks, 50% indicated that financing came from their shareholders, and 37% had received trade credits from suppliers. Parent banks (banks listed as founders of the leasing company) provided financing for 27% of the leasing companies. Only two other source of financing (government credits or loans and unrelated companies) had been used by 8% or more of the companies.

---

6 For the quantitative information - number of leasing deals, size of leasing deals, portfolio size, etc - the number of responses was between 25-30 for 1999, and 35-40 for 2000. Roughly one-quarter of our detailed responses were from companies new to the market in 2000.
As noted above, the primary difficulty with bank financing is the availability of long-term credits, since only an estimated 10% of bank loans (approximately $4 billion in mid-2001) are for terms greater than a year.

The figures in our survey do not show the percentage of financing provided by each of these sources, but the figures do indicate that banks are a source of credit for virtually all leasing companies and that much of this credit is coming from non-related banks. It is important to note here that financing from retained earnings was rarely mentioned, although ‘internal resources’ are often cited. We believe retained earnings and contributed equity are a significant or dominant source of financing for virtually all leasing companies at present, as for most Russian companies; it is more likely that many companies do not yet perceive retained earnings as a ‘source of financing’ or consider it so obvious as to not be worth mentioning.

Leasing company responses also give some sense of who the founders of leasing companies have been. Of the companies responding, just under 20% listed banks as founding structures, roughly the same percentage were founded by government structures, and about 6% by ‘social organizations.’ Over 50% had individuals and companies as their founders, meaning the great majority are to a large degree independent. (Note that numbers total to more than 100% because companies often had more than one founder, and responded with specific percentages).

Of the companies responding, only three indicated that banks owned more than 50% of shareholder equity, and five had more than 50% of shareholder equity.

Source: IFC Leasing Development Group; percentage of leasing companies using each source of finance
held by government structures. The remainder of the companies responding had either individuals or companies controlling more than 50% of shareholder equity. While banks and government structures may effectively control more than these numbers indicate, taken collectively the responses do indicate that the majority of respondents were independent leasing companies.

**NUMBER OF LEASES/COMPANY**

The average leasing company in our survey concluded 43 new lease deals in 2000 compared to 22 in 1999. The average total value of these deals per company was $2.4 million, up from roughly $1 million U.S. in 1999. The average company also had approximately 70 leases in its active portfolio, for an average portfolio value of 160 million rubles or $5.3 million - up from $4.7 million. It is worth noting here that the median values were significantly lower: the median leasing company in our survey concluded 20 new deals in 2000 worth a total median value of $1 million; the median portfolio value was only 54 million rubles, or just under $2 million.

As noted before, the most impressive aspect of these figures is the fact that the companies surveyed reported such large growth in the number and size of new deals concluded, indicating that the growth trend is clearly quite positive. To some extent, these figures do not fully represent the growth of the market because the average portfolio figures do not include results from new companies founded in late 2000 or 2001. For almost half of 2000, there

![Leasing Company Founders](chart.png)

Source: IFC Leasing Development Group

*Only 6% of the leasing companies responding report that they are majority-owned by a bank or financial institution, and 12% are part-owned by a bank or financial institution. More than 35% of the leasing companies responding noted that individuals owned more than 50% of the share capital.*
was an effective ‘freeze’ on leasing licenses being granted by the authorities. Since the number of leasing companies active has also grown considerably, the total size of the market will have grown more than these rough figures demonstrate.

**AVERAGE DEAL SIZE**

The leasing companies surveyed appear to be concentrating on leasing deals that truly place them within the small and medium-sized enterprise segment. Of the companies surveyed, the median company’s average lease deal was valued at approximately $30,000, and the median company’s minimum lease deal was approximately $3000 in 2000. Even maximum lease deals were of reasonable size, ranging from $300,000 for the median company to $1,000,000 on average. The difference between these two figures indicates the extent to which the ‘average’ figure is distorted by a few large leasing deals (one deal was reported at the $10 million level, for example).

These figures support the contention that lease financing is disproportionately important for small and medium-sized enterprises. In fact, there are a number of companies working with deals worth well under $5000, a level that puts lease financing by many companies in the micro-credit category. In practice, the larger commercial leasing companies tend to limit their financing of leasing deals below $10,000-$30,000, since administrative expenses and overhead tend to make the smallest deals less profitable. Smaller, newer leasing companies appear to show considerably more interest in working with small and even micro-leases, and companies working in the poorest regions of Russia also tend to have smaller deals.

**Leasing Company Portfolios - Average Lease Sizes (Thousands of Rubles)**

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Median</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>3,126</td>
<td>991</td>
<td>20,000</td>
<td>17</td>
</tr>
<tr>
<td>2000</td>
<td>4,055</td>
<td>1,553</td>
<td>20,000</td>
<td>56</td>
</tr>
</tbody>
</table>

*Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.*

Average lease deal size grew slightly to approximately $130,000, while the median lease deal size grew much more rapidly to $50,000. This growth in the median lease size most clearly demonstrates the depth and breadth of the growth in leasing, as even relatively small leasing companies were able to grow their average deal size considerably.

**Leasing Company Portfolios - Minimum Lease Sizes (Thousands of Rubles)**

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Median</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>360</td>
<td>115</td>
<td>5,000</td>
<td>1</td>
</tr>
<tr>
<td>2000</td>
<td>352</td>
<td>130</td>
<td>3,000</td>
<td>3</td>
</tr>
</tbody>
</table>

*Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.*

Average lease size was almost unchanged in ruble terms, and median size was unchanged in dollar terms. Judging by these figures, many leasing companies continue to provide financing for very small leases of less than $10,000.
### Leasing Company Portfolios - Maximum Lease Sizes (Thousands of Rubles)

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Median</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>20,244</td>
<td>4,900</td>
<td>315,000</td>
<td>250</td>
</tr>
<tr>
<td>2000</td>
<td>29,739</td>
<td>9,900</td>
<td>277,300</td>
<td>398</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

*Maximum lease sizes for the median leasing company was over $300,000, approximately double the previous year. In other words, more than half of the leasing companies responding would consider leases of over $300,000.*

The trends are also encouraging. The portfolio size of the companies, the number of leasing deals, and the value of deals have all grown noticeably between 1999 and 2000. The total portfolio value of the leasing companies reporting (voluntarily) information to the Leasing Development Group is over 5.4 billion rubles for 2000, or in the neighborhood of $190 million. This is more than 2.3 billion rubles higher than the year before (with the same base of companies reporting), or slightly less than twice the size.

### Leasing Company Portfolios - # of Requests Received

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Median</th>
<th>Total (all companies)</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>50</td>
<td>27</td>
<td>1,445</td>
<td>308</td>
</tr>
<tr>
<td>2000</td>
<td>107</td>
<td>80</td>
<td>3,654</td>
<td>723</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

*Leasing companies surveyed saw the number of leasing requests (applications) more than double, with the median number of requests almost tripling.*

### Leasing Company Portfolios - # of Deals Concluded

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Median</th>
<th>Total (all companies)</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>20</td>
<td>9</td>
<td>540</td>
<td>108</td>
</tr>
<tr>
<td>2000</td>
<td>35</td>
<td>17</td>
<td>1,339</td>
<td>139</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

*Leasing companies responding almost doubled the number of deals concluded between 1999 and 2000: the total number of deals concluded more than doubled due to the entry of new companies.*

### Leasing Company Portfolios - # of Deals in Portfolio

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Median</th>
<th>Total (all companies)</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>43</td>
<td>25</td>
<td>1,086</td>
<td>306</td>
</tr>
<tr>
<td>2000</td>
<td>59</td>
<td>36</td>
<td>2,065</td>
<td>275</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

*Leasing company portfolios grew more slowly due to redemptions and completed deals, but the total number of deals for all companies almost doubled.*
Leasing Company Portfolios - New Deals Signed (Thousands of Rubles)

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Median</th>
<th>Total (all companies)</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>27,661</td>
<td>6,382</td>
<td>774,502</td>
<td>340,000</td>
<td>N/A</td>
</tr>
<tr>
<td>2000</td>
<td>75,717</td>
<td>15,000</td>
<td>2,801,546</td>
<td>635,379</td>
<td>1,914</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

More than $95 million in new deals signed (that is, equipment leased) was reported by the leasing companies surveyed, although only approximately one-half of the companies reported significantly detailed figures to be included in this total.

Leasing Company Portfolios - Outstanding Portfolio Sizes (Thousands of Rubles)

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Median</th>
<th>Total (all companies)</th>
<th>Maximum</th>
<th>Minimum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>123,068</td>
<td>22,979</td>
<td>3,199,759</td>
<td>1,900,000</td>
<td>1,048</td>
</tr>
<tr>
<td>2000</td>
<td>151,958</td>
<td>54,243</td>
<td>5,470,505</td>
<td>1,150,000</td>
<td>1,914</td>
</tr>
</tbody>
</table>

Source: IFC Leasing Development Group. Year-to-year comparison is like-to-like, with new companies included.

The outstanding portfolios of the companies reporting totaled over $185 million.

In the discussion of market size above, we believe we have sufficiently documented our estimate of total market size as being $1.2 billion, and have intentionally been conservative. Other estimates of market size range from $1 billion to $10 billion or more, with most estimates placing the size of the market at well over $1.2 billion.

**TYPES OF EQUIPMENT**

The types of equipment acquired using leasing represents a fairly wide range, although transport (trucks and cars) and ‘manufacturing equipment’ dominate with the average leasing company indicating that these two types represent 23% and 22% respectively. Other types of equipment are shown on the table below; but food processing, wood processing, printing, retail, and office equipment each represent 5% or more of the reported percentages.

The prevalence of transportation equipment is understandable, as this equipment is both more easily repossessed (because more mobile) and secondary markets for vehicles are more developed. On the demand side, as new start-up firms develop, there is also understandably more demand for new delivery equipment, a trend that is evidenced by the growing number of «GAZelle» mini-vans or delivery trucks. These Gazelle trucks are becoming almost ubiquitous on Russian roads, and were a vehicle category that was almost non-existent in the Soviet Union. They are, not surprisingly, a common subject of lease deals.

The large percentage of ‘production equipment’ (a term which is perhaps too broad to give much specific sense) is encouraging, and confirms that a trend of moving to fixed capital equipment leasing is occurring. Since many...
of the other equipment categories could also be classified as production equipment, summing the answers to our survey indicates that the ‘productive equipment’ category (as distinct from transport, trade and services, telecommunications, and others) represents approximately 50% of the equipment leased.

Printing equipment represents a significant area of equipment renewal that is seeing rapid growth, as new and existing printing firms move to newer, more advanced equipment on a different model of production (smaller, more client-focused production).

**PRICING AND SECURITY**

Lease pricing has for the most part tracked with bank lending rates, although with considerably more variance and, as expected, somewhat higher rates. Lending in Russia has tended to track - although with great variance - with the Central Bank’s refinancing rate. The refinancing rate is currently at 25%, down from 45% at the beginning of 2000.

In contrast with most Western countries, the equivalent of the U.S. Treasury bill rate in Russia is usually considered to be the refinancing rate. The comparison is a poor one, however, since little financial intermediation takes place using this rate, and its use as a guide to prevailing market interest rates is limited. Some large Russian companies can borrow at rates well below the refinancing rate, an unheard of situation in the U.S. with respect to the Treasury bill rate.

![Types of Equipment Leased](source: IFC Leasing Development Group)
## Exchange Rates and Interest

<table>
<thead>
<tr>
<th>Year</th>
<th>CBR Refinance Rate</th>
<th>Lending Rate</th>
<th>R/$ Rate, Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>185</td>
<td>320.3</td>
<td>4.562</td>
</tr>
<tr>
<td>1996</td>
<td>110</td>
<td>146.8</td>
<td>5.126</td>
</tr>
<tr>
<td>1997</td>
<td>32</td>
<td>32</td>
<td>5.785</td>
</tr>
<tr>
<td>1998</td>
<td>60</td>
<td>41.5</td>
<td>9.965</td>
</tr>
<tr>
<td>1999</td>
<td>57</td>
<td>40.1</td>
<td>24.836</td>
</tr>
<tr>
<td>2000</td>
<td>32</td>
<td>N/A</td>
<td>28.145</td>
</tr>
<tr>
<td>1-2001</td>
<td>25</td>
<td>18.5</td>
<td>28.382</td>
</tr>
<tr>
<td>6-2001</td>
<td>25</td>
<td>18</td>
<td>29.113</td>
</tr>
</tbody>
</table>

*Source: Russian Economic Trends*

Average ruble rates on lease deals from our survey were between 25% and 35%, while dollar rates were 17-18%. The majority of ruble-based lending was not linked to a dollar equivalent, but slightly less than a third of ruble deals were reported to have some currency risk protection. While the rates charged may seem high, interest on bank loans in the first half of 2001 was estimated by the Russian Academy of Sciences to average 29%, with rates ranging between 19% and 38%. Rates on leasing are hence not out of line with comparable bank loans, particularly given the longer effective terms.

To the ears of those accustomed to hearing of U.S. Treasury rate of under 10%, these rates may seem high. Of course, the important rate is not how much the entrepreneur pays for borrowed money, but how much the entrepreneur earns on that money. And if prices keep pace with inflation (currently running in the area of 20%), the effective rate when nominal rates are at 25% is not particularly high.7

The rates listed above are higher, of course, than the rates at which the largest, most credit-worthy companies can generally borrow - as is to be expected. Given the fact that interest payable on bank loans used to acquire capital assets is often not deductible, the ‘effective rate’ of lease financing may still be lower than bank financing due to the tax shield provided by lease payments.

In a few interesting cases, the financing rate at certain leasing companies actually rose between 1999 and 2000 - a result which seems unnatural, given the significant fall in interest rates between the two years. We believe these counter-intuitive figures are the result of some government-sponsored leasing companies moving to more commercial leasing arrangements from previous concessionary lending rates.

Most leasing companies charge service fees in addition to lending rates, generally between 3-5% of the initial equipment cost (minus any advance). These fees vary widely, however, with some companies charging rates as high as 25%, although the service fees may represent charges for considerably different levels of service. The basis upon which the service fees are calculated (full cost of the equipment, remaining balance, etc.) also varies considerably.

7 The effective rate is the nominal rate minus annual inflation.
Virtually all leasing companies require that lessees provide additional collateral or security when concluding leasing deals. In fact, only two companies reporting claimed to require no additional collateral or other guarantees. This clearly reflects the state of under-development of the Russian leasing market and the insufficiency of the legal framework. Leasing companies consistently emphasize to us that concerns about repossession are their greatest problem - and these concerns are reflected in their actions. The great majority of firms use at least one and often several forms of additional guarantees, often exceeding the value of the lease payments outstanding.

Almost all of the leasing companies surveyed requested one or more of the following forms of security: an advance (typically from 25-35% of the purchase value of the leased equipment), a deposit or other additional collateral, guarantees from other parties (usually firms rather than individuals), pledges of assets or additional insurance. Guarantees from suppliers, banks or individuals were also used, but much less frequently.

On average, each company responding used slightly more than four types of guarantee; while we do not have information on a deal-by-deal basis, our lessee and leasing company interviews indicate that two or three types of guarantee per deal are common. Other popular forms of guarantee - although each was used by less than one-third of leasing companies - included cash guarantees, guarantees from individuals (often the personal assets of lessees), bank guarantees, and supplier guarantees.

Few respondents indicated that they did not require additional guarantees. In sum, it is clear that due to concerns about repossession, Russian leasing companies continue to require high levels of collateral from their clients. While these requirements may seem excessive, they reflect the reality of repossession, which is difficult and costly to effect. To a somewhat lesser degree, it also reflects the underdeveloped secondary markets, since the residual value

![Types of Security Required](chart.png)

Source: IFC Leasing Development Group
remaining on the books may be quite different from that achievable in a forced sale.

Surprisingly perhaps (given the risk implied by the approach to security above), only one-third of leasing companies report having experienced contracts with late payments. We do not have figures on the number of contracts with late payments. We assume that for most companies (including those that have had clients with payment problems), these cases are relatively rare. These results likely reflect two major issues: first, credit supply is far lower than demand, and hence leasing companies and other lending institutions can be very picky. Second, the additional security required makes the cost of defaulting on a leasing deal high, and companies that go through the process are relatively unlikely to risk the assets they or their partners have pledged.

Slightly more than a third of leasing companies have had equipment returned before the end of a leasing deal. In most cases, however, the equipment has been returned either according to contract conditions or by additional negotiation, and only six companies report having to go to court to repossess equipment. We suspect many of these cases date back to the period after the 1998 financial crisis, but do not have data to support this.

This may reflect difficulties in the court system as much as the goodwill of the parties, of course: since the courts are considered both slow and risky, it is often in the interests of both parties simply to ‘cut their losses’ and agree to whatever terms can be negotiated. Either way, the need for improvement of the judicial process for repossession is clear.

Legal Problems, by Type

Source: IFC Leasing Development Group
PROBLEMS AND TAX ISSUES

The great majority of our survey respondents had seen some type of legal problem in their business experience, but certain types of legal difficulties were more common. Tax problems were the most frequently mentioned, followed by civil law questions, accounting, and the lack of a repossession mechanism. Currency regulation, customs and licensing difficulties were also regularly occurring difficulties. The number of respondents having legal problems relating to taxation covered approximately 80% of those companies responding to our survey.

Despite the fact that most respondents noted that they had encountered some legal difficulties relating to taxation, only about a quarter of our respondents said that they had had difficulties with the tax authorities. The great majority of these problems were related to the application of value added tax (VAT).

![Problems with the Tax Authorities, by Type](chart)

Source: IFC Leasing Development Group
LEASING MARKET:
LESSEES’ PERSPECTIVE

WHY LEASING?

