



Leveraging Leases for Small Businesses:

a working analysis of opportunities,
with special reference to situation in Kenya

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1. Asset Finance for Small Business

1.1 Introduction

Small-scale enterprises in developing countries play a critical role in providing a poverty safety-net, a source of income and employment among the rural and urban poor. In some productive and competitive sectors, particularly agriculture and agro-processing industry, they make a significant contribution to economic output too.

Nevertheless the full social and economic potential of small businesses are not being realised. A key problem is access to finance for medium-term investments in relatively modest capital equipment. This constraint undermines small businesses' ability to meet the quality, quantity and timeliness standards required by the larger companies that supply expanding urban and export markets.

In Kenya, for example, growth in the dairy sector appears to have been constrained by failure of the industry to invest at the small-holder farm level in milk-chillers, hay balers and transport equipment. Many service sectors with growth potential in Kenya – for example in computer equipment, office cleaning, printing, mobile communications – also lack the level of vibrant small business representation that is found in other developing economies.

Several factors discourage commercial lending to smaller enterprises and confine lending to medium and large companies. These factors include

- Small businesses generally lack formal forms of collateral needed to secure medium-term finance e.g. a reliable credit history and existing capital assets
- Banks incur high transaction costs relative to sizes of loans which smaller clients require
- Banks face relatively higher degrees of uncertainty about business risks and returns in activities undertaken by smaller enterprises

Leasing has begun to attract attention in the last two years, as an alternative financing mechanism that might overcome some of these factors. Leasing is of interest because unlike other kinds of lending, security for the transaction is provided by the leased asset itself. Thus leasing provides a potential escape route for smaller enterprises from the trap of low-capitalisation, low-profitability and lack of credit history.

1.2 Some Advantages of Leasing

In principle the advantages of leasing, compared to purchasing with debt financing, come from several directions:

- Ability to make repayments is assumed to derive from productive use of equipment to generate a new cash flow, rather than credit history, accumulated capital or salaried earnings.
- Investment risk for financial institutions is reduced because the lessor retains full ownership of the equipment, and thus have a less onerous route to recovery of assets in the event of default.
- Livelihood risks facing small-scale entrepreneurs (whose relative poverty makes them vulnerable to the consequences of business failure) is reduced by spreading investment costs and thus reducing cash-flow pressures.

- Constraints imposed by interest rate ceilings on conventional bank loans, and other prudential banking regulations do not necessarily apply.
- The tax benefits and incentives for capital investment enjoyed by larger firms - i.e. capital allowances / VAT reclaim / depreciation - could be extended (through lessors) to smaller enterprises that are normally unable to take advantage of them.

Potential exists for developing the market for leasing across the board. But in developing economies where capital markets are least sophisticated, it is among small enterprises seeking to invest in medium-ticket assets (US\$ 500 – 10,000) that the greatest un-met demand for lease-type finance exists. Such enterprises have outgrown the group-based loans available from micro-finance institutions, but have very limited access to conventional bank lending for reasons given above. It is in this segment that the greatest potential for social and economic impact probably lies, provided finance is targeted accurately.

1.3 Specific Challenges of Leasing to Smaller Enterprises (Micro-leasing)

In principle, leasing provides a solution to the problem of lack of collateral faced by smaller businesses. However that is only part of the equation. Several specific challenges must be addressed if leasing to small enterprises is to be attractive to lenders / lessors:

1. Administration & monitoring of large numbers of small-value lease contracts
Administering large numbers of small-value contracts generates high overheads. This is true for all types of financial product, but more so for leasing. Monitoring business performance in order to anticipate and pre-empt repayment problems is particularly costly and inaccurate. A viable model of micro-leasing has to solve this constraint.
2. Bolstering the security provided to lessors by asset ownership
To be effective as a form of collateral, leased items should be relatively easy to move and sell on (high residual value). This characteristic, unfortunately, also makes such assets more prone to theft or absconding by the lessee. In practice, lessors will need additional forms of security for lease contracts, especially with small rural entrepreneurs who may be harder to trace.
3. Appraisal of market opportunities in small enterprise business sectors
Viable leasing depends – to a greater extent than other kinds of financing - on accurate appraisal of the markets for lessees' products and services. This is because the ability to make repayments is assumed to derive from productive use of equipment.
Financial institutions (whether Banks, HP companies or MFIs) are not strong on market appraisal in small-scale business sectors. Neither is self-assessment by lessees adequate, given the propensity of small business trades to be swamped by excessive new entrants. Some other form of market appraisal capability is therefore needed.
4. Assessment of commercial value & technical appropriateness of leased equipment
Inappropriate technology choices are a common cause of business failure. Knowledge about the value, reliability and technological appropriateness (inputs required, outputs obtained, quality of outputs and inputs, maintenance requirements etc) of specific items of small-scale capital equipment is also not readily available to either prospective lessors or lessees themselves. The problem is exacerbated where second-hand equipment is needed. Another source of technical capability is therefore required in this area.

