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Leasing Companies

IFC has invested well over \$100 million for its own account in leasing companies in developing countries. These investments have yielded encouraging results. In a recent review, IFC's independent Operations Evaluation Unit (OEU) examined the performance of 15 IFC-assisted leasing companies and analyzed the factors contributing to the success or failure of six of them. These companies, located in Asia and Latin America, had total assets ranging from \$1 million to \$2 billion.

The leasing companies have provided good returns and have contributed to the development of the host countries. They mobilized substantial funds from commercial sources—in one case, over 100 times the amounts provided over the years by IFC itself. They effectively allocated resources to private enterprises and contributed to the development of domestic capital markets. And they responded to two of IFC's special concerns—assisting small businesses, and assisting small or low-income countries, like Botswana, Malawi, and Bangladesh.

IFC's experience with leasing companies has generally been better than its experience with term-lending institutions such as development finance companies. Although many factors contributed to the differing results between the two types of institutions and among individual institutions, two were particularly important: portfolio performance, and spreads.

Portfolio Performance

The study found that leasing companies generally had better-performing portfolios than term-lending institutions. Leasing companies benefit from several advantages in collecting amounts due and, when necessary, recovering assets financed. In most countries, lessors can repossess equipment without the need for lengthy court procedures. Since they have an interest in specific pieces of equipment, they can repossess assets without triggering acceleration clauses and without having to share assets with other creditors. Thus, lessors typically act more quickly to protect their position before a lessee's operations deteriorate drastically. Recognizing this, lessees often give priority to lease payments over debt service payments. When companies seek the protection of the courts to permit a financial restructuring, lease obligations are normally not subject to the moratorium imposed on debt service. And when leasing companies are forced to repossess equipment, they can retain sales proceeds in excess of principal amounts outstanding on the underlying leases. When inflation rates are high, surpluses on liquidating repossessed equipment may go a long way toward offsetting unavoidable losses.

Not all leasing companies, of course, have good credit experience. Economic conditions, for example, can affect the portfolios of leasing companies as well as lenders. In economies that had relied heavily on protected import-substitution industries, the structural adjustments that eventually became necessary had a significant impact on leasing companies, particularly when they had passed foreign exchange risks on to borrowers incapable of handling them. Most of these leasing companies suffered from the difficult economic conditions of the early to mid-1980s, when worldwide recessions and painful structural change undermined clients' ability to pay. Nevertheless, some leasing companies weathered economic shocks smoothly. One, for example, survived an extremely difficult period better than others in the same country because management tightened credit criteria and drastically cut back operations when warning signs first appeared.

Although being in the leasing business provided certain advantages and country conditions created certain constraints, an institution's handling of credit decisions and its monitoring and supervision practices remained crucial to the performance of its portfolio.

Caution v. Aggressiveness

As with all financial institutions, a balance of caution and aggressiveness was the key to good performance. Institutions with good portfolios consistently opted for quality over quantity. In the case of one leasing company, the technical partner specifically instructed the original chief executive to go slow in identifying good clients and testing the water, rather than putting a large volume of leases on the books. The care exercised by this leasing company in selecting clients was reflected in its unusually good portfolio performance compared with other institutions in the same country.

By contrast, institutions that developed portfolio problems were more aggressive and were willing to sacrifice quality to expand their volume. In one case, the sponsors' original forecasts were based on the likely rate of recruitment, the time needed to train new staff and develop appropriate systems, and a gradual increase in staff productivity. The leasing company's management, however, amended forecast productivity levels to bring them in line with mature leasing companies controlled by the technical partner and then aggressively tried to achieve the more ambitious targets. As a result, this leasing company developed major portfolio problems by its third year of operations.

Exposure Limits

Leasing company policy statements typically limit single enterprise or group exposures and single industry or equipment-type exposures in relation to the institution's net worth or its portfolio. While most of the leasing companies reviewed respected these limits, some ignored, overruled, or took advantage of the loose wording of policy statements. One leasing company, for example, took excessive exposures in individual clients, groups, industries, and types of equipment. Before IFC even disbursed, the company increased its single-enterprise policy limit and then took an exposure in one venture equivalent to roughly 50 percent of its equity. It also took advantage of a policy statement provision allowing it to exceed its single industry and single equipment type limits until the end of its third year. When the country devalued its currency and began major structural adjustments, this institution was hit heavily and had to write off amounts equivalent to roughly 50 percent of its equity in the ensuing few years.