Lessees interviewed cite several significant reasons why they have concluded lease deals. These reasons include increased flexibility, lower collateral or guarantee requirements, longer terms, lower bureaucratic demands, advantageous tax rules and more support vis-a-vis suppliers. By far the most important reason cited - and the most frequent - is the simple unavailability of bank loans for many lessees.

Surprisingly, several lessees noted that they were referred by a bank to an independent leasing company - with the bank suggesting that the leasing company would be interested. This indicates that some banks recognize that leasing works in situations where bank loans may not. The only question remaining is why many of these banks have not chosen to either establish their own leasing company or work with an independent leasing company on a regular basis.

This information underlines an important point about leasing: in many cases, leasing is an alternative source of finance that does not compete directly with bank lending. Leasing has its own advantages and disadvantages that appeal to different borrowers than bank loans.

EXISTING SOURCES OF CREDIT

For the most part, lessees we interviewed claimed that they had little or no access to other forms of credit - at least when their first lease was signed. As in most countries with extensive leasing industries, there are two primary motivations for acquiring the use of equipment through leasing. For some companies - particularly larger, more sophisticated companies with good access to different forms of credit - leasing is important because it allows some off-balance sheet financing, better management of equipment and other special types of risk and flexible cash flow management. In addition, it does not jeopardize existing borrowing covenants and has tax advantages.

For other companies, the benefits listed above may provide some additional motivation, but the key impetus is access to credit. This is the case for the great majority of small to medium-sized enterprises we deal with and have interviewed. They approach leasing companies because they do not - or believe they do not - have access to bank credits. Other benefits are clearly secondary motivations. As noted previously, almost three quarters of bank loans by volume are believed to be to companies with whom the banks have worked for more than three years, and more than half for more than five years. Only 8% are to companies with whom banks have worked for less than one year.

In interviews with small businesses, the businesspeople often commented that the only true alternative to lease financing that they had access to was ‘loans from individuals.’ This was often from friends, family, or acquaintances, but also
from third parties. In almost all cases, these loans were considered undesirable. In other words, informal lending was the only viable alternative, and was often referred to as a last resort. When these informal loans are made on a commercial basis (that is, not from friends or family), our interviewees consistently referred to rates of 10-12% per month. On a purely cost basis, rates from leasing companies are largely, ranging from 25-35%, competitive with bank loans, which average 29%.

We do see some continued and increased interest in leasing transactions from larger corporations that likely have access to regular bank funding or sufficient internal resources. For the most part in Russia today, this means oil and gas and mining companies, the only truly cash rich companies. We have seen several transactions (with more in the pipeline) of oil companies acquiring equipment using leasing through their own subsidiaries or closely related companies. Some of these companies may use this source of credit to finance the expansion of their own leasing activities, but for the most part this activity is still relatively restricted.

The low level of leasing activity among larger firms is likely still related to the small number of companies with sufficient cash flow to have the choice of leasing or other sources of financing, imperfections in the legal and regulatory base, and the ability of influential companies to negotiate their own tax advantages. Finally, even in the large corporate sector, the number of financial professionals with solid understanding of leasing is still relatively low.

There is a specific factor to the Russian market that may in the short to medium term increase the attractiveness of leasing. The Russian banking sector as a whole has a fairly bad reputation, with the possible exception of Sberbank. The Russian financial crisis of 1998, with the associated collapse of many banks, did not endear the sector to most Russians, including businesspeople in the real sector (some of whom had loans ‘called’ for immediate payment).

While this image may be unfair to many of the banks, the fact remains that a large number of Russian businesses are wary of working closely with a powerful banking institution - particularly if getting credit means revealing substantially all of one’s business details. This factor may help leasing companies increase their client base, as expanding businesses may prefer to work with leasing companies.

**EXISTING BANKING RELATIONSHIPS**

As noted above, many small and medium-sized enterprises that have recently concluded leasing deals appear to have no significant banking relationship. «Banking» activities may involve little more than maintaining accounts for payments and minimal deposit accounts. For smaller businesses, a significant amount of payments (for supplies, inventory and the like) may take place in cash or by bank transfer without an account. Since banks show a clear preference for lending to customers of long standing (in Russia, more than three years), the lack of an ongoing banking relationship is also a limitation for receiving bank financing.
While confidence in and use of the banking system is growing, for the smallest lessees (particularly sole proprietorships) a leasing deal may represent the first use of the banking system ever, or the first use of the banking system aside from personal savings accounts.

There may also be a side effect in this case of bringing smaller businesses ‘out of the shadows’, as the Tax Service’s advertisements put it. With the first access to real external financing, firms for the first time may have sufficient incentive to bring their businesses out of the gray market, where firms operate quasi-legally: not breaking any laws, perhaps, but not fully declaring their income, sales or purchases.

**PROBLEMS/ISSUES**

From the perspective of lessees, there are several problems that are often identified with respect to leasing. Most of these problems apply equally to regular bank lending, but they are nonetheless impediments to even further development of the leasing industry. For the most part, the problems identified can be split into two general categories: lack of availability and sector capacity, and legal problems. We will not go into detail about ‘other problems’, which are those that we believe to be specific to a particular lease deal or company but seem to be otherwise unrelated to the industry as a whole. As in any industry - particularly a new one with a legal framework that has changed rapidly - problems occur.

**Availability of Leasing and Lack of Capacity**

While the leasing industry has grown quickly and there is now better availability of credit in general and leasing in particular, the supply is still insufficient. In most regions of Russia (with the exceptions of Moscow and St. Petersburg), there are less than five leasing companies operating - and in a great many regions there are only one or two. Given some degree of specialization between the companies, there is effectively no competition between companies and low availability. Outside of the regional centers, there may be no active leasing companies at all.

In some cases, this is expressed by lessees in the form that the leasing companies are ‘too demanding’. Further analysis sometimes indicates that the leasing companies require a certain approach to the leasing deal that is disadvantageous to the lessee, and the leasing company may not be willing to adapt its approach. This is often the case for questions of insurance or upon whose balance sheet the leased equipment is carried. In our view, this is a direct result of the continuing lack of competition: while leasing companies may be more flexible than banks, they will be able to insist on their own procedures if there are no other organizations able to provide similar services.

A related problem is that lessees (potential or actual) occasionally mention that a given leasing deal was not possible or was long delayed due to difficulties the leasing company itself had obtaining financing. In other cases, leasing companies have limited capacity to finance large deals, and their own equity or lending portfolio may be too small to allow for sufficient diversification with one large lease. These problems have been described in greater detail above, but demonstrate further that there is still substantial room for growth in the Russian leasing industry.
Finally, our conversations with lessees leave out the most important part of the market: those companies that may need credit through leasing but simply do not yet have access to a leasing company. This group includes all ‘potential lessees’, which in theory means most Russian enterprises.

**Legal Problems**

From the lessee’s perspective, the single most frequent complaint is the high guarantee or collateral requirements imposed on potential lessees. Well-informed lessees are increasingly aware that in the West, the leased equipment itself is often sufficient collateral for a lease deal - and that no additional guarantees may be required.

For the reasons outlined earlier, repossession in Russia is considerably more difficult and uncertain than in the West. Secondary markets are also less developed. Given these conditions, it is natural that additional guarantees may be required.

More to the point, in our view this is an inappropriate comparison. A more appropriate analysis is to compare the guarantees required for a lease deal to those required for bank credits, and the important difference is relative, not absolute. Since ownership of the leased asset is the main distinction, we would expect that the guarantees would be lower than where ownership is in the hands of the borrower, not nil.

After all, defending ownership rights may be less difficult than defending the rights of a traditional creditor, but is neither cost-free nor risk-free. Our analysis of the leasing market indicates that while additional guarantees are required for the vast majority of commercial leasing deals, the guarantees required are indeed often considerably lower than for comparable bank credits.

**Other Problems**

Our interviews and meetings also indicate that many other difficulties are consistently raised by lessees, such as taxes, corruption, crime, an uncertain legal system, low demand due to economic problems, problems with local authorities, etc. While we have not done a formal analysis, the great majority of these problems do not appear to be any different than those confronted by any entrepreneur in Russia, and we do not believe they are specific to lessees.
HISTORICAL PERSPECTIVE

**Early Period (late 1980’s to 1994)**

Leasing first appeared in Russia during the Soviet era, when it was used primarily as a means of purchasing ships and aircraft. These transactions, however, were very few in number. In the early 1990s, the first commercial leasing companies began to appear in Russia, most of which were established by commercial banks.


By the mid-1990s, the government, having assessed the potential for leasing and its advantages for the country’s economic development, passed a number of resolutions aimed at supporting the development of the leasing sector. As a result, the market witnessed the emergence of new companies established by financial-industrial groups in order to modernize their production facilities. By 1994, the Association of Russian Leasing Companies, Rosleasing, was established by a group of 15 leasing companies. Today, the number of companies belonging to Rosleasing is over 80, although this membership also includes insurance companies, banks, and other organizations.

The first regulations defining and regulating leasing were Presidential Decree No. 1929 (September 1994) and subsequently Government Resolution No. 633 (June 1995). Each of these documents provided a basic definition and form to leasing deals and contracts, including the general principles of leasing and the rights and obligations of the parties.

The initial development of leasing in Russia was later propelled further by two resolutions passed by the Russian Government. The first, Resolution 1133 (November 1995) declared that a lessee could include lease payments in their cost of production. The second, Resolution 752 (June 1996), stipulated that parties to a lease contract could record accelerated depreciation of leased assets on their financial statements. However, these resolutions were far from comprehensive, and left some key tax and accounting questions unclarified. As government resolutions, there was no guarantee that they would not be contradicted by later regulations or superseded by legislation.

This era marked the emergence of leasing as an industry in Russia. It grew not only in terms of the number of leasing companies, but also in terms of the volume of transactions. In 1995, for example, Rosleasing members concluded transactions totaling 170 billion (old) rubles ($42 million), while in 1996 that figure had grown to 670 billion rubles ($130 million), and in 1997, 2.8 trillion rubles ($476 million). Since 1998, Rosleasing’s figures have shown little change in dollar terms, with a slight decline in 1999 and growth again in 2000 to only $523 million.

**Post-Crisis Industry Consolidation (1999-2001)**

The crisis that occurred in the Russian financial industry following the August 1998 crisis had a profound impact on the development of leasing in Russia. The primary effect was the sudden contraction in long-term funding available from
Russian banks. This resulted in a significant reduction in the number of active leasing companies. As well, according to our estimates, the volume of leasing transactions fell from approximately $1.4 billion in 1998 to a little more than $400 million in 1999.

In spite of the contraction in the market, those leasing companies with experienced and professional management that were not dependent on banks rendered insolvent by the crisis have managed to grow their businesses in the last two years. As a result, we have seen a significant divergence in the market and the growth of a core group of leasing companies taking third-party risk with experienced and professional management. Medium-term bank credits are still rare, and hence the most successful leasing companies have found other sources of capital.

While the growth of these advanced leasing companies was initially driven by their parent-bank's clients, they are now more aggressively pursuing new customers. A high proportion of the lease financing provided by independent leasing companies goes to small and medium-sized enterprises, a portion of the Russian economy that still has substantial room for growth. While the entry point for a leasing company is traditionally motor vehicles, it is also true that as these companies develop confidence in their ability to assess risk, they often begin leasing more complicated manufacturing and productive equipment - often with the same clients on repeat business.

We believe that this is an extremely positive trend for the Russian leasing industry. A number of smaller regional entities have also managed to leverage their experience and expertise to mobilize credit resources in regions further afield than the financial center of Moscow, which should contribute greatly to real productivity growth.
MACRO-ECONOMIC OVERVIEW AND IMPACT ON LEASING

Russia's economic situation continued to improve throughout 2000 and the first half of 2001. GDP growth reached 8.3% in 2000, although it has slowed somewhat since then and is expected to be in the area of 4-5% for 2001 and 3.8% for 2002, according to official Russian statistics. Although official statistics are often questionable, independent analysts confirm that the growth is real - and most importantly, that the growth trend continues. For the first time in well over a decade, substantial growth is occurring for the third consecutive year.

**Russian Economy at a Glance 2000**

| Population | 144.8 million |
| GDP | $251.1 billion |
| GDP (PPP)* | $721.9 billion |
| GDP per head | $1,729 |
| GDP PPP per head | $4,970 |
| Budget spending | $34.0 billion |
| Inflation | 20.8% |
| Current Account Balance (% of GDP) | 18.5% |
| External Debt | $163.0 billion |
| Industrial Production, % Annual Growth | 9% |

* Source: Economist Intelligence Unit

High world prices for oil, Russia’s main export earner, contributed considerably to growth in 2000, and prices remained higher than anticipated for the entire period. The Russian government has hence benefited from a considerable cash inflow to the federal budget, leaving it in the enviable position of having a budget surplus of 2.3% of national GDP. Continued budget surpluses are expected, although this will depend to a large degree on oil receipts.

| Nominal GDP (US$ billion) | 419 | 436 | 282.4 | 193.2 | 251.1 | 306.6 | 345.1 |
| Nominal GDP (US$ billion at PPP) | 616.4 | 634.1 | 610.6 | 653.2 | 721.9 | 781.7 | 822.5 |
| Nominal GDP (Ruble billion) | 2,145.7 | 2,521.9 | 2,741.1 | 4,757.2 | 7,063.4 | 9,019.9 | 10,800.9 |
| Expenditure on GDP (% real change) | -3.4% | 0.9% | -4.9% | 5.4% | 8.3% | 4.5% | 3.8% |

* Source: Economist Intelligence Unit

Imports and exports continued to grow, but petrodollars left Russia with a trade surplus of $61 billion and a current account surplus of $46 billion in 2000.

* PPP: Purchasing Power Parity. This measure is used to adjust for different price and wage levels between countries, particularly for goods that are not traded externally.
Investors - both foreign and Russian - continue to be cautious about investing, and capital outflows are still large, although apparently declining.

Output in most areas of the economy has risen - an encouraging reversal from the seemingly continuous decline of Russian industry throughout most of the 1990s. In all, 2000 industrial production grew 11.9% in 2000, and in the first five months of 2001 by 7.8% (year-on-year). Industrial production is expected to be up by 4% for all of 2001, according to independent experts.

Growth, however, is uneven: Moscow is booming, but growth has been slower to materialize in many regions, and some industrial sectors (such as agriculture and aviation) remain extremely weak. The Russian economy has to a significant degree recovered from the financial crisis of 1998, although in absolute terms it remains smaller since the ruble devaluation has changed the terms of comparison. In purchasing power parity (PPP) terms, the economy has been far less volatile, and declined only slightly in 1998. At present, ongoing worldwide economic conditions - which are far from entirely positive - have not direly affected Russia, although a prolonged slump in oil prices would reduce growth.

«Too Much Money»

The cash inflows from the oil bonanza, however, have also led to inflation being relatively high throughout the period, and over 12% in the first six months of 2001 alone.

Ultimately, inflation in Russia will depend to a large degree on world oil prices: if they remain high, current monetary policies almost directly lead to inflation. Government plans to raise tariffs for household expenses (including gas, heating and electricity) will only add to pressures, and the government will feel considerable pressure to raise pensions, federal salaries and other payments to individuals - money which generally gets spent immediately. The government seems determined to at least rein in this effect by further centralizing tariff regulation.

The underlying cause of the current inflation is undeniably monetary, however. The Central Bank has raised its foreign currency reserves by almost three times since the financial crisis, as non-gold reserves grew to almost $35.3 billion at present from approximately $12 billion in fall 1998. In effect, the Central Bank has been flooding the market with rubles as it purchases dollars from exporters.

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Intl Reserves, $ billion</th>
<th>Exports Total ($ bn)</th>
<th>Imports Total</th>
<th>Trade Balance</th>
<th>Monetary Base, RRuble billion</th>
<th>Nominal GDP, RRuble billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>17.2</td>
<td>81.1</td>
<td>60.8</td>
<td>20.2</td>
<td>103.8</td>
<td>1540.5</td>
</tr>
<tr>
<td>1996</td>
<td>15.3</td>
<td>88.6</td>
<td>68.8</td>
<td>19.8</td>
<td>130.9</td>
<td>2145.7</td>
</tr>
<tr>
<td>1997</td>
<td>17.8</td>
<td>88.2</td>
<td>73.7</td>
<td>14.5</td>
<td>164.5</td>
<td>2478.6</td>
</tr>
<tr>
<td>1998</td>
<td>12.2</td>
<td>74.2</td>
<td>59.1</td>
<td>15.1</td>
<td>210.4</td>
<td>2741.1</td>
</tr>
<tr>
<td>1999</td>
<td>12.5</td>
<td>75.8</td>
<td>39.7</td>
<td>36.1</td>
<td>324.3</td>
<td>4757.2</td>
</tr>
<tr>
<td>2000</td>
<td>28</td>
<td>105.5</td>
<td>44.9</td>
<td>60.6</td>
<td>519.6</td>
<td>7063.4</td>
</tr>
<tr>
<td>1.2001</td>
<td>29.6</td>
<td>8.4*</td>
<td>5.2*</td>
<td>5.2*</td>
<td>488</td>
<td></td>
</tr>
<tr>
<td>6.2001</td>
<td>35.1</td>
<td>9.1*</td>
<td>4.5*</td>
<td>4.6*</td>
<td>583.1</td>
<td></td>
</tr>
</tbody>
</table>

* Source: Economist Intelligence Unit; * - monthly figures.
The Central Bank still largely lacks the tools required to sterilize dollar inflows, since domestic debt markets are close to non-existent. Indeed, there are few tradable financial instruments of any kind available at present, and there are only two liquid financial instruments in wide use: the dollar and the ruble, both of which are declining slowly in value. For many Russian firms and almost the entire population, the dollar and the ruble are the only liquid instruments with which to hedge against inflation.