2. “Leveraged Leasing” as a Solution

2.1 Using Supply-chain Linkages to Facilitate Leasing

One novel way to tackle the constraints described above is to use existing business relationships between small enterprises and larger corporations in supply-chains as a lever to facilitate leasing activity.

This kind of “leveraged leasing” is specially relevant to industries where large numbers of small enterprises produce inputs or provide services on a regular and predictable basis for much larger companies further down a supply chain. In principle, it can also work where small enterprises are the regular distributors (eg. retailers / vendors) of products from larger suppliers.

In Kenya, examples of this sort of business relationship can be found easily in agricultural supply chains within dairy, fish and export horticulture (vegetables, flowers) industries. They also arise in many other sectors, including office equipment supplies and services, construction, transport, health care, and retail / vending.

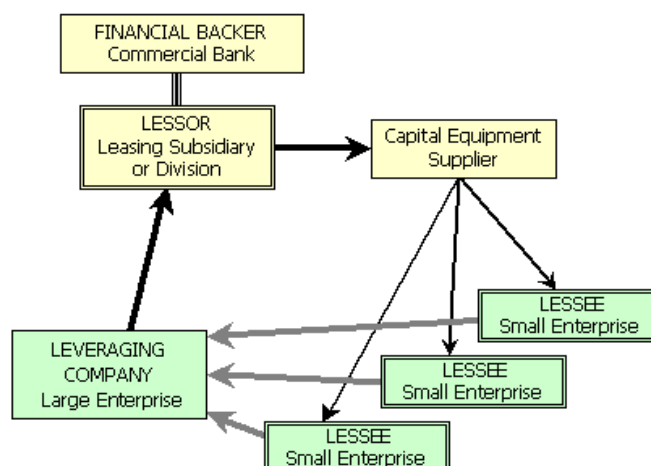
In the context of these business-relationships, both parties (small & corporate) are likely to have good incentives to increase investment in productive capital. For individual small enterprises, the incentive maybe growth and business stability. For the larger company, the opportunity to upgrade their supply-chain, addressing issues of quality, punctuality or volume.

The supply-chain relationship can facilitate asset financing in several ways: by reducing business uncertainty for the small enterprise, by providing a form of collateral for the financier / lessor, and by lowering the costs of lease administration. A specialised leasing company can literally realise the financial benefits of the goodwill and historical relationship between supplier and buyer, to everyone’s advantage.

2.2 How It Works

Leveraged leasing involves three parties – the lessor (financier), the lessee (small enterprise which will operate the asset) and a leveraging company (buyer). The basic components of this approach are:

- Leases are offered to small enterprises (lessees) which have existing relationships involving regular supplies or services to a larger firm that they supply (the leveraging company).
- Lessees undertake to supply (and the leveraging company to purchase) a minimum quantity of goods or services sufficient at least to cover the value of lease payments.
- Leveraging companies undertake to monitor lessees’ performance, deducting and assigning lease instalments directly to the lessor from payments owed to the lessee for goods / services supplied.
- In the event of default, the lessor has a call not only on the leased asset itself, but also on any outstanding payments (typically 60 or 90 days supply) that the leveraging company owes the lessee.



This model has several advantages which address at least some aspects of the four challenges listed earlier (section 1.3):

Providing assurance of lessee business viability.

The willingness of leveraging company to participate in such a scheme, incurring extra administrative costs, can itself be taken by the lessor to help confirm the market for lessees' products / services, and hence the fundamental viability of lessees' businesses. This reduction in the business risks associated with financing is significant, given how difficult and relatively costly banks find the appraisal of loan applications from small businesses.