Security and Guarantees

Although the policy statements of the older leasing companies generally did not mention security or guarantees, some new leasing companies have addressed these issues. They have commonly called for concentration on equipment that is clearly identifiable, removable, unlikely to become rapidly obsolescent, and able to be leased again in the event of repossession. The leasing companies have usually placed great stress on the security provided by the leased equipment, and many have also sought additional security or guarantees for riskier operations or unusually large exposures. Security and guarantees have contributed to the leasing companies' good portfolio performance.

Reliance on Equipment Dealers

Portfolio performance in several leasing companies was adversely affected by excessive reliance on equipment dealers as a source of business. One leasing company, for example, tried to build up its volume rapidly by arranging to finance the equipment sales of local dealers and was not careful in reviewing the individual proposals or the financial strength and business practices of the dealers. This marketing strategy led to excessive reliance on dealers' guarantees, rather than the buyers' ability to pay—a particularly dangerous practice when dealers issued guarantees they could not honor. Despite these dangers, several spread-based institutions successfully used equipment dealers as a source of business. They were careful, however, in choosing dealers and lessees. They sought not only to avoid the dangers that caused trouble to others but also to emphasize high quality equipment with good resale value.

Procedures and Systems

Adequate procedures and systems were also important for a healthy portfolio. Three factors were vital: establishment of proper procedures from the outset, modifications in procedures and systems as operations changed, and checks and balances.

Staff responsible for generating business may allow their credit judgments to be influenced by their desire to build up volume. Moreover, financial intermediaries may be subject to political influence or corruption, particularly when governments maintain interest rates at low levels. The institutions reviewed tried to avoid these dangers in two ways: first, by separating responsibility for judgments on credit matters from responsibility for generating volume; second, by requiring the approval of several staff members for positive credit decisions. One institution even made credit decisions above a certain level contingent on the approval of directors nominated by the two largest shareholders.

Monitoring and Supervision

Most of the leasing companies visited clients regularly. One, however, considered regular client visits too costly because the amounts outstanding were small. As it began to enter into larger leases, however, it did not adapt its supervision practices and, as a result, was not in a position to take early action to deal with emerging problems. Institutions with good portfolios, in contrast, took aggressive action when clients fell behind on payments. They intensified their visits and made strong collection efforts, including taking steps to repossess leased equipment, court action, or both. At least two leasing companies tried to develop financial discipline in countries where this tradition was weak by convincing clients that lease payments were equivalent to utility payments and that delays would result in repossession of essential equipment.

Spreads

Leasing companies have typically been able to realize higher spreads than lending institutions. Clients have been willing to pay higher spreads due to the possibility of financing a higher proportion of the cost of an asset than would be possible when borrowing, the lesser need for collateral and compensating balances, the greater speed in arranging lease financing, the possibility of excluding lease obligations from balance sheets, and tax advantages.

Some leasing companies, moreover, have benefited from four other advantages:

- Good portfolio performance has reduced the difference between theoretical and realized spreads. Non-performing assets can reduce spreads materially. For example, with an interest rate of 10 percent on 5 percent of non-performing assets, an institution would lose 50 basis points of its spread. Since the leasing companies reviewed generally had healthy portfolios, they did not suffer as much as some lenders with weaker portfolios.
- Several leasing companies increased their spreads by incurring mismatches in the maturities or interest rate resetting dates of their assets and liabilities. In doing so, they increased the volatility of their spreads and, hence, the inherent risks in their operations. In one case, however, knowing that it could have recourse to undrawn long-term loan commitments, a leasing company financed its operations with low cost, short-term funding and achieved a spread averaging 15 percent over its first three years.
- Leasing companies have generally been free from direct government controls on interest rates—a common problem in developing countries—and have thus been able to base their operations on higher rates than competing lending institutions. Not all, however, escaped the consequences of government interference in financial markets. Restrictions on interest rates of competing term-lending institutions limited the rates of several leasing companies, and limits on interest rates interfered with another's ability to attract resources and add an adequate spread.
- Many leasing companies in developing countries have benefited from government restrictions on the number of firms allowed in the market and so have achieved unusually high spreads. Liberalization of capital markets, however, has been eliminating this advantage in more and more countries.

All these factors, however, still do not explain why profitability has remained higher than in other spread-based operations. Spreads and profits have come down over time, as markets have become more competitive, but more aggressive competition may be necessary to eliminate the gap in profitability. IFC's developmental contribution may be particularly important when introducing the first leasing company to a new market, but helping to establish new leasing companies in countries where leasing is already well-established can also contribute to development.

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