In the meantime, the government has relaxed the requirement that 75% of foreign currency earnings be sold to the Central Bank for rubles. This rate will fall to 50% in January 2002, which should reduce the rate of increase in the money supply.

Since the ruble has declined slowly in value against the dollar while prices have risen, the ruble gained 9% over the dollar in 2000 in real terms, and the trend has quickened since then. This real appreciation of the ruble has already had an effect in the real economy, with export growth slowing and import growth accelerating - a particularly noticeable trend in recent months.

Although Russian manufacturing is still in poor shape, the primary cause is not relative exchange rates. Russian manufacturers are uncompetitive internationally due to poor quality, under-developed domestic markets, and capital equipment that is out of date or simply unsuited to the new economy.

Despite these pressures, year on year growth of fixed capital investments at large and medium-sized enterprises was 12%. Total investment (nominal spending on construction and equipment) grew by 17.3% to represent roughly 18% of GDP, or $46 billion. Most of this growth in investment by companies is financed using retained earnings (50%); bank credits represent only 4%, and other non-budgetary credits 6%. These numbers are inexact, however, as a large proportion of profits and investments are unaccounted in official statistics for tax reasons or because the smallest enterprises are simply not captured. Total commercial bank credit outstanding to enterprises and organizations in March 2001 increased by 3% and equaled 808 billion rubles, or roughly $28 billion. The great majority of funds are loaned for terms of less than a year, however: only 10% of bank loans have terms of longer than twelve months.

**Microeconomic Developments and the Macroeconomy**

On the microeconomic side, the government has outlined an impressive plan for reform in several major sectors. The electricity sector, the housing sector, land sales, tax policy, telecommunications and - eventually - perhaps even the natural gas industry will face major changes over the next five to ten years. While one might dispute any of the plans on specifics - the devil is, of course, in the details and the implementation - the will to tackle the major outstanding reform issues appears increasingly to exist.

The financial sector remains extremely weak and uncertain. Most banks still suffer major liquidity problems, and a serious term mismatch between lending requirements and funding availability. Many banks have little more than short-term or demand deposits available for lending, and little or no funds available for loans of any long-term nature. This situation is unlikely to change dramatically in the near term.
The bleak-sounding description above understates the extent of the changes occurring in recent years, however. One of the key elements of the slow evolution of the Russian economic environment is the development of small and medium-sized enterprises, particularly those closer to the consumer, for which reliable figures do not exist (Goskomstat's collection procedures are geared to larger enterprises). In industries where cash payment is predominant and the products are retailed quickly, cash is filtering through to the lower levels of the economy. Examples include brewing, food processing, and light industry. This change is also reflected in the cash share of demand, which has grown to 73% of all revenues from below 50% in 1999.

The growth of small and medium-sized enterprises in Russia has been extremely slow compared to the more dynamic economies of Central and Eastern Europe but is gaining momentum. The growth and impact of small and medium-sized enterprises (SMEs) has a cumulative effect in addition to the immediate effects, and while the absolute number of SMEs is still relatively small, it is nonetheless much larger than years before. Statistics show steady growth in the formation of new businesses.

In addition, the government and the State Duma are cooperating on an extensive program of ‘de-bureaucratizing’ the Russian economy, with important measures such as reducing licensing requirements. While de-bureaucratizing the Russian economy is an enormous and difficult task with a high potential for disappointment, it also holds the potential to unlock more entrepreneurial potential than perhaps any other reform.

**The Effects of Reform on the Leasing Industry**

From the perspective of the leasing industry, tax policy holds the greatest chance of improving the current leasing environment. Recently adopted amendments to the Tax Code reduce the profit tax from 35% to 24% and eliminate many of the current tax breaks and subsidies while introducing tax deductions that are common in most other places in the world, such as insurance, advertising and interest expenses.9

This change in the marginal profit tax rate overstates the change in the corporate tax burden (which is variously estimated at between 15% to 25%) due to the prevalence of tax or other ‘advantages’ - that is, subsidies. These advantages are highly inefficient and result in highly volatile effective tax rates, as they vary tremendously by industry and other factors. These variable tax rates also effectively discriminate against SMEs, as they have fewer administrative resources with which to take advantage of these variable subsidies.

The changes to the Tax Code as adopted by the State Duma in July 2001 will almost certainly improve the business environment, although not evenly. For example, allowing the deduction of interest expenses will reduce the relative advantage that leasing enjoys over bank lending - although this is by no means a bad thing.

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9 In practice, some of these expenses were deductible, but often with fairly specific and unworkable limitations.
The LDG has been involved in a process that should lead to amendments to the current Law on Leasing, although the Duma has not yet considered these draft amendments in second reading. All industry participants are in agreement that the Law must be changed to reflect considerable problems in analyzing and managing the legal risk of leasing transactions. While existing leasing companies have generally learned to work within the present legal framework, the problems continue to act as a significant barrier to greater participation on the part of other investors. Until these problems are solved, access to finance for Russian leasing companies from international financial institutions, suppliers, international banks and export credit agencies will continue to be limited.

Problems enforcing specific aspects of the current regulatory environment still frequently occur, but a more solid body of instructions from the federal ministries and agencies and court decisions now exists. Using this framework, leasing companies now face a lower likelihood of arbitrary decisions from the government, the tax police or from regional authorities, and - if obliged to take legal action to defend their rights - now stand a better chance of winning in court.

**Remaining Obstacles to Development of the Leasing Industry**

Several major obstacles will continue to limit the development of the leasing industry in future even after the adoption of amendments to the current Law on Leasing. First, credit is extremely limited in Russia, and improvement in this area depends on the entire Russian economy and development of the domestic banking and financial system. In the meantime, we expect to see continued involvement of government and quasi-government activities in the leasing sector - particularly in 'strategic' industries, such as agriculture, aircraft and, to a far lesser degree, support for small and medium-sized enterprises.

Second, leasing companies still face considerable difficulties in repossessing equipment in the case of default. With relatively few exceptions, lessors do not yet trust the court system to defend their ownership rights. The current legal system and court practices, which tilt the balance of protection in favor of debtors, have the perverse and unintended effect of reducing credit availability to all potential borrowers. Improving the confidence of lenders (including and especially lessors) that their rights will be protected will remain a key to unleashing further credit growth.

Third, the leasing industry itself is still relatively small, lacks sufficient trained professionals, and the leasing mechanism is not well understood by potential lessees (that is, all businesses and business people). This is one area of major activity of the Leasing Development Group, which runs training programs and seminars throughout the country. The LDG has trained a large number of leasing company professionals, and is shifting its emphasis to 'leasing for lessees'.

Fourth, the equipment leasing market is also seriously constrained by the lack of secondary equipment markets. This further constrains leasing since neither lessee nor lessor is willing to place any faith in the residual (or resale) value of the equipment leased. Until a proper resale market develops, lessees will be prevented from realizing the full benefits of leasing.
This will be the most long-term change of all, since secondary markets are traditionally amongst the last parts of the leasing market to develop. In addition, the tremendous pace of technological change in Russia as old equipment is replaced (often piecemeal due to cash flow constraints) means that predicting future market prices for equipment is more of a black art than a science. Some suppliers in Russia have begun to address this difficulty by providing ‘buy-back guarantees’ to Russian leasing companies, in this way sharing a portion of the risk.
OVERVIEW OF THE RUSSIAN CREDIT MARKET
(INCLUDING BANKS AND SUPPLIERS)

HOW DO COMPANIES (LESSEES/POTENTIAL LESSEES) FINANCE ASSET PURCHASES

By far the most significant source of capital for asset purchases in Russia is retained earnings, followed by equity contributions. The credit market is simply insufficiently developed to finance the immense quantities of capital required. Despite this severe constraint, investment in Russia is estimated at 18% of GDP, compared to the 10-15% typical in OECD countries.

Since almost all companies will eventually reach the point where internal resources are insufficient to capitalize on opportunities available, this is a major constraint on company growth. From a corporate finance perspective, of course, it is also often inefficient to finance growth entirely from internal equity.

For small and medium-sized enterprises, being limited to internal equity alone is a larger obstacle. As a simple example, a business that needs a $10,000 truck but currently has only $1,000 in annual profits may never have sufficient retained earnings to purchase the vehicle - even if it were to contribute an extra $10,000 in free cash flow annually. In other words, internal equity is insufficient because it may be completely decoupled from the profitability of the project.

In our discussions with lessees, two key aspects of bank loans are consistently mentioned as effectively ruling out this source of finance for many of them. Lessees confirm that the shortage of credits available for bank lending for anything longer than a year is a major limitation.

Lessees also consistently note that the credit, collateral and payment requirements established by leasing companies are considerably more flexible and less cumbersome than those available at banks.

As an example, one key difference that can arise is the amount and form of collateral or guarantee required. While difficulties in repossession and the lack of secondary markets mean that the leased equipment is often not - in contrast with the West - sufficient collateral, the form and size of the additional collateral required may be lower for a lease than for a loan.

In this respect, we see considerable use by leasing companies of a wide form and variety of collateral or repayment guarantees. Some of these - such as a personal guarantee by an enterprise owner - may not be sufficient for a bank, but acceptable for a leasing company's internal purposes.
APPETITE OF SUPPLIERS (FOREIGN AND DOMESTIC) TO FINANCE EQUIPMENT PURCHASES

Equipment suppliers form an important source of financing for enterprise finance, both in Russia and in the West. In part, this reflects the key advantage suppliers have in bearing equipment risk and in establishing or working within secondary equipment markets. Indeed, some of the largest financial companies in the world - let alone leasing companies - began as house financiers to large equipment suppliers (GE Capital, General Motors Acceptance, Boeing's aircraft leasing subsidiary); in some cases, the financial business contributes more to the annual profits of such conglomerates than the manufacturing business.

In Russia, however, the way in which suppliers finance equipment purchase is far less straightforward - and makes less use of leasing than is the case for their Western counterparts. The key difference in the last ten years has been the prevalence of barter or other non-cash or cash substitute deals. Since barter usually includes some premium over the cash-equivalent price paid for equipment, barter deals imply some kind of finance by the supplier for payments made in kind. In essence, the barter deal involves a finance component since the supplier must accept payment delays and a new type of product risk until the goods received in barter are converted into cash.

Other forms of equipment finance that have been common in Russia have been payment in Veksels (corporate promissory notes), often at a significant discount, payment in tax offsets, payment in other supplies and other novel payment schemes. In recent years, Russian companies have moved progressively to more cash-oriented payment schemes, and the percentage of corporate transactions involving barter has fallen precipitously in the last five years (with a significant but short-lived ‘bump’ in barter after the August 1998 financial crisis).

Foreign suppliers (with the exception of other CIS countries) demonstrate far less willingness to participate in these forms of equipment finance. The overhead and uncertainty of these deals are such that they usually do not pay for non-resident companies. Even normal trade credit is far less common, with a large number of business deals involving most or substantially all payments - including for equipment - up-front or on delivery. This represents a tremendous cash outflow for the purchaser, particularly in cases where equipment will take some time to be installed or become productive. Even large companies are not immune to cashflow restrictions that make outright purchase of equipment problematic or at least costly.

Nonetheless, credits on the purchase of equipment or other changes to typical payment terms are relatively common. Typical changes include discounts for up-front payment or some delay in payments.

We have seen increased willingness on the part of suppliers to accept some counterparty risk from leasing companies or to provide other forms of equipment finance, particularly in conjunction with other lenders. In several cases, suppliers have provided ‘buy-back guarantees’ for either the end of the lease or, in case of repossession, reducing substantially the equipment risk for the leasing company.
There is still considerable reluctance, particularly on the part of foreign suppliers, to provide much in the way of equipment finance to leasing companies (or most other purchasers). Suppliers that show some flexibility - however minor - in terms of providing somewhat more flexible payment schedules can make the conclusion of a leasing deal far more likely. Since Russian leasing companies also suffer from capital constraints but have far more diverse cashflows than lessees, they may represent considerably less risk than lending directly to the purchaser.

Suppliers are showing increasing interest in working with leasing companies, since they can usually pay far more quickly than end-users and have access to their own sources of credit. Leasing companies are usually able to pay up-front for a much larger proportion of the total purchase cost than a lessee (who typically pays an advance payment of 25-35%), reducing the non-payment risk substantially for any supplier credits granted.

**PROJECTED ANNUAL CAPITAL REQUIREMENTS**

By far the most significant source of capital for asset purchases in Russia is retained earnings, followed by equity contributions. The credit market is simply insufficiently developed to finance the immense quantities of capital required. Despite this severe constraint, investment in Russia is estimated at 18% of GDP.

This does not tell the whole story, however. The requirement for private-sector investment in Russia is considerably higher than this figure would indicate. In addition, there is immense demand for investment in new productive activities or in entirely new enterprises.

Nonetheless, one can get an idea of the immense investment required by looking at a few specific sectors. In the agricultural sector alone, investments required in the next five to ten years are estimated in the hundreds of billions of rubles (tens of billions of dollars) simply to maintain current production levels. Agricultural machinery is now being renewed at a rate of less than one percent a year. Estimated annual losses of grain due to insufficient or unavailable harvesting machinery are in the area of 10 million tonnes a year. In addition, at least 10% of the annual grain harvest is lost because current harvesting machinery is significantly less efficient than the Western equivalents. Since the harvest in 2001 is expected to total around 65 million tonnes, the combined losses due to insufficient or poor-quality equipment are (to say the least) significant.

The situation is similar in the electricity generation and distribution sectors. A 1999 study by United Energy Systems (UES) claims that half of the current stock of turbo-generators used in thermal power generation (64% of Russian electricity) are over 25 years old, the normal service life. Similarly, over 60% of hydro-electric turbines of 50MW and higher capacity are over 25 years old, and hydroelec-

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10 While analyzing 'demand' in the absence of price is economically questionable (strictly speaking, one should only look at demand at a given price level), there is no doubt that much of Russia's current capital base needs to be renewed and that the low availability of credit is a more significant issue than price (the interest rate).
Electric power is 19% of national electricity production. Since much of the balance of electricity output is made up of nuclear plants, which may or may not be replaced, the requirements for investment are large - even if Russia were to cut back on electricity exports to neighboring countries.

Separate from the purely private sector demand for investment in productive capacity, but related, are requirements for infrastructure (roads, utilities, residential housing, etc). These requirements are often overstated, but nonetheless are estimated in the hundreds of billions of dollars. Since total outstanding bank lending at present is on the order of only $30 billion (see below), with bank funds withdrawn from the real sector outweighing those given back in the form of loans, current credit available is clearly insufficient. While infrastructure investment may come primarily from the public sector, this work will largely be contracted out to private firms that will require equipment.

CREDIT AVAILABLE, CREDITS TO ENTERPRISES AND LOAN TERMS

The lending market has seen considerable growth in 1999-2000, with much more lending now concentrated on lending to businesses and consumers - that is, it is no longer dominated by lending to the federal government on the GKO (treasury bill) market. The market is miniscule compared to Western economies, however, and while growth is high, it will take some years of fast growth for credit markets to begin to rival those of more developed economies.

The consumer bank lending market has grown almost three times in the last year, with consumer loans outstanding reaching 76 billion rubles (approximately $2.5 billion) in June 2001. Considering that lending rates are still comparatively high (from 25-35% for ruble loans, 14-20% for dollars), the appetite for borrowing is clear. It is estimated that half of the consumer lending market is currently Moscow-based. Banking industry sources have informally indicated to us that a large portion of 'consumer' lending - for some banks as much as 60% or more - may be intended for commercial purposes, but borrowed by individuals.

Perhaps even more significant is that a great deal of this lending is from smaller banks plus Sberbank. The larger banks - which with a few exceptions tend to be linked to large financial-industrial groups - still concentrate their lending activities on group members. In contrast to 1998, the lack of highly profitable lending to the government is beginning to force the banking sector to seek other revenue sources, and the diversification provided by lending to individual clients is another motivating factor.

Total bank lending has also grown, but is still relatively limited. For example, the top twenty banks in Russia had, as of April 1, 2001, approximately $34 billion in outstanding assets in loans - more than half of which is accounted for by Sberbank and Vneshtorgbank. Only seven banks had loan portfolios totaling more than $1 billion, and less than forty of the top 100 banks have loan portfolios of more than $100 million.

An even more important issue than the amount of money lent by banks is the loan terms available. Only 10% of bank credits are for periods longer than one year, and
the average loan term is less than six months. The vast majority of loans are also made only to clients with whom the banks have had relatively long-term relationships, restricting credit available to small and medium-sized enterprises further.