Reducing monitoring and administrative costs

By undertaking the administration of lease payment collection within its own financial systems, the leveraging company role massively reduces the lessor's overhead costs. The leveraging company is also in a privileged position to monitor the performance of lessee's businesses since it will become aware of problems in lessee performance and output before default occurs.

Bolstering lessee's collateral security

In addition to the security provided by retention of legal ownership of the leased asset, leveraged lease contracts can be constructed so that in the event of default lessors claim on the retained earnings which leveraging companies owe their suppliers (the lessees). Typically this could be 60 or 90 days income depending on payment terms.

This form of collateral can be as valuable, in practice, as legal entitlement to recover the asset. Its use is not confined to asset-backed financing arrangements. At least one finance company in Kenya is already employing it to secure short-term loans to small businesses. (see box about Micro Kenya Ltd)

Spreading costs of technology appraisal

A further advantage of a leveraged approach to leasing, is that costs and risks associated with making inappropriate technology choices (including searching for, procuring and adapting technology to specific business applications) can be spread between clients with similar needs. Individual small businesses do not necessarily have the skills and scope of experience to make sound technology-choice decisions. Equally this is rarely a function that banks / lessors will want to involve themselves in. In some circumstances the leveraging company may even be the best source of technological expertise about what equipment to acquire and where to acquire it.

MicroKenya Ltd's experience of "leveraged" finance

MicroKenya Ltd is a private finance company providing services for individuals and small businesses in Kenya since 2000. It is 40% owned by the Acacia Fund Ltd - a private equity fund created by CDC and Norfund. The bulk of MicroKenya's business consists of individual consumer loans administered and secured through payroll-schemes with major employers in the corporate and parastatal sector.

MicroKenya also has a successful specialised product line providing loans to small enterprises which supply products or services to MicroKenya's larger clients. This product makes up 16% of their business volume. Around 80 - 100 such leveraged loans in the range of US\$ 500 – 5000, have been arranged since 2002.

For example, small holder dairy farmers who supply milk, and transporters who distribute milk for Brookside (a large dairy corporation) have benefited from these "leveraged" loans.

Similarly, small-scale growers of fresh vegetables who supply large hotels and horticultural exporters (EverFresh, HomeGrown) have taken loans - typically over 12 months - from MicroKenya.

MicroKenya's product works by securing loans against the regular income suppliers receive from their large corporate buyers. Repayments are deducted at source by the "leveraging company".

For example, a farmer who regularly earns US\$ 250 per month can secure a loan of US\$ 750 (three times monthly income), and has repayment instalments (e.g. \$80 per month) deducted by the buyer.

Most of the clients are properly incorporated and registered with Kenya Revenue Authority for Income Tax and PAYE. They all have bank accounts. They are nevertheless still small in size with numbers of

employees varying from 5 – 50. There will usually be one shareholder only or in some cases two people who control the company. A study commissioned by Norfund into the use of MicroKenya loans found that the single biggest use was to support or grow business.

The corporate companies which participate in these arrangements co-operate as a way of supporting the growth of their suppliers. In most cases, the leveraged loans schemes have followed on from successful payroll-based loans schemes for corporate employees, where MicroKenya has an established relationship with the relevant finance department.

MicroKenya have since extended supplier financing to include finance of one-off contracts for corporate clients. Where small businesses get a large supply order from a corporate buyer but do not have the working capital to fulfil the order, MicroKenya will advance funds to the borrower provided that the buyer agrees to pay directly to MicroKenya upon satisfactory completion of the order. The balance is transferred to the borrower net of loan repayment and interest etc.

Examples of leveraged contract finance provided under this scheme include:

- *Printing of the National Census (a Central Bureau of Statistics project funded by DFID)*
- *Printing of calendars and 2000 Bar Name Boards for EABL*
- *Supplier of school books and stationery to schools benefiting under the World Bank funded free primary education.*
- *Panel-beating jobs commissioned by an insurance company. Panel-beaters typically have huge cash-flow constraints: they are awarded repair jobs, and must acquire the parts, panels and paint in advance, only getting paid 45-60 days later.*
- *Acquisition of office equipment for supplier to complete a large order*
- *Importation of generic pharmaceuticals, funded against purchase orders*

In the event of borrower default MicroKenya will report enterprises to the Kenyan credit reference bureau and seek recovery of funds through the normal legal channels. However, MicroKenya find that this is an arduous procedure. In practice their loan security mainly derives from the reluctance of client businesses to disrupt their established productive relationship with the corporate buyer.