<table>
<thead>
<tr>
<th></th>
<th>Ruble Loans</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(millions of rubles)</td>
<td></td>
</tr>
<tr>
<td><strong>Sberbank</strong></td>
<td>47,235,538</td>
<td>305,630,212</td>
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<tr>
<td><strong>Vneshtorgbank</strong></td>
<td>44,615,916</td>
<td>82,999,602</td>
</tr>
<tr>
<td><strong>Gazprombank</strong></td>
<td>16,697,436</td>
<td>48,350,854</td>
</tr>
<tr>
<td><strong>Alfa-Bank</strong></td>
<td>22,582,904</td>
<td>42,138,558</td>
</tr>
<tr>
<td><strong>International Industrial Bank</strong></td>
<td>26,153,285</td>
<td>48,357,785</td>
</tr>
<tr>
<td><strong>International Moscow Bank (MMB)</strong></td>
<td>2,870,090</td>
<td>46,229,592</td>
</tr>
<tr>
<td><strong>Surgutneftegazbank</strong></td>
<td>1,017,891</td>
<td>1,451,027</td>
</tr>
<tr>
<td><strong>Trust and Investment Bank</strong></td>
<td>3,376,196</td>
<td>23,286,057</td>
</tr>
<tr>
<td><strong>Bank of Moscow</strong></td>
<td>3,484,606</td>
<td>22,144,534</td>
</tr>
<tr>
<td><strong>Rosbank</strong></td>
<td>7,279,214</td>
<td>27,561,202</td>
</tr>
<tr>
<td><strong>SBS-Agro</strong></td>
<td>(44,601,403)</td>
<td>36,681,064</td>
</tr>
<tr>
<td><strong>Citibank</strong></td>
<td>3,498,528</td>
<td>20,156,027</td>
</tr>
<tr>
<td><strong>MDM Bank</strong></td>
<td>4,382,523</td>
<td>18,741,463</td>
</tr>
<tr>
<td><strong>Bashkreditbank</strong></td>
<td>3,951,710</td>
<td>13,105,893</td>
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<td><strong>Industrial-Construction Bank</strong></td>
<td>2,047,736</td>
<td>14,249,180</td>
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<tr>
<td><strong>Menatep St. Petersburg</strong></td>
<td>2,657,050</td>
<td>12,771,534</td>
</tr>
<tr>
<td><strong>Rossisky Kredit</strong></td>
<td>(24,817,010)</td>
<td>15,992,516</td>
</tr>
<tr>
<td><strong>Raiffeisenbank</strong></td>
<td>1,207,260</td>
<td>16,101,491</td>
</tr>
<tr>
<td><strong>Petrokommerts</strong></td>
<td>1,457,971</td>
<td>7,374,885</td>
</tr>
<tr>
<td><strong>Avtobank</strong></td>
<td>1,658,173</td>
<td>10,052,731</td>
</tr>
</tbody>
</table>

**Source:** Kommersant-Bank, 23 August 2001

**Although overall lending has grown relatively quickly since December 2000, and even more dramatically in 2000, corporate lending stayed relatively stable in 2001. Other lending - personal loans and interbank lending - has grown far more quickly.**

**Ruble Loan Tenors**

Ruble Loans (millions of rubles), of which by maturity:

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Loans</th>
<th>Corporate Loans</th>
<th>up to 30 days</th>
<th>31 to 90 days</th>
<th>91 to 180 days</th>
<th>181 days to 1 year</th>
<th>1 to 3 years</th>
<th>more than 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999.12.31</td>
<td>292,715</td>
<td>244,320</td>
<td>19,865</td>
<td>18,570</td>
<td>29,270</td>
<td>98,093</td>
<td>34,104</td>
<td>27,629</td>
</tr>
<tr>
<td>2001.31.03</td>
<td>661,253</td>
<td>539,479</td>
<td>63,299</td>
<td>40,225</td>
<td>92,515</td>
<td>224,577</td>
<td>72,318</td>
<td>36,151</td>
</tr>
</tbody>
</table>

**Source:** Bank of Russia

**Despite the outward signs of increased stability, the proportion of lending longer than one year has remained virtually unchanged in 2000-2001. Surveys of banks usually show that less than 10% of lending is for terms longer than one year.**
## Foreign Currency Loan Tenors

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Loans (millions of rubles)</th>
<th>Corporate Loans (millions of rubles)</th>
<th>up to 30 days</th>
<th>31 to 90 days</th>
<th>91 to 180 days</th>
<th>181 days to 1 year</th>
<th>1 to 3 years</th>
<th>more than 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999.12.31</td>
<td>304,097</td>
<td>200,870</td>
<td>7,832</td>
<td>10,375</td>
<td>16,802</td>
<td>50,122</td>
<td>49,065</td>
<td>47,057</td>
</tr>
<tr>
<td>2000.12.31</td>
<td>367,953</td>
<td>255,963</td>
<td>9,859</td>
<td>8,777</td>
<td>19,930</td>
<td>75,929</td>
<td>69,781</td>
<td>58,088</td>
</tr>
<tr>
<td>2001.31.03</td>
<td>406,257</td>
<td>268,586</td>
<td>7,596</td>
<td>11,284</td>
<td>23,782</td>
<td>78,598</td>
<td>72,050</td>
<td>60,108</td>
</tr>
<tr>
<td>2001.30.06</td>
<td>421,295</td>
<td>280,142</td>
<td>4,840</td>
<td>10,584</td>
<td>27,574</td>
<td>90,798</td>
<td>75,244</td>
<td>55,392</td>
</tr>
</tbody>
</table>

Source: Bank of Russia

### Longer-term lending is more often in foreign currency terms than in ruble terms, an indication that the market is still concerned about the long-term stability of the ruble.

Even more of a limiting factor is the small number of banks with significant sums on deposit: only six banks have deposit bases of more than $1 billion. Only two banks (again, Sberbank and Vneshtorgbank) have capital of more than $1 billion, and only 15 have capital of more than $100 million. While the Russian banking market has many more banks than many other economies (up to 1200 at present), the great majority of these are tiny by international comparisons.

To put some numbers to these figures by way of comparison, Canada has one bank with over $180 billion in assets, $130 billion in deposits and $8 billion in equity. The Canadian banking sector has roughly $1 trillion in domestic assets held by banks, and roughly half that amount in both outstanding loans and deposits. All of the top six banks had assets of at least $50 billion, although it is worth noting that the Canadian banking sector is highly concentrated.

On this scale, even the relative Russian giant of Sberbank looks like a relatively small international bank. The assets of the entire Russian banking sector - numbering slightly less than 1500 banks - totaled under $100 billion and total equity under $18 billion in August 2001, according to *Ekspert* magazine.\(^1\)

## NON-COMMERCIAL OR MIXED-SOURCE CREDIT

The Russian leasing market, as is the case for lending and financing of industry in general, is distinguished by some fairly sharp differences with those of other countries. In leasing as in other areas of enterprise finance, the specific industry, location, and size of the corporation can change the credit picture dramatically. Access to commercial credit is severely restricted throughout the country, but particularly in certain regions and industries.

Where a particular industry or even company is particularly important and where credit is close to non-existent, governments (whether federal, regional or municipal) have often stepped in to help ease the company or industry over a rough

\(^1\) *Ekspert*, 17 September 2001.
To the extent possible in this study, we have concentrated our efforts on the commercial leasing industry - that is, leasing companies that work on a purely commercial basis. This is easier said than done, however: a number of leasing companies have some measure of state participation, although often quite minimal or nominal in nature. In some specific industries, though, state support may dominate, and this is particularly true of the agricultural and aviation leasing industries.

As a leader in the Russian agricultural leasing market put it, «only companies with state or regional budget support can work successfully in the agricultural sector.» While we do not necessarily agree with this formulation, it is clear that state support of the agricultural sector will continue to dominate in the medium term. Our various survey results show that few commercial leasing companies are willing to work in the agricultural sector.

In practice, we do not apply the test of ‘commercial leasing’ in carrying out this study, although most of our survey respondents are commercial leasing companies. Various levels of government believe that there is a market failure in the classic economic sense, and have chosen to use one of the available tools (leasing) to help correct for it. The LDG invests its time and effort in supporting leasing as a commercial credit instrument, but we also recognize that - as a flexible tool - it may also be useful in other circumstances.

More importantly, it is our belief - and market trends support this assertion - that even government-supported lease deals will become increasingly commercial in nature. If the typical agricultural lease or credit of two to three years ago was essentially a pure grant since the lease or agricultural credits were rarely repaid, we expect that more agricultural loans in future will be commercial in nature. At present, we see some evidence that agricultural leases are being granted on increasingly strict credit terms - and the loans and leases are more often expected to be paid back.

**BANKS’ ATTITUDE TO LEASING**

Banks have a crucial role to play in the leasing industry. Banks will inevitably be a significant source of lease financing (either directly or indirectly), and provide the lending product that is most directly comparable, the bank loan. That said, Russian banks increasingly understand the importance of leasing and that in many respects it complements the lending products provided by commercial banks. One of the consistently surprising comments we hear from lessees is that bank lending officers referred them to unrelated leasing companies or simply asked their clients «have you considered talking to a leasing company?»

Banking involvement in the leasing industry in Russia could involve several different forms, but to date the primary involvement has been by using affiliated
leasing companies. These affiliated companies usually involve some ownership stake by the bank, and in many cases we believe this amounts to a controlling stake. There are many banks, however, that have little or no direct involvement in the leasing sector. Banks are also restricted to lending no more than 25% of their equity to any one lender, including affiliated leasing companies.

Banks that have been involved tend to understand well the advantages of leasing for their clients. Lending decisions are sometimes effectively made by the bank, with the bank credit department itself often being used to evaluate the creditworthiness of a client. In other cases, however, the affiliated leasing companies (at least those that are not simply paper subsidiaries) have some additional leeway to conclude leasing deals, although funds available are generally as limited as with the banks themselves.

Independent leasing companies do borrow from commercial banks, however, despite the limitations in funds available and the conservative approach of banks. In a survey carried out by the Leasing Development Group, over two-thirds of leasing companies responding reported having received financing from unrelated banks. The major constraint on this type of lending remains the term mismatch between the funds available to banks and the requirements of leasing companies, who need loan terms as close as possible to the lease agreements (two to five years).

Commercial banks also provide funds to leasing companies to fund specific deals, particularly when the banks are already familiar with the lessee. In such cases, there is usually some additional bank guarantee, such as all lessee funds being held at the bank and all cash flows passing through the bank's accounts.

While bank involvement is still relatively low, there is increased awareness of the advantages of leasing for both the leasing company and the lessee. As long as leasing remains an attractive option compared to bank lending, we expect banks to make increased use of affiliated leasing companies. In this sense, they perceive leasing to be a viable, alternative financial instrument that avoids the complications of obtaining collateral and guarantees through normal bank lending.

**AVAILABILITY OF TWO TO THREE YEAR MONEY**

A significant proportion of leasing companies use initial capital contributions by owners of the leasing companies and retained earnings to finance at least some of their lending. This is primarily due to the extreme shortage of two to three year money at fixed rates available to leasing companies from the banking sector. Since leasing deals are usually fixed-rate, this is a severe constraint on the growth of lease financing. Nonetheless, most leasing companies surveyed by the LDG indicate that they receive at least a portion of their financing from banks, and over 60% receive financing from unconnected banks - that is, banks that are not investors in the leasing company.

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12 Russian Academy of Sciences study (IMEMO), cited in Ekspert Oborudovanie, 8 August 2001.
The shortage of medium-term money is not simply the result of reluctance on the part of banks or other lenders, as the number of leasing companies receiving some bank financing shows. The banking sector itself suffers from severe capitalization constraints, and bank funds from depositors are both small and extremely short-term.

As an example of the severe shortage of long-term money, a recent survey of banks and companies demonstrates the difficulties faced. The average term of loans to companies was only 5.4 months, and only 10% of bank credits reported were for terms of more than one year (all figures as of Q2 2001). The banks surveyed expected this figure to grow to only 11% by October. Total loans and credits from banks were only expected to grow by 3-4% in the next six months. Perhaps even more crucially for potential lessees, 74% of credits were to companies with which the banks had worked for more than three years, with over half of loans to clients of more than five years.

To the extent commercial banks have a deposit base held for any length of time, these deposits are almost all essentially demand deposits - meaning that lending for longer periods is risky. There has been encouraging growth in household deposits in Russian banks, which have grown by roughly 9% annually to April 2001. As a proportion of the monetary base, however, bank deposits have actually fallen. Finally, many Russian bank funds are held not even as demand deposits, but as payments awaiting transfer: a number of Russian banks appear to survive primarily as payments-processing banks.

The one large exception to the above constraints is Sberbank, the state savings bank, which is largely owned and effectively controlled by the Central Bank. Since Sberbank benefits from a de facto government guarantee on its deposits, and since it remains the ‘bank of last resort’, Sberbank is perhaps the only bank able to rely on a relatively stable deposit base in the event of a crisis. Sberbank’s own funds availability, while massive compared to competitor banks, is still small in relation to the size of the Russian economy. In addition, while Sberbank has several related leasing companies, these activities are still small in relation to Sberbank’s size and tend to focus on larger leasing deals. If Sberbank does decide to focus on leasing, it could change the sector considerably, simply by using its impressive near-universal presence throughout Russia and the funds at its disposal. This is unlikely, however, for a variety of reasons.

In sum, two to three year credit availability is extremely low, a situation which will improve only slowly as the economy improves, as the Central Bank and the government introduce new, reliable financial instruments, and as the banking system is reformed and strengthens.

The ability of leasing companies to leverage their financial base to a fairly high ratio, however, means that the funds available to the leasing industry to deploy in credit operations will have a greater effect on the economy than would seem to be the case. In addition, even ‘slow’ growth in the availability of mid-term funds in absolute terms could result in spectacular growth in percentage terms.
BREAKDOWN OF RUSSIAN OWNED BANKS AT DIFFERENT ASSET LEVELS

<table>
<thead>
<tr>
<th>Bank</th>
<th>Capital (Thousands of rubles)</th>
<th>Total Assets (Thousands of rubles)</th>
<th>Capital (Thousands of dollars)</th>
<th>Total Assets (Thousands of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sberbank</td>
<td>47,587,555</td>
<td>507,268,014</td>
<td>1,640,950</td>
<td>17,492,000</td>
</tr>
<tr>
<td>Vneshtorgbank</td>
<td>45,334,055</td>
<td>140,445,086</td>
<td>1,563,243</td>
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<td>International Industrial Bank</td>
<td>26,354,111</td>
<td>71,840,924</td>
<td>908,762</td>
<td>2,477,273</td>
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<tr>
<td>Alfa-Bank</td>
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<td>70,343,081</td>
<td>712,846</td>
<td>2,425,623</td>
</tr>
<tr>
<td>Gazprombank</td>
<td>16,187,943</td>
<td>81,830,570</td>
<td>558,205</td>
<td>2,821,744</td>
</tr>
<tr>
<td>Rosbank</td>
<td>7,657,785</td>
<td>41,579,525</td>
<td>264,062</td>
<td>1,433,777</td>
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<tr>
<td>Globeks</td>
<td>5,085,207</td>
<td>13,412,889</td>
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<td>462,513</td>
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<td>MDM Bank</td>
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<td>3,583,994</td>
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<td>123,586</td>
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<td>National Reserve Bank</td>
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<td>453,242</td>
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<td>8,562,235</td>
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<td>295,249</td>
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<tr>
<td>Bank of Moscow</td>
<td>2,265,813</td>
<td>42,278,555</td>
<td>78,131</td>
<td>1,457,881</td>
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<td>Guta Bank</td>
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<td>71,268</td>
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<td>Evrofinance</td>
<td>1,899,530</td>
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<td>Dow &amp; Invest. Bank</td>
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<td>48,456,039</td>
<td>64,842</td>
<td>1,670,898</td>
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<tr>
<td>Menatep St. Petersburg</td>
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<td>1,725,693</td>
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<td>59,507</td>
<td>98,968</td>
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</tbody>
</table>


BANKS’ ATTITUDE TO LEASING, EITHER DIRECT OR INDIRECT VIA LOANS TO LEASING COMPANIES

The main problem with the attitude of banks (and other potential lenders to the leasing industry) relates to weaknesses in the legal system. Primarily, it remains difficult - if not impossible - for companies (including banks) to rely upon the court system to enforce valid claims. Banks and other lenders therefore rely to a high degree on some form of company control - whether this is by outright ownership, control of management, or control of the company cash flows.

This requirement is becoming less absolute, however, as companies establish longer track records of cooperation with their banks and reputations that show them to be ‘creditworthy.’ Leasing companies have not been excluded from this trend, but the characteristics of the leasing business - high leverage, dependence on management, etc. - and their need for relatively large quantities of funds mean that they must demonstrate even higher reliability and trustworthiness than typical borrowers.

The best leasing companies have responded by opening their books, running their businesses extremely carefully and cautiously, diversifying their client base, and by working closely with their banking partners. These are, in fact, the
same criteria that IFC's investment departments use to evaluate potential partners in the leasing business.

Having noted all of the above, the severe shortage of medium-term funds is the primary constraint on further bank funding.

GOVERNMENT FINANCING OF THE LEASING INDUSTRY - TYPES OF GOVERNMENT

In broad terms, ‘government’ involvement in the leasing industry can be categorized in several different ways. Important distinctions are the level of government, the type of activity, and the industry involved. Each of these distinctions will tend to overlap with the others, as shown below.

Government activity in leasing (apart from legislative and regulatory activities) can be broken down into federal, regional and municipal levels. At the federal level, the government tends to get involved in leasing deals mainly by providing long-term credits to strategic industries. The aviation and agricultural industries are the prime recipients of government support in this area. We should note that while there may be some cross-border ‘leasing’ of military equipment, we have not taken account of any non-commercial leasing of this type for this market survey.

At the regional level, the situation is similar, but more restricted: many regions have used leasing as a means of providing credits to agricultural enterprises, and sometimes to support important local industries. For example, some regional governments have provided credits to leasing companies to assist in sales from an important local factory.

In other cases, regional administrations have formed local leasing companies to increase credit availability to local enterprises. While support for small and medium-sized enterprises may appear to be an unnecessary government program and possible competition for the commercial leasing industry, we have found that the presence of such a company is a good indication of the local or regional government’s support for leasing - which can translate into a friendly environment for commercial companies. The amounts of government funds involved are also usually quite small, and insufficient to distort the credit markets.

As for competition from government-supported commercial leasing companies, there is currently such low competition in most regions that this is not a serious concern. The government-sponsored leasing companies also usually have low enough capital bases that they welcome the arrival of a commercial leasing company, which can help their customers ‘graduate’ to larger leasing deals. The government-sponsored leasing companies are not, at present, a significant source of revenue for the government, and hence there is little reason for the government to fear commercial competition.