In addition, MicroKenya's clients are typically paid 60 to 90 days in arrears by their corporate customers. As a result MicroKenya usually enjoy the security of a receiving a minimum of two or three months instalments – and some advance warning of repayment problems arising.

MicroKenya has not experienced significant problems with the remittance of funds by their private corporate partners, but it has sometimes struggled to get parastatal firms to transfer funds promptly. There is enormous scope to extend this sort of funding in the parastatal and government sector but they found problems in getting the bureaucrats to agree to pay the finance company directly. In some instances, MicroKenya have set up a controlled bank account in the name of the supplier. This has generally worked but does open up the financier to increased risk.

2.4 Potential Market for Leveraged Leasing

If financial deepening in general, and leasing in particular is to have a positive economic impact it must reach those business sectors which are assessed by prior economic analysis and market research to have significant medium-term growth prospects.

Various sources of anecdotal evidence suggest a large potential market. The study by Mutesasira *et al.* in Uganda and Tanzania, for example, reports that none of the players advertise or promote their lease products since demand already outstrips the supply of loan capital.

Tim Carson (MicroKenya Director), for example, also believes there is considerable scope for growth in this type of financing. The company has not as yet sought to aggressively market its leveraged loans, but has seen the product grow alongside their mainstream business (i.e. payroll-secured loans). He believes there is tremendous scope to develop leasing of office and business computer equipment – something that is standard practice in South Africa for example.

Indicative sectors for exploration are shown in the table below:

SECTOR	Small Enterprises	Productive Capital Required	Potential Leveraging Companies
VEHICLE MAINTENANCE	Repair Shops (within Petrol Stations)	Vehicle Maintenance Equipment	Petroleum Companies
HORTICULTURE	Vegetable Growers	Cultivators, Sprayers, Chillers	Export Buyers / Supermarkets
RURAL ROAD MAINTENANCE	Road Maintenance Contractors	Graders, Compactors	Local Authorities
HEALTH CARE	Dental surgeries, Diagnostic labs Morgues	Dental Equipment, Diagnostic Lab Equipment Morgue Equipment	Hospitals
FISH EXPORT	Fishermen	Boats, Cool Boxes, Landing Jetties,	Fish Export Traders
FRUIT PROCESSING	Fruit Growers	Juice / Pulp Extractors Storage, Transport Equip	Fruit juice processing companies e.g. Delmonte
DAIRY	Dairy Farmers	Milk Chillers, Transport Equipment, Hay Balers	Medium & large-scale dairies e.g. Brookside

2.5 Kick-starting the Market: Entry Points

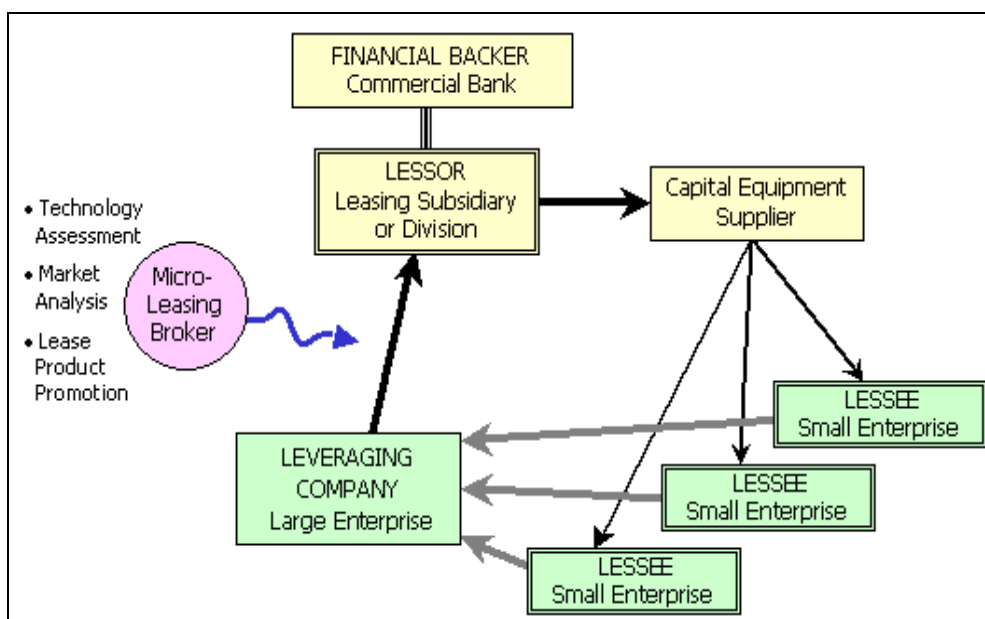
A leveraged approach to leasing appears to offer a practical way of mitigating some of the constraints on the development of markets for asset financing – by reducing the particular costs and risks to lessors of leasing to smaller businesses.