At the municipal level, activity has been less noticeable. Nonetheless, some municipal administrations have taken small steps such as forming local leasing
companies and assisting in providing credit to local enterprises (often on the basis of a local initiative to support small and medium-sized enterprises).

Despite all of the above, there have been some encouraging signs. We have noted a trend on the part of regional governments to lend on an increasingly commercialized basis. In other words, they are now lending with the expectation of being repaid, and with interest actually being charged (although perhaps at less than market rates). Russian food processors - at least some of them - are now in increasingly good fiscal shape, with barter payments falling steadily, and they are beginning to work with successful farms to ensure a steady supply of their primary inputs.

In both cases, the situation has changed from some years before. Most importantly, there is now the prospect of finding a commonality of interests with regional governments as regards leasing and lending in general, even to the agricultural sector. The imperative from the government perspective is often to reduce budgetary spending for agricultural support (as the sector has begun to recover on its own) and to increase the impact by providing support only to those producers that have begun to improve their operations.
OVERVIEW OF THE RUSSIAN CREDIT MARKET (INCLUDING BANKS AND SUPPLIERS)

HOW DO COMPANIES (LESSEES/POTENTIAL LESSEES) FINANCE ASSET PURCHASES

By far the most significant source of capital for asset purchases in Russia is retained earnings, followed by equity contributions. The credit market is simply insufficiently developed to finance the immense quantities of capital required. Despite this severe constraint, investment in Russia is estimated at 18% of GDP, compared to the 10-15% typical in OECD countries.

Since almost all companies will eventually reach the point where internal resources are insufficient to capitalize on opportunities available, this is a major constraint on company growth. From a corporate finance perspective, of course, it is also often inefficient to finance growth entirely from internal equity.

For small and medium-sized enterprises, being limited to internal equity alone is a larger obstacle. As a simple example, a business that needs a $10,000 truck but currently has only $1,000 in annual profits may never have sufficient retained earnings to purchase the vehicle - even if it were to contribute an extra $10,000 in free cash flow annually. In other words, internal equity is insufficient because it may be completely decoupled from the profitability of the project.

In our discussions with lessees, two key aspects of bank loans are consistently mentioned as effectively ruling out this source of finance for many of them. Lessees confirm that the shortage of credits available for bank lending for anything longer than a year is a major limitation.

Lessees also consistently note that the credit, collateral and payment requirements established by leasing companies are considerably more flexible and less cumbersome than those available at banks.

As an example, one key difference that can arise is the amount and form of collateral or guarantee required. While difficulties in repossession and the lack of secondary markets mean that the leased equipment is often not - in contrast with the West - sufficient collateral, the form and size of the additional collateral required may be lower for a lease than for a loan.

In this respect, we see considerable use by leasing companies of a wide form and variety of collateral or repayment guarantees. Some of these - such as a personal guarantee by an enterprise owner - may not be sufficient for a bank, but acceptable for a leasing company's internal purposes.
APPETITE OF SUPPLIERS (FOREIGN AND DOMESTIC) TO FINANCE EQUIPMENT PURCHASES

Equipment suppliers form an important source of financing for enterprise finance, both in Russia and in the West. In part, this reflects the key advantage suppliers have in bearing equipment risk and in establishing or working within secondary equipment markets. Indeed, some of the largest financial companies in the world - let alone leasing companies - began as house financiers to large equipment suppliers (GE Capital, General Motors Acceptance, Boeing’s aircraft leasing subsidiary); in some cases, the financial business contributes more to the annual profits of such conglomerates than the manufacturing business.

In Russia, however, the way in which suppliers finance equipment purchase is far less straightforward - and makes less use of leasing than is the case for their Western counterparts. The key difference in the last ten years has been the prevalence of barter or other non-cash or cash substitute deals. Since barter usually includes some premium over the cash-equivalent price paid for equipment, barter deals imply some kind of finance by the supplier for payments made in kind. In essence, the barter deal involves a finance component since the supplier must accept payment delays and a new type of product risk until the goods received in barter are converted into cash.

Other forms of equipment finance that have been common in Russia have been payment in Veksels (corporate promissory notes), often at a significant discount, payment in tax offsets, payment in other supplies and other novel payment schemes. In recent years, Russian companies have moved progressively to more cash-oriented payment schemes, and the percentage of corporate transactions involving barter has fallen precipitously in the last five years (with a significant but short-lived ‘bump’ in barter after the August 1998 financial crisis).

Foreign suppliers (with the exception of other CIS countries) demonstrate far less willingness to participate in these forms of equipment finance. The overhead and uncertainty of these deals are such that they usually do not pay for non-resident companies. Even normal trade credit is far less common, with a large number of business deals involving most or substantially all payments - including for equipment - up-front or on delivery. This represents a tremendous cash outflow for the purchaser, particularly in cases where equipment will take some time to be installed or become productive. Even large companies are not immune to cashflow restrictions that make outright purchase of equipment problematic or at least costly.

Nonetheless, credits on the purchase of equipment or other changes to typical payment terms are relatively common. Typical changes include discounts for up-front payment or some delay in payments.

We have seen increased willingness on the part of suppliers to accept some counterparty risk from leasing companies or to provide other forms of equipment finance, particularly in conjunction with other lenders. In several cases, suppliers have provided ‘buy-back guarantees’ for either the end of the lease or, in case of repossession, reducing substantially the equipment risk for the leasing company.
There is still considerable reluctance, particularly on the part of foreign suppliers, to provide much in the way of equipment finance to leasing companies (or most other purchasers). Suppliers that show some flexibility - however minor - in terms of providing somewhat more flexible payment schedules can make the conclusion of a leasing deal far more likely. Since Russian leasing companies also suffer from capital constraints but have far more diverse cashflows than lessees, they may represent considerably less risk than lending directly to the purchaser.

Suppliers are showing increasing interest in working with leasing companies, since they can usually pay far more quickly than end-users and have access to their own sources of credit. Leasing companies are usually able to pay up-front for a much larger proportion of the total purchase cost than a lessee (who typically pays an advance payment of 25-35%), reducing the non-payment risk substantially for any supplier credits granted.

**PROJECTED ANNUAL CAPITAL REQUIREMENTS**

By far the most significant source of capital for asset purchases in Russia is retained earnings, followed by equity contributions. The credit market is simply insufficiently developed to finance the immense quantities of capital required. Despite this severe constraint, investment in Russia is estimated at 18% of GDP.

This does not tell the whole story, however. The requirement for private-sector investment in Russia is considerably higher than this figure would indicate. In addition, there is immense demand for investment in new productive activities or in entirely new enterprises.

Nonetheless, one can get an idea of the immense investment required by looking at a few specific sectors. In the agricultural sector alone, investments required in the next five to ten years are estimated in the hundreds of billions of rubles (tens of billions of dollars) simply to maintain current production levels. Agricultural machinery is now being renewed at a rate of less than one percent a year. Estimated annual losses of grain due to insufficient or unavailable harvesting machinery are in the area of 10 million tonnes a year. In addition, at least 10% of the annual grain harvest is lost because current harvesting machinery is significantly less efficient than the Western equivalents. Since the harvest in 2001 is expected to total around 65 million tonnes, the combined losses due to insufficient or poor-quality equipment are (to say the least) significant.

The situation is similar in the electricity generation and distribution sectors. A 1999 study by United Energy Systems (UES) claims that half of the current stock of turbo-generators used in thermal power generation (64% of Russian electricity) are over 25 years old, the normal service life. Similarly, over 60% of hydro-electric turbines of 50MW and higher capacity are over 25 years old, and hydroelec-

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10 While analyzing 'demand' in the absence of price is economically questionable (strictly speaking, one should only look at demand at a given price level), there is no doubt that much of Russia's current capital base needs to be renewed and that the low availability of credit is a more significant issue than price (the interest rate).
tric power is 19% of national electricity production. Since much of the balance of electricity output is made up of nuclear plants, which may or may not be replaced, the requirements for investment are large - even if Russia were to cut back on electricity exports to neighboring countries.

Separate from the purely private sector demand for investment in productive capacity, but related, are requirements for infrastructure (roads, utilities, residential housing, etc). These requirements are often overstated, but nonetheless are estimated in the hundreds of billions of dollars. Since total outstanding bank lending at present is on the order of only $30 billion (see below), with bank funds withdrawn from the real sector outweighing those given back in the form of loans, current credit available is clearly insufficient. While infrastructure investment may come primarily from the public sector, this work will largely be contracted out to private firms that will require equipment.

**CREDIT AVAILABLE, CREDITS TO ENTERPRISES AND LOAN TERMS**

The lending market has seen considerable growth in 1999-2000, with much more lending now concentrated on lending to businesses and consumers - that is, it is no longer dominated by lending to the federal government on the GKO (treasury bill) market. The market is miniscule compared to Western economies, however, and while growth is high, it will take some years of fast growth for credit markets to begin to rival those of more developed economies.

The consumer bank lending market has grown almost three times in the last year, with consumer loans outstanding reaching 76 billion rubles (approximately $2.5 billion) in June 2001. Considering that lending rates are still comparatively high (from 25-35% for ruble loans, 14-20% for dollars), the appetite for borrowing is clear. It is estimated that half of the consumer lending market is currently Moscow-based. Banking industry sources have informally indicated to us that a large portion of 'consumer' lending - for some banks as much as 60% or more - may be intended for commercial purposes, but borrowed by individuals.

Perhaps even more significant is that a great deal of this lending is from smaller banks plus Sberbank. The larger banks - which with a few exceptions tend to be linked to large financial-industrial groups - still concentrate their lending activities on group members. In contrast to 1998, the lack of highly profitable lending to the government is beginning to force the banking sector to seek other revenue sources, and the diversification provided by lending to individual clients is another motivating factor.

Total bank lending has also grown, but is still relatively limited. For example, the top twenty banks in Russia had, as of April 1, 2001, approximately $34 billion in outstanding assets in loans - more than half of which is accounted for by Sberbank and Vneshtorgbank. Only seven banks had loan portfolios totaling more than $1 billion, and less than forty of the top 100 banks have loan portfolios of more than $100 million.

An even more important issue than the amount of money lent by banks is the loan terms available. Only 10% of bank credits are for periods longer than one year, and
the average loan term is less than six months. The vast majority of loans are also made only to clients with whom the banks have had relatively long-term relationships, restricting credit available to small and medium-sized enterprises further.

**Ruble Loan Tenors**

Ruble Loans (millions of rubles), of which by maturity:

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Loans</th>
<th>Corporate Loans</th>
<th>up to 30 days</th>
<th>31 to 90 days</th>
<th>91 to 180 days</th>
<th>181 days to 1 year</th>
<th>1 to 3 years</th>
<th>more than 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999.12.31</td>
<td>292,715</td>
<td>244,320</td>
<td>19,865</td>
<td>18,570</td>
<td>29,270</td>
<td>98,993</td>
<td>34,104</td>
<td>27,629</td>
</tr>
<tr>
<td>2001.11.3</td>
<td>661,253</td>
<td>539,479</td>
<td>63,299</td>
<td>40,225</td>
<td>92,515</td>
<td>224,577</td>
<td>72,318</td>
<td>36,151</td>
</tr>
</tbody>
</table>

**Source:** Bank of Russia

Although overall lending has grown relatively quickly since December 2000, and even more dramatically in 2000, corporate lending stayed relatively stable in 2001. Other lending - personal loans and interbank lending - has grown far more quickly.
Foreign Currency Loan Tenors

<table>
<thead>
<tr>
<th>Date</th>
<th>Total Loans</th>
<th>Corporate Loans</th>
<th>up to 30 days</th>
<th>31 to 90 days</th>
<th>91 to 180 days</th>
<th>181 days to 1 year</th>
<th>1 to 3 years</th>
<th>more than 3 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999.12.31</td>
<td>304,097</td>
<td>200,870</td>
<td>7,832</td>
<td>10,375</td>
<td>16,802</td>
<td>50,122</td>
<td>49,065</td>
<td>47,057</td>
</tr>
<tr>
<td>2000.12.31</td>
<td>367,953</td>
<td>255,963</td>
<td>9,859</td>
<td>8,777</td>
<td>19,930</td>
<td>75,929</td>
<td>69,781</td>
<td>58,088</td>
</tr>
<tr>
<td>2001.31.03</td>
<td>406,257</td>
<td>268,586</td>
<td>7,596</td>
<td>11,284</td>
<td>23,782</td>
<td>78,598</td>
<td>72,050</td>
<td>60,108</td>
</tr>
<tr>
<td>2001.30.06</td>
<td>421,295</td>
<td>280,142</td>
<td>4,840</td>
<td>10,584</td>
<td>27,574</td>
<td>90,798</td>
<td>75,244</td>
<td>55,392</td>
</tr>
</tbody>
</table>

Source: Bank of Russia

Longer-term lending is more often in foreign currency terms than in ruble terms, an indication that the market is still concerned about the long-term stability of the ruble.

Even more of a limiting factor is the small number of banks with significant sums on deposit: only six banks have deposit bases of more than $1 billion. Only two banks (again, Sberbank and Vneshtorgbank) have capital of more than $1 billion, and only 15 have capital of more than $100 million. While the Russian banking market has many more banks than many other economies (up to 1200 at present), the great majority of these are tiny by international comparisons.

To put some numbers to these figures by way of comparison, Canada has one bank with over $180 billion in assets, $130 billion in deposits and $8 billion in equity. The Canadian banking sector has roughly $1 trillion in domestic assets held by banks, and roughly half that amount in both outstanding loans and deposits. All of the top six banks had assets of at least $50 billion, although it is worth noting that the Canadian banking sector is highly concentrated.

On this scale, even the relative Russian giant of Sberbank looks like a relatively small international bank. The assets of the entire Russian banking sector - numbering slightly less than 1500 banks - totaled under $100 billion and total equity under $18 billion in August 2001, according to Ekspert magazine.11

NON-COMMERCIAL OR MIXED-SOURCE CREDIT

The Russian leasing market, as is the case for lending and financing of industry in general, is distinguished by some fairly sharp differences with those of other countries. In leasing as in other areas of enterprise finance, the specific industry, location, and size of the corporation can change the credit picture dramatically. Access to commercial credit is severely restricted throughout the country, but particularly in certain regions and industries.

Where a particular industry or even company is particularly important and where credit is close to non-existent, governments (whether federal, regional or municipal) have often stepped in to help ease the company or industry 'over a rough

spot. This help can take many forms: credits, tax deductions, outright subsidies, state orders, etc. We have also witnessed a trend towards the use of leasing as a form of state-supported enterprise credit.

To the extent possible in this study, we have concentrated our efforts on the commercial leasing industry - that is, leasing companies that work on a purely commercial basis. This is easier said than done, however: a number of leasing companies have some measure of state participation, although often quite minimal or nominal in nature. In some specific industries, though, state support may dominate, and this is particularly true of the agricultural and aviation leasing industries.

As a leader in the Russian agricultural leasing market put it, «only companies with state or regional budget support can work successfully in the agricultural sector.» While we do not necessarily agree with this formulation, it is clear that state support of the agricultural sector will continue to dominate in the medium term. Our various survey results show that few commercial leasing companies are willing to work in the agricultural sector.

In practice, we do not apply the test of ‘commercial leasing’ in carrying out this study, although most of our survey respondents are commercial leasing companies. Various levels of government believe that there is a market failure in the classic economic sense, and have chosen to use one of the available tools (leasing) to help correct for it. The LDG invests its time and effort in supporting leasing as a commercial credit instrument, but we also recognize that - as a flexible tool - it may also be useful in other circumstances.

More importantly, it is our belief - and market trends support this assertion - that even government-supported lease deals will become increasingly commercial in nature. If the typical agricultural lease or credit of two to three years ago was essentially a pure grant since the lease or agricultural credits were rarely repaid, we expect that more agricultural loans in future will be commercial in nature. At present, we see some evidence that agricultural leases are being granted on increasingly strict credit terms - and the loans and leases are more often expected to be paid back.

**BANKS’ ATTITUDE TO LEASING**

Banks have a crucial role to play in the leasing industry. Banks will inevitably be a significant source of lease financing (either directly or indirectly), and provide the lending product that is most directly comparable, the bank loan. That said, Russian banks increasingly understand the importance of leasing and that in many respects it complements the lending products provided by commercial banks. One of the consistently surprising comments we hear from lessees is that bank lending officers referred them to unrelated leasing companies or simply asked their clients «have you considered talking to a leasing company?»

Banking involvement in the leasing industry in Russia could involve several different forms, but to date the primary involvement has been by using affiliated
leasing companies. These affiliated companies usually involve some ownership stake by the bank, and in many cases we believe this amounts to a controlling stake. There are many banks, however, that have little or no direct involvement in the leasing sector. Banks are also restricted to lending no more than 25% of their equity to any one lender, including affiliated leasing companies.

Banks that have been involved tend to understand well the advantages of leasing for their clients. Lending decisions are sometimes effectively made by the bank, with the bank credit department itself often being used to evaluate the creditworthiness of a client. In other cases, however, the affiliated leasing companies (at least those that are not simply paper subsidiaries) have some additional leeway to conclude leasing deals, although funds available are generally as limited as with the banks themselves.

Independent leasing companies do borrow from commercial banks, however, despite the limitations in funds available and the conservative approach of banks. In a survey carried out by the Leasing Development Group, over two-thirds of leasing companies responding reported having received financing from unrelated banks. The major constraint on this type of lending remains the term mismatch between the funds available to banks and the requirements of leasing companies, who need loan terms as close as possible to the lease agreements (two to five years).

Commercial banks also provide funds to leasing companies to fund specific deals, particularly when the banks are already familiar with the lessee. In such cases, there is usually some additional bank guarantee, such as all lessee funds being held at the bank and all cash flows passing through the bank's accounts.

While bank involvement is still relatively low, there is increased awareness of the advantages of leasing for both the leasing company and the lessee. As long as leasing remains an attractive option compared to bank lending, we expect banks to make increased use of affiliated leasing companies. In this sense, they perceive leasing to be a viable, alternative financial instrument that avoids the complications of obtaining collateral and guarantees through normal bank lending.

**AVAILABILITY OF TWO TO THREE YEAR MONEY**

A significant proportion of leasing companies use initial capital contributions by owners of the leasing companies and retained earnings to finance at least some of their lending. This is primarily due to the extreme shortage of two to three year money at fixed rates available to leasing companies from the banking sector. Since leasing deals are usually fixed-rate, this is a severe constraint on the growth of lease financing. Nonetheless, most leasing companies surveyed by the LDG indicate that they receive at least a portion of their financing from banks, and over 60% receive financing from unconnected banks - that is, banks that are not investors in the leasing company.

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1 Russian Academy of Sciences study (IMEMO), cited in Ekspert Oborudovanie, 8 August 2001.
The shortage of medium-term money is not simply the result of reluctance on the part of banks or other lenders, as the number of leasing companies receiving some bank financing shows. The banking sector itself suffers from severe capitalization constraints, and bank funds from depositors are both small and extremely short-term.

As an example of the severe shortage of long-term money, a recent survey of banks and companies demonstrates the difficulties faced. The average term of loans to companies was only 5.4 months, and only 10% of bank credits reported were for terms of more than one year (all figures as of Q2 2001). The banks surveyed expected this figure to grow to only 11% by October. Total loans and credits from banks were only expected to grow by 3-4% in the next six months. Perhaps even more crucially for potential lessees, 74% of credits were to companies with which the banks had worked for more than three years, with over half of loans to clients of more than five years.

To the extent commercial banks have a deposit base held for any length of time, these deposits are almost all essentially demand deposits - meaning that lending for longer periods is risky. There has been encouraging growth in household deposits in Russian banks, which have grown by roughly 9% annually to April 2001. As a proportion of the monetary base, however, bank deposits have actually fallen. Finally, many Russian bank funds are held not even as demand deposits, but as payments awaiting transfer: a number of Russian banks appear to survive primarily as payments-processing banks.

The one large exception to the above constraints is Sberbank, the state savings bank, which is largely owned and effectively controlled by the Central Bank. Since Sberbank benefits from a de facto government guarantee on its deposits, and since it remains the ‘bank of last resort’, Sberbank is perhaps the only bank able to rely on a relatively stable deposit base in the event of a crisis. Sberbank’s own funds availability, while massive compared to competitor banks, is still small in relation to the size of the Russian economy. In addition, while Sberbank has several related leasing companies, these activities are still small in relation to Sberbank’s size and tend to focus on larger leasing deals. If Sberbank does decide to focus on leasing, it could change the sector considerably, simply by using its impressive near-universal presence throughout Russia and the funds at its disposal. This is unlikely, however, for a variety of reasons.

In sum, two to three year credit availability is extremely low, a situation which will improve only slowly as the economy improves, as the Central Bank and the government introduce new, reliable financial instruments, and as the banking system is reformed and strengthens.

The ability of leasing companies to leverage their financial base to a fairly high ratio, however, means that the funds available to the leasing industry to deploy in credit operations will have a greater effect on the economy than would seem to be the case. In addition, even ‘slow’ growth in the availability of mid-term funds in absolute terms could result in spectacular growth in percentage terms.
## BREAKDOWN OF RUSSIAN OWNED BANKS AT DIFFERENT ASSET LEVELS

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Capital (Thousands of rubles)</th>
<th>Total Assets (Thousands of rubles)</th>
<th>Capital (Thousands of dollars)</th>
<th>Total Assets (Thousands of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sberbank</td>
<td>47,587,555</td>
<td>507,268,014</td>
<td>1,640,950</td>
<td>17,492,000</td>
</tr>
<tr>
<td>Vneshtorgbank</td>
<td>45,334,055</td>
<td>140,445,086</td>
<td>1,563,243</td>
<td>4,842,954</td>
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<tr>
<td>International Industrial Bank</td>
<td>26,354,111</td>
<td>71,840,924</td>
<td>908,762</td>
<td>2,477,273</td>
</tr>
<tr>
<td>Alfa-Bank</td>
<td>20,672,531</td>
<td>70,343,081</td>
<td>712,846</td>
<td>2,425,623</td>
</tr>
<tr>
<td>Gazprombank</td>
<td>16,187,943</td>
<td>81,830,570</td>
<td>558,205</td>
<td>2,821,744</td>
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<tr>
<td>Rosbank</td>
<td>7,657,785</td>
<td>41,579,525</td>
<td>264,062</td>
<td>1,433,777</td>
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<tr>
<td>Globeks</td>
<td>5,085,207</td>
<td>13,412,889</td>
<td>175,352</td>
<td>462,513</td>
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<td>MDM Bank</td>
<td>4,119,393</td>
<td>22,942,231</td>
<td>142,048</td>
<td>791,111</td>
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<tr>
<td>Bashkreditbank</td>
<td>3,971,858</td>
<td>21,066,901</td>
<td>136,961</td>
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<tr>
<td>Russian Development Bank</td>
<td>3,717,363</td>
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<td>128,185</td>
<td>123,586</td>
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<td>National Reserve Bank</td>
<td>2,977,192</td>
<td>13,144,019</td>
<td>102,662</td>
<td>453,242</td>
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<tr>
<td>AK Bars</td>
<td>2,614,163</td>
<td>8,562,235</td>
<td>90,144</td>
<td>295,249</td>
</tr>
<tr>
<td>Bank of Moscow</td>
<td>2,265,813</td>
<td>42,278,555</td>
<td>78,131</td>
<td>1,457,881</td>
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<td>Guta Bank</td>
<td>2,066,770</td>
<td>12,669,150</td>
<td>71,268</td>
<td>436,867</td>
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<td>Nomos Bank</td>
<td>2,055,068</td>
<td>9,420,506</td>
<td>70,864</td>
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<td>Evrofinance</td>
<td>1,899,530</td>
<td>11,708,475</td>
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<td>403,741</td>
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<td>Dov &amp; Invest. Bank</td>
<td>1,880,427</td>
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<td>64,842</td>
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<td>Menatep St. Petersburg</td>
<td>1,771,907</td>
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<td>Legprombank</td>
<td>1,725,693</td>
<td>2,870,086</td>
<td>59,507</td>
<td>98,968</td>
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</tbody>
</table>


## BANKS’ ATTITUDE TO LEASING, EITHER DIRECT OR INDIRECT VIA LOANS TO LEASING COMPANIES

The main problem with the attitude of banks (and other potential lenders to the leasing industry) relates to weaknesses in the legal system. Primarily, it remains difficult - if not impossible - for companies (including banks) to rely upon the court system to enforce valid claims. Banks and other lenders therefore rely to a high degree on some form of company control - whether this is by outright ownership, control of management, or control of the company cash flows.

This requirement is becoming less absolute, however, as companies establish longer track records of cooperation with their banks and reputations that show them to be ‘creditworthy.’ Leasing companies have not been excluded from this trend, but the characteristics of the leasing business - high leverage, dependence on management, etc. - and their need for relatively large quantities of funds mean that they must demonstrate even higher reliability and trustworthiness than typical borrowers.

The best leasing companies have responded by opening their books, running their businesses extremely carefully and cautiously, diversifying their client base, and by working closely with their banking partners. These are, in fact, the
same criteria that IFC's investment departments use to evaluate potential partners in the leasing business.

Having noted all of the above, the severe shortage of medium-term funds is the primary constraint on further bank funding.

**GOVERNMENT FINANCING OF THE LEASING INDUSTRY - TYPES OF GOVERNMENT**

In broad terms, ‘government’ involvement in the leasing industry can be categorized in several different ways. Important distinctions are the level of government, the type of activity, and the industry involved. Each of these distinctions will tend to overlap with the others, as shown below.

Government activity in leasing (apart from legislative and regulatory activities) can be broken down into federal, regional and municipal levels. At the federal level, the government tends to get involved in leasing deals mainly by providing long-term credits to strategic industries. The aviation and agricultural industries are the prime recipients of government support in this area. We should note that while there may be some cross-border ‘leasing’ of military equipment, we have not taken account of any non-commercial leasing of this type for this market survey.

At the regional level, the situation is similar, but more restricted: many regions have used leasing as a means of providing credits to agricultural enterprises, and sometimes to support important local industries. For example, some regional governments have provided credits to leasing companies to assist in sales from an important local factory.

In other cases, regional administrations have formed local leasing companies to increase credit availability to local enterprises. While support for small and medium-sized enterprises may appear to be an unnecessary government program and possible competition for the commercial leasing industry, we have found that the presence of such a company is a good indication of the local or regional government’s support for leasing – which can translate into a friendly environment for commercial companies. The amounts of government funds involved are also usually quite small, and insufficient to distort the credit markets.

As for competition from government-supported commercial leasing companies, there is currently such low competition in most regions that this is not a serious concern. The government-sponsored leasing companies also usually have low enough capital bases that they welcome the arrival of a commercial leasing company, which can help their customers ‘graduate’ to larger leasing deals. The government-sponsored leasing companies are not, at present, a significant source of revenue for the government, and hence there is little reason for the government to fear commercial competition.

At the municipal level, activity has been less noticeable. Nonetheless, some municipal administrations have taken small steps such as forming local leasing
companies and assisting in providing credit to local enterprises (often on the basis of a local initiative to support small and medium-sized enterprises).

Despite all of the above, there have been some encouraging signs. We have noted a trend on the part of regional governments to lend on an increasingly commercialized basis. In other words, they are now lending with the expectation of being repaid, and with interest actually being charged (although perhaps at less than market rates). Russian food processors - at least some of them - are now in increasingly good fiscal shape, with barter payments falling steadily, and they are beginning to work with successful farms to ensure a steady supply of their primary inputs.

In both cases, the situation has changed from some years before. Most importantly, there is now the prospect of finding a commonality of interests with regional governments as regards leasing and lending in general, even to the agricultural sector. The imperative from the government perspective is often to reduce budgetary spending for agricultural support (as the sector has begun to recover on its own) and to increase the impact by providing support only to those producers that have begun to improve their operations.
LEASING DEALS: THE BASICS (BRIEF OUTLINE)

Russian leasing deals according to the Law on Leasing and the Civil Code take the following form: equipment (an asset) is purchased from a supplier by a lessor on behalf of a lessee. The lessor remains the owner of the equipment, while the lessee has usage rights to the equipment in return for lease payments. At the end of the specified term, the lessee may acquire ownership as agreed between the lessee and the lessor. In general, the parties have considerable freedom of contract to establish other aspects governing their relationships either through supplementary agreements or in the lease contract itself, limited primarily by the Civil Code and other regulatory acts.

For precision, when we refer to leasing and financial leasing in Russia, we are specifically referring to the term in the Russian Civil Code finansovaya arenda (lizing). Russian law defines leasing as financial leasing, although the use of the term does not fully correspond to the general use of the term in other countries. Leasing (financial rent) is considered a subset of rent (arenda).

In practice, most Russian lease agreements amount to fully paid-out acquisition of the equipment and can be defined as financial leases, but the law would cover some operating leases. Under Russian law, lease agreements that do not meet the definition of a Russian financial lease are treated as rental agreements, and the Russian Civil Code does not distinguish between ‘rent’ and ‘operating leases’, in spite of the attempt to create such a distinction in the Law on Leasing.

There are other additional requirements under the law, but the basic description above details most of the essential elements of a lease under Russian law. Aside from the requirement of fulfilling the requirements as outlined below, the parties to a lease deal are generally free to conclude other agreements or stipulate other conditions in their contracts, subject to other legislation and the Russian Civil Code.

- **Three-Sided Transaction:** all Russian leases include three parties: a supplier, a lessor, and a lessee. This element serves to ensure that the lessee retains the essential rights of a consumer with respect to the supplier (i.e., the lessee may pursue resolution directly with the supplier if the equipment is deficient in some way). The supplier has few other obligations unless otherwise stipulated.

- **Ownership:** the lessor retains ownership of (ownership rights to) the equipment. In contrast to a loan, in case of default the owner is simply enforcing ownership rights to a specific piece of equipment, and is not subject to debt seniority or other covenants. This right extends only to the equipment that is the subject of the lease, not to any other monies owed.
- **Usage rights**: in return for regular payments, the lessee obtains only usage rights, not ownership, for the term of the lease. This right is surrendered if lease payments are not kept current.

- **Payments**: the parties agree to a specific payment schedule, which is part of the lease agreement. There are few restrictions on how the lease payments may be structured.

- **Specified term**: the lease deal is subject to a specified term. At the end of the term, the lessee surrenders the usage rights (and hence possession of the equipment) to the lessor - subject to any supplementary agreements. At this point, neither side has any further obligations to the other unless otherwise stipulated.

- **Supplementary agreements**: with some exceptions, the parties to the agreement have considerable freedom to conclude supplementary agreements or specify other terms or conditions in the body of the lease agreement itself. Specifically, most leases in Russia provide for sale of the equipment (that is, transfer of ownership rights) to the lessee at the end of the lease term for a specified sum, usually in a separate sales contract. Other agreements might include a buy-back agreement with the supplier or other agreements to apportion financial obligations or risk. Lease agreements often include specific language on procedures in case of default, disputes or other problems (which are subject to limitations in the Civil Code). Supplementary agreements may include additional guarantees, restrictions on use of equipment, or any number of other details as agreed by the parties. All supplementary agreements or additional contract stipulations are subject to the Civil Code and to Russian law and procedures, as would any other legal contract.

- **Other Details**:  
  - Entrepreneurial use: equipment must be used for entrepreneurial purposes. In practice, this generally means that government organizations cannot participate in leasing deals and that individuals may not lease equipment for their personal use.  
  - Taxes: the lease agreement specifies important details with respect to taxes (for example, whether the leased asset is carried on the balance sheet of the lessor or the lessee).

**The Basic Advantages of a Leasing Deal**

As the basic description above shows, the Russian financial lease is in many respects simply another way of financing equipment acquisition in the form of usage rights. Leases offer significantly greater flexibility than bank loans, however, and are therefore an essential tool in equipment renewal in market economies. In economic terms, many of the advantages below are considered ‘risk allocation’ benefits: leasing allows the parties to allocate risk between them according to their own knowledge, market advantages and appetite for risk.

The key advantages are:

- **Collateralization**: since the lessor retains ownership of the equipment, it is less difficult to repossess it in the case of payment problems - and the equipment is not subject to the claims of other creditors. While this benefit is not entirely reli-
able in Russia, market practice shows that leasing deals often do have lower levels of required collateral than regular bank loans. In comparison to other countries (where the equipment itself may be a sufficient guarantee), however, the level of collateral required is often significantly higher.

- **Priority but Limited Credit Seniority**: the lessor retains ownership of the leased equipment and is not subject to debt seniority of other parties, although only for the leased asset itself. From the lessee’s perspective, default on a lease is less risky than for a loan, for which claims against all of the lessee’s assets are the primary recourse - i.e., it is less likely that default would result in a potentially bankruptcy-inducing claim.

- **Less Stringent Credit Requirements**: compared to banks, leasing companies are subject to less regulation of the risk they may take. The key difference is that leasing companies do not take public deposits and have few minimum capital requirements - in other words, the failure of a leasing company is not considered in itself dangerous to the financial system. This means that leases may be for smaller amounts, in riskier situations, and to companies with little or no credit history. Leasing may also be more profitable in return for taking on this risk or for providing other services.

- **Risk-sharing**: the specifics of a leasing deal allow considerable latitude for tailoring a leasing deal to match the risk ‘appetites’ (or ability to bear a given type of risk) of the parties to the deal. For example, the lease deal may allow more flexibility regarding disposal of the asset at the end of the lease term. This may lower the costs or risk to the parties involved.

- **Flexibility**: subject to legal restrictions, the parties to a lease have wide latitude to define the terms of their agreement, including payment schedules, the transfer of risk, and the inclusion of other services.

- **Tax Regime**: the Russian tax regime makes specific allowance for the unique role leasing plays in the renewal and acquisition of equipment. Most importantly, the current tax regime: (1) recognizes the shorter-term nature of leasing and allows accelerated depreciation of the leased equipment; (2) allows for appropriate recognition of interest expenses and lease payments as part of the cost of production, hence lowering profit taxes; (3) recognizes that the parties to a lease deal may have different financing environments; and (4) allows them to choose which party records the asset on the balance sheet (and hence depreciation charges).

This is not to say that leasing is appropriate in all circumstances, or that the current legal, regulatory and tax situation is perfect. In particular, application of the existing legal and regulatory base is uneven, and there are some significant gaps and contradiction in the current legal and regulatory documentation. The Law on Leasing itself contains numerous clauses which contradict the Civil Code, the Tax Code, other laws, and even the law itself, and many of these clauses have no effect. Nonetheless, the situation has stabilized considerably, offers significant advantages over other forms of financing, and many of the proposed amendments and corrections - if and when they are passed - will represent a clear improvement.
The following section outlines the legal, taxation and accounting environments of leasing in detail. We have broken the analysis down into legislative, tax and accounting sections, followed by a section that discusses more exotic details such as cross-border leasing that will likely affect only a relatively small proportion of leasing deals.