However, it is clear – if only from the scarcity of active players in Kenya – that the market for this sort of financial product will not emerge easily and spontaneously in the current business climate. The added “complication” of involving three parties in each lease contract creates a natural obstacle to market development.

In particular, the key role played by leveraging companies is not one which is easy to engage. MicroKenya’s experience indicates how important it is to establish a trusting business relationship between lessors and leveraging companies in particular. In most cases, the business of providing leveraged loans to small enterprise clients developed after MicroKenya had already set up payroll-based lending schemes with the leveraging companies. Good working relationships with the staff of the relevant finance departments who administer the schemes proved a key ingredient.

These sort of entry points then seem to be essential, at least while the leveraged approach is generally unfamiliar. Even with such relationships in place, MicroKenya reported difficulties in engaging (more bureaucratic) parastatal corporations in similar arrangements. Again it seems likely that this is a question of unfamiliarity, rather than an intrinsic limitation to the approach.

Beyond the challenge of engaging leveraging companies in principle to the product, there remain other obstacles to market development. A lease brokering role may be required. Access to specific market analysis and technical assessment services would facilitate the brokering process. Such brokering services could provide companies or institutions venturing into micro-leasing with advice about the market for leasing productive capital in specific industries where potential for small-enterprise growth, and the opportunities for use of leveraged finance, are strongest.



3. Summary & Conclusions

- Leasing has potential as a method of asset financing that can be encouraged (for example through appropriate tax policies) to stimulate business investment in productive capital. Because lease repayments derive from productive use of assets, leasing can be a mechanism that enables firms to grow despite lack of a strong credit history or accumulated capital.
- Although leasing is attracting attention in developing economies, such as Kenya, the market is currently mainly confined to large corporations, and the potential social and economic benefits of stimulating investment in small businesses has not been realised.
- There are four intrinsic constraints on the development of leasing markets and products that meet the particular needs of small business clients: relatively high transaction costs, asset recovery risks, uncertainty about client business viability and costs of technology appraisal.
- “Leveraged leasing” is a model of financial service that helps overcome these constraints and could therefore help stimulate the emergence of leasing targeted at smaller businesses. The contract between lessor and lessee is supplemented by guarantees from a leveraging company which is a regular buyer of the lessee’s products or services.
- The advantages of leveraged leasing over debt financing include: reduction of administrative and monitoring costs; assurance of lessee business viability; bolstering of collateral security, and spreading costs of technology appraisal.
- The major limitation of leveraged leasing is that the market is limited to small businesses that are already or on the point of becoming established in supply-chain relationships with large companies willing to play the leveraging role. Nevertheless, there is considerable scope for investment and upgrading within such supply chains – with economic and other benefits.
- Existing experience of “leveraging” models of finance, in Kenya, suggest that the mechanism can be very successful at deepening access to finance. The example of MicroKenya Ltd’s experience was cited.
- One of the principal success factors appears to be the ability of banks/ lessors to confidently engage potential leveraging companies in schemes. MicroKenya succeeded by piggy-backing its product for small-scale suppliers to large corporations, on the back of a scheme providing consumer credit for their employees.
- If leasing companies are to succeed in developing a recognised market for “leveraged leases” – which more directly engages potential leveraging companies, then it may be necessary to have a

lease brokering service that advises lessors about the market for leasing productive capital in specific industries where potential for small-enterprise growth, and the opportunities for use of leveraged finance, are strongest.

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