**LEGISLATIVE**

**Current Situation**

The existing legal framework for leasing in Russia is relatively well developed. The most important legal documents regulating leasing include the Civil Code (in particular, Chapter 34, which outlines the basic definition of leasing) and the Law on Leasing («the Law»), which was adopted in autumn of 1998. Russia formally joined the Unidroit Convention on International Leasing in 1998 and the text of the convention is also a formal part of the legal framework. Apart from these legislative acts, there are other laws and regulatory documents that affect leasing operations. Again, under Russian law, ‘leasing’ refers to the Russian definition of financial leasing (*finansovaya arenda*); lease or rental agreements that do not meet these requirements are considered ‘rent.’

The legal and regulatory documents governing leasing collectively establish:

- the basic concepts and definitions for leasing;
- a significant degree of freedom of contract for parties to a leasing deal (as long as the contracts do not otherwise contradict the Civil Code);
- a favorable tax regime, in particular the application of accelerated depreciation to the leased asset and the ability to apply leasing payments to the cost of production (in both cases, reducing profit tax payable).

Leasing is considered a specific form of rent, and as such, has a number of distinguishing features:

- There are three participants: a lessor, a lessee and a supplier (seller) of equipment. The parties to a leasing deal cannot fulfill more than one of these roles except in the case of a lease buy-back, where the lessee can also participate as the supplier.
- There will necessarily be two or more contracts within the context of a leasing deal, with a sales contract between the lessor and supplier and a lease contract between the lessor and the lessee as a minimum. There may be supplementary agreements, such as for insurance, credit, service, and any number of other agreements.
- The leased equipment must be used for entrepreneurial purposes.
- The leased equipment must be acquired specifically for the purpose of leasing.

Since leasing is considered a form of investment activity used to assist in acquiring fixed assets and has particular characteristics and requirements, a special tax regime is applied to leasing deals that meet the above criteria.
Leasing, as currently structured, is a form of activity that requires licensing. The Ministry of Economic Development and Trade is responsible for the licensing process. This requirement will be removed in February 2002, when a new law on licensing adopted in July 2001 enters into force.

Although the legal basis for leasing is relatively well developed, it contains many problems and difficulties in application. The most important of these are:

- The instability of the regulatory base, in particular the regulatory documents issued by government agencies and ministries;
- Contradictions existing between the various legal and regulatory documents;
- Contradictions between the regulatory documents and instructions issued by government agencies and current legislation. This leads to difficulties when carrying out leasing, in particular with the tax and customs authorities.

The federal Law on Leasing is, unfortunately, one of the clearest examples of this type of problem: the Law contradicts not only the Civil Code and other legislation, but at times even itself. The primary problem with the Law on Leasing is that its authors did not apply the appropriate principles of leasing contained in the Unidroit Convention or the Civil Code.

More problematic in practice is that the Law on Leasing attempts to include sections regulating tax, customs and currency questions affecting leasing directly within the law, whereas Russian practice requires that these questions be regulated by special legislation such as the Tax Code. As such, the State Customs Committee has published a letter «On the Application of the Federal Law ‘On Leasing’» which indicates that Article 34 of the Law on customs payments for equipment imported for leasing contradicts the tax legislation. The Customs Committee therefore continues to apply the conditions outlined in the existing tax and customs legislation, and ignores the offending article.

The State Duma is currently considering a draft bill of amendments to the current Law, which as of printing, has been passed in second reading. The goal driving the preparation of this bill has been to remove all of the existing contradictions in the current law and to introduce certain civil procedures and norms to assist the development of leasing. In addition, the State Duma deputies that initiated the process of considering amendments intend to consider in future any necessary amendments or other changes to other legislative documents, including the Customs Code, that are currently hindering the development of leasing.

**Real Estate Leasing**

Since the main focus of this survey is equipment leasing, we will just note a few of the main features and peculiarities of real estate leasing.

Russian legislation does not foresee specific requirements applying to real estate leasing, aside from the requirement of registering the agreement itself and the rights and obligations arising from it. The Ministry of Justice and its various bodies are responsible for registering real estate claims and deals.
It is important to note, however, that the long amortization period for real estate and the low depreciation rates will tend to create large accounting profits that are subject to profit tax. Since the term of the lease agreement will almost certainly not coincide with the full depreciation term of real estate, the tax obligations of the lessor will be significantly higher if the lessee also purchases the real estate at the end of the term of the leasing deal.

TAXATION

The main advantages of leasing from a taxation standpoint are the flexible approach allowed towards recording assets (choice of the balance sheet of the lessor or the lessee), the ability to record lease payments as part of the cost of production (that is, to expense the payments), the fact that the lessor can record interest expenses as part of the cost of production (which is not generally allowed in current legislation set to expire at the end of 2001), and the application of accelerated depreciation.

There are three sections below, to distinguish between the current tax situation, changes that have occurred in the 2000-2001 period, and changes adopted recently that will take effect in the future (for the most part, from January 1, 2002).

Current Situation

The parties to leasing deals often run into difficulties with the application of tax regulations in the course of a lease agreement. Since the rules are sometimes contradictory or imprecise, leasing companies and lessees are rightly concerned that the tax authorities will disagree with their interpretation of the rules - and that this could lead to significant fines or penalties. Even without the imposition of penalties, if certain aspects of a leasing deal such as accelerated depreciation were to be retroactively denied, the deal itself could lose its economic justification; any uncertainty about the right to apply accelerated depreciation therefore reduces the attractiveness of leasing.

Unfortunately, interpretive documents (such as letters from the Ministry of Finance or the tax authorities) do not have legal force, and local tax inspectors throughout the country sometimes interpret the rules themselves. Further, in Civil Code countries such as Russia court precedent does not of itself have legal status, so court decisions are an insufficient guide to future court decisions. As such, we still recommend that companies get clarification from the responsible authorities in each region - although referring to documents from the central Ministry offices may help establish one's case.

The parties to leasing deals can, of course, challenge improper rulings or misapplication of the norms either by working directly with the agency in question or through the courts. The Leasing Development Group knows of several cases where leasing companies have challenged application of the norms in court successfully, and the trend seems to be toward better application of the laws and regulations.
Current Tax Regulations

In addition to the problems mentioned above, the process of passing the Tax Code, which establishes the fundamental principles of the Russian tax system, introduced additional complications. The first part of the Tax Code took force on January 1, 1999, and parts of the second part on January 1, 2001. The second part establishes the procedures for value added tax (VAT), tariffs, personal income tax and social contributions.

It is important to note that the enabling legislation for the second part of the Tax Code also amended a number of related laws. Using the procedures enumerated in the Tax Code therefore requires careful consideration of the amendments found in the enabling legislation, law No. 118-FZ.

At present, the parties to a lease deal have access to the following treatments that can make leasing very attractive from a tax perspective compared to a bank loan:

- The parties to a lease deal are entitled to apply accelerated depreciation using a factor of up to three; 13
- The lessee is entitled to expense the full amount of the lease payments (if the asset is carried on the lessor’s balance sheet) or include accelerated depreciation charges (if on the lessee’s balance sheet) as part of the cost of production.
- The lessor is entitled to expense interest charges for funds borrowed to finance equipment purchases for lease as part of the cost of production. (This does not apply to funds borrowed for equipment that is not leased out - that is, to equipment acquired for the leasing company’s own use).

All of the above result in reduced profit taxes, since the lessee and lessor increase the amounts charged to expenses (cost of production). Of course, this only applies if the companies are earning a profit and hence paying profit tax, but the net result is that leasing can be a particularly efficient form of finance from a taxation standpoint.

Positive Developments in 2000-2001

We would like to point out specific changes that have occurred recently. As noted, the situation has slowly improved, and while far from perfect, the changes are significant and mostly positive.

Value Added Tax

The situation for calculation of value added tax (VAT) in leasing deals was previously problematic. In particular, the primary difficulty was that it was unclear whether the lessee could offset VAT included in leasing payments against its own retail sales if the leased asset was carried on its own balance sheet. Previously, the ability to offset VAT payments depended on the ability to claim expenses against the cost of production; the Tax Code has removed this dependency, and VAT offsets are now relatively straightforward. Nonetheless,

our survey of leasing companies indicates that the vast majority of tax problems involve the value added tax.

**Changes to Tax Procedures for Leasing Payments for Small Enterprises**

Until the adoption of the Tax Code, lease payments for small enterprises were exempt from VAT payments. This was intended to support small enterprises, but more often than not actually increased the cost of leasing. This occurred because the lessor, unable to claim a VAT offset according to legislation since the end-user had a VAT exemption, incorporated the cost of its own VAT charges (incurred upon acquisition of the leased equipment) into the lease payments. This 'pseudo-subsidy' was removed with the entry into force of the second part of the Tax Code.

**Turnover Tax**

The most undoubtedly positive change to the tax structure has been the reduction in the turnover tax (tax on revenue), and the planned removal of this tax entirely. Until 2001, the total turnover tax was 4%, a level that significantly increased the cost of leasing deals - particularly since leasing companies, as credit-granting operations, generally have narrow gross margins and depend on high turnover to cover overhead costs. Leasing companies paid turnover tax on the total sum of leasing payments, even if they were operating at a loss.

In January 2001, the two turnover taxes, social fund payments of 1.5% and the 'road tax' of 2.5%, were reduced. The social fund tax was eliminated entirely, and the road tax was reduced to 1%; the road tax will be eliminated on January 1, 2003.

**Upcoming Changes**

With the adoption of the recent changes to the tax code, a number of changes will take place in the tax structure, particularly from January of 2002.

As discussed, the road tax of 1% of turnover will be eliminated entirely from 2003. Other changes were adopted in July 2001 by the State Duma in the form of the «Profit Tax» chapter to the second part of the Tax Code, which has now been signed into law. This bill defines the rules and norms of depreciation of fixed assets for tax purposes and the basis of taxable income (profit). Most of the changes will take effect from January 1, 2002.

In the new Chapter of the Tax Code, the Duma adopted the following changes specific to leasing deals:

- the parties to a leasing deal are entitled to use accelerated depreciation for tax purposes, although the specific mechanism for calculation has changed. The accelerated depreciation factor remains at the current three. The methods of calculating depreciation include straight-line and a modified declining balance approach (declining balance is calculated using months rather than years). On balance, these changes are either neutral or slightly beneficial compared to current practice.
- The parties to a leasing deal still have the right to choose whose balance sheet the asset is recorded on. This is not a change, but
recording this entitlement in the Tax Code and clarifying any remaining questions regarding accounting should remove any remaining uncertainty on this point.

- Limits have been placed on the ability to deduct interest for funds borrowed from ‘affiliated parties'; these mainly affect subsidiaries within a single corporate structure and leasing companies receiving the vast majority of their financing from a single foreign source. The motivation is to ensure that these deductions are not used as a tax avoidance scheme, and the limit for foreign funds is that funds borrowed from a single source cannot be greater than 12.5 times equity if the source owns more than 20% of the leasing company. While the restriction is important, it is not necessarily onerous.

As noted above, the Duma has also reduced the profit tax rate to 24%. In addition, more expenses will be eligible for treatment as legitimate costs of production, and hence will reduce taxable profits; in this respect, we should note that both interest expenses and advertising are to be considered deductible expenses. Various tax subsidies and other deductions have been removed; the great majority of these were inefficient and problematic, but the exact effect varies by industry.

We believe this new Tax Code is a significant step forward for the leasing industry as the key aspects of a leasing-friendly tax regime have been preserved. In particular, retaining accelerated depreciation and the choice of balance sheet recognition are perhaps the most important aspects. Reducing the profit tax and recognizing legitimate business expenditures should benefit all companies - including potential leasing clients - and should therefore also be welcomed.

Indeed, enshrining these advantages in the Tax Code reduces some of the uncertainty that surrounded these advantages before, as the various regulatory acts included some contradictions whereas the Tax Code has priority over other regulatory documents. The Leasing Development Group has had frequent discussions with legislators, government officials and leasing industry participants on the issue of the Tax Code. It should be noted that leasing industry participants are extremely positive about the new Tax Code.

Some of the changes to the Tax Code may, perhaps surprisingly, reduce the relative advantage of leasing over other forms of finance. For example, the profit tax rate will be reduced to 24% as of January 2002, which makes the use of internal funds (such as retained earnings and equity contributions) relatively less expensive. Similarly, the proposed changes include allowing companies to charge interest expenses against the cost of production - a change that will bring the Russian tax code into line with those of most other countries and provide more rational economic incentives for business.

These changes are not bad news for the leasing industry: while the relative advantage of leasing may be marginally reduced, this will likely not result in shrinkage of the leasing market but the expansion of all credit markets. In particular, since leasing is an alternative source of finance that attracts different clients than bank loans (with some overlap), the marginal change should not significantly affect the leasing market. It should also contribute to increased growth, as many enter-
prises will effectively have access to affordable credit for the first time since the transition process began. Similarly, the reduced profit tax should increase incentives to expand business, and internal funds (retained earnings, primarily) will remain insufficient for all but the rarest of enterprises.

These developments are therefore to be welcomed, as they will improve the overall business climate. In other words, while some of these changes may not directly assist leasing companies, they should result in a larger number of healthier, more credit-worthy leasing clients - to the benefit of all those in the industry and the country as a whole.

**ACCOUNTING**

The main document regulating the accounting for leasing is Ministry of Finance Order (Prikaz) No. 15 «On accounting for operations under a leasing agreement» of February 2, 1997. In the course of a leasing deal other normative documents will apply such as the documents «Accounting for economic activity of enterprises», «Instructions for application of accounting rules», and «Regulations on accounting for revenues, expenditures, and assets.»

Order No. 15 outlines the following peculiarities of a leasing deal:

- The lessor remains the owner of the asset leased throughout the period of the leasing agreement;
- The leased asset can be recorded on the balance sheet of either the lessor or the lessee, as agreed by the parties to the lease agreement.

The details of the accounting procedures are listed below, grouped by whether the asset is recorded on the lessor's or the lessee's balance sheet. We should note here that in most cases, it is advantageous to both parties to record the asset on the lessor's balance sheet and to pass any savings on to the lessee. In the majority of cases we see - but not all - this is how leasing deals are accounted for.

**Asset Recorded on the Lessor’s Balance Sheet**

If the asset is recorded on the lessor's balance sheet, the following accounting procedures are used:

**Lessor:**

- Records the asset as a purchase at the price paid to the supplier plus any corresponding costs (such as transport);
- Calculates and records depreciation charges;
- Records leasing payments received as sales revenue;
- Calculates and pays property tax applicable to the asset.

**Lessee:**

- Records the leased asset on the off-balance sheet asset account (this has no affect on taxes or other basic accounting measures);
- Records leasing payments in full against the cost of production (expenses).
Asset Recorded on the Lessee’s Balance Sheet

The following accounting procedure is used when the leased asset is recorded on the lessee’s balance sheet.

**Lessor:**
- Records the asset on the off-balance sheet account «Assets rented out»;
- Records the sum of the leasing payments over the term of the leasing agreement as accounts receivable at the start of the leasing term;
- Records the difference between the total sum of the leasing agreement and the purchase price of the leased asset as «Future (unearned) income»;
- Each lease payment is applied against the accounts receivable account;
- The proportion of each payment that corresponds to future income is booked to sales, and the future income account is depleted over the term of the lease.

**Lessee:**
- Records the leased asset in fixed assets at the value of the sum of all leasing payments;
- Records the sum of the leasing payments over the term of the leasing agreement as accounts payable;
- Calculates and records depreciation charges as current expenses;
- Records leasing payments as reductions to accounts payable;
- Calculates and pays property tax applicable on the leased asset.

We should also note that when the asset is carried on the balance sheet of the lessee, some issues that have yet to be fully clarified can arise. In particular, accounting procedures are not yet established if the lease is completed before the full term of the lease (leaving the method for writing off the remaining accounts receivable unclear), the use of the sales account with respect to «future revenues» and a number of other questions. These problems may contribute in part to the tendency to keep assets on the balance sheet of the lessor, where the accounting implications are clearer.\(^\text{14}\)

In cases where there are contradictions in the accounting instructions for leasing operations, fines or other penalties may be imposed by the tax authorities. To avoid these situations, the parties to a leasing deal should get clarification from the tax authorities or other relevant government bodies as to how the accounting norms are to be applied.

Expected Changes

**Accounting - Expected Changes**

The system of accounting inherited from the Soviet period did not give a realistic picture of an enterprise’s state of affairs, and hence potential investors and creditors were generally unable to form accurate conclusions about the financial situation of the enterprise.

\(^{14}\) For further information, see "Financial Leasing in Russia - Overview of the Legal and Regulatory Framework ", IFC, 2001, section "Accounting for Leasing Operations".

63
The current Russian accounting system - while in a process of rapid change - fulfills a dual purpose. First and foremost, it provides the basis for accounting for firm revenues, assets and activities for taxation purposes. Second, the accounting standards provide information to the firm’s owners and creditors.

In the West, these two functions have often - although not always - been split. It is largely accepted that the needs of a taxation system are quite different from those of the firm’s owners (although the interests can overlap). It is also generally accepted in this sense that two types of books will be kept, although they are expected to coincide fully in terms of data sources.

In 1998, the government adopted a program of accounting reform and the Ministry of Finance and other relevant agencies began to work on the program. One of the main goals was to begin to apply international accounting standards within Russia.

The option of simply translating international standards into Russian and then applying them was considered rather than ‘reworking’ and adapting them to Russia. According to the Ministry of Finance leadership, adapting international standards (that is, «taking into account national characteristics») was more promising, even though the process of adapting the existing standards would take considerably longer. Over the last few years (from roughly 1998), enterprises have been adopting the new accounting standards. In the long term, the reform should come closer to meeting the legitimate needs of the corporate tax system and owners and managers alike.

**INTERNATIONAL LEASING**

**Current Situation**

International (cross-border) lease deals are those where the lessee or the lessor are not residents of the Russian Federation. Where the supplier is a non-resident but both lessee and lessor are Russian, normal domestic leasing law applies. In international leasing deals, additional questions arise - particularly those related to tax, customs and currency regulations.

We should note one major distinction between types of leasing deals. Since Russia is a signatory to the Unidroit Convention on International Financial Leasing, the Unidroit procedures take precedence over Russian law when the convention applies. For the most part, the parties to such a leasing deal must both be residents of countries that are signatories to the Unidroit Convention on International Financial Leasing.

The Unidroit Convention is intended to help regulate international financial leasing deals by providing a well-understood regulatory framework that has been specifically developed for application in cross-border circumstances. The parties to the leasing deal generally have the option of specifying which legislation will apply, the domestic legislation of one party or the other or the Unidroit convention - but the choice must be specified in the lease deal. In most other cases, Russian domestic law will apply in full. Further information about the Unidroit Convention is available at [http://www.unidroit.org](http://www.unidroit.org)
As will be clear below, the variants possible under international leasing deals are numerous, since bilateral or other treaties on tax, investment and other subjects (particularly Double Taxation Agreements) may adapt or modify the applicable regime depending on which two countries the parties to a leasing deal are registered in. For this reason, we strongly recommend that parties to international leasing agreements get professional legal assistance. The information below is intended to help get a sense of the basic framework.

**Taxation for International Leasing Deals**

Non-resident leasing companies must register with the tax services. Registration may consist of receiving permission to undertake certain activities, or simply informing the tax authorities, depending on the type of activity undertaken and the type of equipment being leased.

**Profit Tax**

If the Russian participant is a leasing company (lessor), then profit tax is paid according to the usual domestic conditions. In this case, profit taxes paid in accordance with foreign legislation are counted against taxes paid according to Russian legislation.

If the Russian participant is a lessee and the lessor a non-resident of the Russian Federation, the following points apply:

- Profit taxes for foreign legal entities with permanent representative offices in Russia are calculated in the same way as for Russian enterprises.
- If the foreign entity does not have a representative office, taxes are applied at the rate of 20% of the lease payments minus the cost of the leased asset, interest payments on credit used to acquire the leased asset, and property taxes paid on the equipment. The lessee is to withhold (pay) the taxes on behalf of the foreign leasing company.

When the new Profit Tax chapter of the Tax Code enters into force on January 1, 2002, the tax situation for foreign leasing companies without permanent representative offices will change significantly. The most significant change is the reduction in applicable profit tax to 10% while the tax base will be larger, since all revenues in Russia will be taxable without deductions for expenses.

Other tax regimes may be applied according to international treaties signed and ratified by the USSR or the Russian Federation.

**Value Added Tax**

When the leasing company is a resident of the Russian Federation, value added tax (VAT) is not paid, as the leasing service is provided outside Russia and is not subject to taxation here (that is, any VAT would be paid in the country where the equipment is leased).

If the lessor is a foreign entity, the Russian lessee is responsible for ensuring that VAT is paid, and must withhold VAT from each leasing payment at 16.67% (the
equivalent of 20% added to the leasing payment before taxes). The foreign lessor is entitled to request the offset or repayment of VAT paid by the foreign company when the leased equipment was imported into Russia.

**Property Tax**

The foreign leasing company will need to pay property taxes when the leased equipment remains on its balance sheet. The value of the leased equipment for purposes of property tax is the remaining value of the equipment after depreciation. The initial value of the equipment is the purchase price of the equipment minus wear and tear according to legislation in the lessor’s country of origin (subject to certain limitations). As is the case for profit tax, other conditions may apply where international treaties and agreements exist.

**Customs Regulation of International Leasing Agreements**

Equipment may be imported or exported according to one of two customs regimes, either for permanent or temporary import.

**Import Regime (Permanent Import)**

When equipment is imported under the normal customs regime (for permanent import), the party importing the equipment (whether the lessee or the lessor) is required to pay in full any applicable duties, tariffs, excise taxes and value added taxes applicable. Tariffs in Russia generally range from 5% to 25% of the import value. In turn, VAT is calculated after (in addition to) import duties and excise taxes.

**Export Regime (Permanent Export)**

Equipment exported (for example by a Russian supplier) is free from local taxes such as VAT, but subject to any export duties or other requirements stipulated by customs legislation. For the most part, export duties apply not to equipment but to oil and gas, precious metals and other raw materials exports.

**Temporary Import (Export) Regime**

Leased equipment can also be imported or exported under the temporary customs regime. Under the temporary customs regime, the goods are freed in part from some taxes: tariffs are paid at the rate of 3% for each month or part thereof of the duties which would have been payable under the normal import regime. The application of the temporary import regime is difficult in practice for leasing, since the maximum period allowed is two years. After the two years, the equipment must be either re-exported or transferred for use under the regular import procedures (effectively, the equipment is ‘regularized’ as if it had been imported normally).

**CURRENCY REGULATIONS**

In accordance with the law «On Currency Regulation and Currency Control», all foreign currency operations in Russia are divided into two categories: current or capital transactions. Transactions that extend beyond 90 days are considered to be capital transactions, and require the permission and a license from the Central Bank.
According to Article 34 of the Law on Leasing, payments under a lease agreement with a term of more than six months are considered to be current transactions. Unfortunately, this article contradicts currency legislation that is currently in force, and may not be applied with certainty. Some leasing companies and others have asked the Central Bank whether Article 34 would apply, and received clarification that leasing deals would be considered current transactions in accordance with Article 34 and hence not require a license. It is not clear, however, that the Central Bank's opinion is sufficient, and the problem persists.

**Expected Changes**

As the State Duma has enacted a new Tax Code, there will be changes affecting international leasing deals. For the most part, however, these changes are no different than those that apply to domestic lease deals - the most important of which is the reduction in the profit tax to 24% and the elimination of a number of special tax breaks.

The Duma has also passed in second reading amendments to the Law on Leasing that are to be considered in the fall Duma session. We do not expect this to bring significant changes to the regulatory framework for international leasing.
APPENDICES

LESSEES: WHAT DID THE EQUIPMENT ALLOW YOU TO DO?

Increase sales

The economic motivation behind leasing as compared to general bank lending in the most simple terms is *that there is a positive cash flow for the lessee attributable to the leased asset*. Leasing is used only for assets of some sort, and never for inventory or working capital (except in the case of some buy-back leasing arrangements). Note that the positive cash flow effect may be due to reduced costs, not just increased production or sales, although leased assets are more commonly associated with increased production and sales. Since the lessee is using the asset to realize an increased cash flow in return for payments to the asset’s formal owner, the lessee has every incentive to continue to pay the owner - or risk losing usage rights and hence the additional cash flow from the asset.

There are numerous other benefits to leasing, in particular the ability to allocate in a very flexible manner the partition of risk between the parties. Fundamentally, however, the key factor is that the usage rights are more important to the lessee than the ownership rights because they directly contribute to increased profits.

Given this basic motivation, we would expect that (except, as noted above, when used to reduce costs) lessees should see increased revenues and profits after entering into a leasing deal. Our recent lessee interviews and surveys indicate that this is indeed the primary motivation for lessees. While our samples and interviews are insufficient at present to provide a statistically robust figure, we often see substantial jumps in revenues and profits amongst lessees relatively shortly after acquiring equipment through leasing.

Increase employment

Proving a cause-and-effect relationship between the level of employment in a company and the acquisition of equipment through leasing is a methodologically difficult proposition. Ideally, one would need to do a large-sample survey of lessees and all other companies and undertake careful statistical analysis of the differences between the two groups (controlling for all other possible factors). The Leasing Development Group has begun collecting such information, although it will fall short of a large-sample statistical survey.

Nonetheless, the theoretical proposition that leasing (and other forms of credit) lead to job growth is relatively simple. The basic theory is that companies acquire equipment to increase sales and profits where they would otherwise not be able. The equipment has both a direct and indirect effect: presumably some staff are needed to operate the equipment itself, and in addition, other areas of the company (sales staff, administrative staff, etc.) will also need to grow. Finally, the increased revenues and profits will be re-invested (either directly or indirectly), resulting in increased employment elsewhere.
The particular attraction of leasing over other forms of lending is that, since it requires fewer guarantees and is less risky for the borrower, it is a more accessible form of credit for small and medium-sized enterprises (SMEs).

As a simple explanation of the job benefits of leasing, we will analyze a hypothetical leasing deal (based on an actual interview) that is quite typical: the purchase of a small truck or minivan for deliveries.

The Snegurochka company produces home-style Russian salads. Until recently, Snegurochka sold its production to nearby groceries. Due to the high quality of the salads, Snegurochka often received requests to provide salads for restaurants, conferences, weddings and other special occasions, but often had to decline the offers because it could not deliver.

The owner of Snegurochka decided to acquire a Gazelle mini-van to make deliveries, and to ask one of her current employees to make deliveries on a part-time basis. Purchasing the mini-van was out of the question, since it required a cash outlay of $7000, while the firm had only $2500 in cash available for the purchase. The van was acquired through leasing with a $2500 advance.

Salad sales increased slowly at first, then dramatically as the size of the catering market for weddings and special events became clear. Soon, a full-time driver was hired, with the former driver returning to her original position - since demand for salads was growing.

The catering market turned out to be far more profitable than selling to groceries, and additional workers were hired to produce salads. Soon, a second driver was hired to make deliveries at night and on the weekends, since special events tended to be rare on weekdays.

Catering customers began to ask about other products, and Snegurochka began to make other products for catering: pastries, cakes, and other buffet foods. As a sideline, the catering business began to provide flowers for receptions and staff for the receptions (such as barmen and wait staff). A mini-bus was required to move the staff from reception to reception, and night and weekend staff for the kitchen due to additional catering demands.

This example is not a fairy tale, despite the company name (roughly, «Snow White» in Russian). The ability to expand into new markets can be seriously constrained by cash limitations, and credit is of course required. Leasing may be appropriate in this particular instance primarily because the secondary value of a small truck is fairly clear, and the revenues from the truck clearly attributable to the equipment.

More importantly, equipment leased tends to relieve bottlenecks - freeing up resources to allow other company resources to reach their full potential.
Throughout the life of the LDG, we have come across a number of rather compelling examples of how leasing can help companies (suppliers) grow their businesses. Furthermore, we are often approached for advice on how to use leasing to sell products in this market. The following details the steps we recommend to foreign and domestic equipment companies in order to determine the feasibility of using leasing to sell equipment in Russia.

1. Is your product leaseable?

This means, is it relatively liquid? Is it leased in other markets? Is there a secondary market for the product in Russia? Can you identify multiple potential customers? Is it easily dis-assembled or transported? Is it fairly standardized? Equipment that corresponds to these criteria is more easily leased and the existence of secondary markets will tend to reduce the risk to the lessor, and hence the cost to the lessee.

2. Does your potential customer, the prospective lessee, have existing banking relationships in Russia?

Most notably for leases considered mid-market and up (greater than $50,000), it is generally preferable that a lessee have an existing banking relationship. Preferably, the lessee should have a credit relationship and its bank should have experience directly or indirectly with leasing.

3. Identify solid leasing companies near key customers.

We cannot stress enough the importance of developing long-term relationships. As the Russian market matures, competition for customers will likely increase. The sooner suppliers are able to identify Russian leasing companies with whom they can work, the sooner they will be able to leverage these relationships to risk-share and develop new markets. Given the importance of being relatively close to lessees, it is usually essential to find leasing companies working in the region in question.

4. Start small and simple.

While a small deal ($25,000 to $50,000) often doesn’t seem to warrant the time or energy, it is often an ideal way to initiate a relationship with a leasing company. In Russia, as in other similar countries, the initial complexity is often overcome once the parties conclude a handful of transactions.

5. Have a realistic approach to risk.

Suppliers should recognize that while leasing is a flexible means of allocating risk, it may not be able to remove all risk. Some of the advantages to working with a leasing company are that the leasing company bears most of the risk of
dealing with the final consumer, provides most required credits to the lessee, and takes on the task of evaluating the credit-worthiness of the customer for individual deals. Since the supplier can use the same leasing company for multiple transactions, the fixed cost of evaluating customers’ credit-worthiness is reduced for the supplier. Finally, since the leasing company effectively begins to establish a specialization in the equipment leased, equipment risk is reduced. That said, suppliers that are willing to share some risks with leasing companies by, for example, providing buy-back guarantees, limited trade credits, or other solutions, will have better chances of using leasing effectively to increase sales over the long term.
EXAMPLES OF LEASING DEALS

This section contains profiles of three actual lessees and their experience with leasing, along with our comments and analysis. While we are, for privacy reasons, not naming the companies and individuals involved, they are all based on actual leasing deals (sometimes several from one lessee). They are provided to demonstrate in a more narrative (and less ‘academic’) form than contained in the rest of this report.

Example 1 - Moving from Retail/Wholesale to Production

Company A began life in a provincial capital as a soft drink, juice and mineral water distributor - a business that is still functioning. Eventually, the family-run business decided that it was too dependent on producers, and needed to diversify its business by moving into its own production. As they put it, «trade in finished goods is not sustainable in the long term.»

They established a second company and began to produce prepared (salted and dried) fish for retail sale and use by local restaurants, both markets in which they had good contacts. A significant constraint on their business was the company's limited capacity to deliver its final production, and so a delivery vehicle was obtained through a local leasing company. Soon two more vehicles were acquired: a truck for deliveries and a van for driving staff home. Subsequent leases have included refrigerators and other, less ‘mobile’ equipment.

The lease for the van is perhaps the most interesting: the van was needed to allow the company to move to 24-hour production using shifts, since public transport was not available at all hours and staff did not own their own vehicles. Hence, a lease for a relatively small value removed a serious production constraint.

The company now employs about 75 people, with plans to expand employment to 120 in the next year. While the company also receives loans from banks, the loans are primarily to cover purchases of raw materials and for extremely short periods. The owner describes the loans as expensive (since interest cannot always be claimed as expenses), too limited, and too short-term to use extensively. Due to the seasonal nature of the raw material purchases, all available working capital is often used for these purchases - at precisely the time they also need to acquire equipment.

The owner says that the only other form of finance available to this firm for equipment purchases is retained earnings, which are, of course, limited. Short-term plans for equipment acquisition include delivery vehicles, trucks, tractor-trailers, and refrigerators. In the medium-term, the company plans to move to new facilities and outfit the new location with new equipment.
Example 2

Company B, located in a Siberian capital, sold packaging material and other plastic products for several years. The company had the opportunity to purchase a disused plastic production factory from the state, for which it received some limited state credits. The equipment in use was extremely run-down, however, and only produced an intermediate form of plastic used to produce the final goods.

In late 1997 and 1998, Company B was in negotiation with a foreign firm to completely equip the factory with new equipment. This equipment would use the current intermediate production to produce the end products, and a later phase of the project would see the intermediate production equipment entirely replaced. Together, both phases of the project were to cost in the neighborhood of $10 million.

The 1998 Russian financial crisis intervened, however, and both the foreign supplier and the large local bank pulled out of the project before it was completed. Company B therefore used some of its retained earnings to repair existing equipment and boost production, which was now more competitive with foreign equivalents due to the ruble devaluation.

Using leasing, the company then acquired equipment from a CIS-based manufacturer to produce the final goods. Products comparable to Company B's output on the local market were available only from China, the Far East, and European Russia, and were comparatively expensive. Company B's production grew to fill this niche.

In the last year and a half, the company has acquired several more pieces of equipment, but the equipment now comes primarily from Western suppliers. «Consumers used to buy anything - as long as it was available, they would buy it. Now, they're looking for quality, and the better quality foreign goods are now more affordable. Still, we can own this market if we can produce equal quality. But we can only do that with new equipment.» The company has since expanded into production of several related products made from the same raw materials.

Comments:

- Key advantages here included availability of finance not available from other sources, tax efficiency, and the low cost compared to bank loans
- Companies often move from small value leases (particularly vehicles) to larger leases for more specialized equipment
- The equipment acquired in this case allowed the company to remove key production bottlenecks
- The transition from sales and commerce to production is also a common trend among lessees, although more often, lessees move into production of a product they are already familiar with
Company B turned to leasing because bank credits were no longer available. Although leasing is working well, the funds available in the local market are still insufficient, but management has decided to expand and improve quality progressively, rather than all at once.

- Many lessees are re-establishing or expanding production after key plans fell through after the 1998 financial crisis
- These newer expansion plans are often smaller in scope, and more step-by-step in nature
- Leasing is also commonly used to respond to three common local demand factors: local availability of processed products, quality improvement, and providing a wider range of products

**Example 3**

Company C, a wood processing company, was founded in the 1920s, and privatized in 1994. The company produces components used in local home-building, entirely for the Siberian region, and the products are sold in more than ten regions of Russia.

The company’s equipment was for the most part old and not adapted to changing demand on the market. Specifically, the company did not intend to increase production levels at this point, but improve quality and move to more flexible production that would increase the range of products offered.

Since the company was profitable, the company found before signing a lease deal that leasing would have a lower final cost, and used a tender process to determine the best leasing company. The company had already acquired new equipment in previous years using retained earnings, but decided it was time to begin to use credit to permit more efficient use of its limited financial resources.

While the equipment leased was expected to lead directly to the establishment of ten new jobs, the company has been growing rapidly. The company’s staff count had grown by over 50% in under two years to over 500 employees. The equipment leased was Russian-made, since foreign alternatives were far more expensive. While the Russian alternative was less automated and required more staff, this solution was considered more efficient given the relatively low labor costs.

- Leasing often involves foreign equipment, but acquiring domestically-manufactured equipment is far from rare
- Larger companies also use leasing, particularly during periods of rapid growth and to expand into new markets
- Leasing is often used not to increase the volume of production but to re-profile production to changing market demand