

Microenterprise and small business leasing – lessons from Pakistan

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Although not well known in poorer countries, evidence from Network Leasing Corporation in Pakistan and from elsewhere suggests that leasing may well have a significant part to play in enabling micro and small enterprises (MSES) to buy equipment which would otherwise be unavailable to them. Experience so far suggests that leasing is particularly useful for small and larger microenterprises, but the potential for reaching subsistence enterprises is still to be explored and remains untested. This article seeks to answer four questions: What is MSE leasing? Why is MSE leasing of particular interest? What is the experience of Network Leasing Corporation? What is the further potential for MSE leasing?

LEASING IS A CONTRACTUAL arrangement between two parties, by which you (the lessee) have the use of an asset (normally a piece of equipment) belonging to me (the lessor) in exchange for regular payments by you to me for a fixed period of time. It is this separation of ownership (by me) and use (by you) which is at the Centre of leasing.

Leasing has been known for many years, but has only achieved widespread use in developed countries in the second half of the twentieth century. It remains hardly known in the majority of developing countries. The IFC describes three different types of lease.

Financial leases. These are a way in which businesses can finance the purchase of equipment. The total payments over the life of the lease are designed to cover the cost of the asset, so that the lessee can buy the asset for a nominal fee at the end of the contract period. Full ownership remains with the lessor until all payments have been made.

Operating leases. These are not a way of financing equipment purchase. They are a way of paying for short-term use of an asset on an instalment basis. The lessor will retain ownership of the asset and seek to make a number of successive leases. It is a type of equipment hire.

Hire purchase. This is another way of financing the purchase of an asset, but it is more commonly found in the retail sector and for small items such as sewing machines. A key difference from financial leasing is that as the periodic payments are made under the hire purchase contract, then so the ownership of the asset gradually transfers to the lessee.

This article will be concentrating on finance leases, since it is this instrument which has been most used by Network Leasing and others. In

practice, the key features of finance leasing (henceforth just 'leasing') are as follows:

- The lessor's appraisal of whether to make the lease focuses on the ability of the leased asset to generate a cash flow which will cover the payments to be made to the lessor. Compared to a bank, there is less emphasis on security beyond the leased asset itself.
- Tied as it is to the purchase of a particular piece of equipment, it is clear that leasing is a way of financing fixed assets for the business. It is not a way of financing working capital which, by definition, will be sold on by the business.
- Compared to most sources of MSE finance, a lease is for a significantly longer period of time, typically three years. This generally reflects the realistic payback period for significant pieces of equipment.
- The money to pay for the leased asset at the start never actually passes through the hands of the lessee. The lessor makes direct payment (generally by cheque) to the supplier of the equipment.

- When a lessee defaults on payments, repossession of the asset should be quite straightforward, since ownership of the asset remains with the lessor. It is, of course, important that the law allows such repossessions to take place easily and cheaply.

Why is MSE leasing of particular interest?

Leasing has a number of advantages for potential lessees.

Availability. In many developing countries, medium and long-term bank finance is simply not available to MSEs. Leasing can fill that gap.

Simplicity. Leasing does not require the lessee to provide long and detailed financial records, nor to get involved in the provision of complex collateral security such as mortgages over land and buildings.

Cost. Leasing is characterised by low transaction costs resulting from the simple and quick procedures involved. These procedures compare very favourably both with the often time-consuming attendance at group meetings required by most microfinance institutions and with the accessibility (transport to town, etc.) and corruption costs characteristic of trying to borrow from a commercial bank. Although leasing interest rates are higher than those which are (in theory) available from commercial banks, they tend to be rather lower than those which are (genuinely) available from microfinance institutions.

Tax breaks. These may be of less interest than they would be in wealthier countries. As Gallardo points out, 'Lessees can offset their full lease payments against income before tax, compared to just the depreciation allowance or interest charges on bank loans'. There are also VAT advantages in some countries.

Gallardo also identifies a number of advantages which accrue to lessors. These include:

- the increased security which results from the lessor buying the asset, thus removing the possibility of funds diversion;

- reduced appraisal and documentation costs compared to standard commercial bank lending;

- the increased profit which results from the lessor being able to claim tax relief on the depreciation of the asset;

- provided they do not take deposits, leasing companies should be subject to less regulation than banks; and

- as already mentioned, repossession should be simpler than with a bank loan.

Lastly, lease finance is likely to be of particular interest to donor agencies for all the above reasons, because taken together these should result in an increased level of funding available for capital investment by MSEs. In turn, it is anticipated that this capital investment will result in increased employment by the MSEs concerned, and in increased incomes for both business owners and employees. Furthermore, leasing is likely to be of particular interest to manufacturing and service businesses who have a greater need for capital equipment and are likely to have a greater impact on the local economy in which they operate. Equally, MSEs as a whole are more likely than larger businesses to produce goods from local resources, using local labour and designed to meet local needs.

Leasing should also be attractive to donor agencies because done properly it is a profitable activity which has clear potential for achieving financial sustainability i.e. offering services to large numbers of MSEs on a long-term basis without a continuing subsidy. In particular, the very clear systems and procedures involved in leasing also mean that increasing the scale of operations and hence outreach is highly feasible, since high levels of technical skills and decision-making discretion are not required at the level of operational staff.

It also seems to be the case that leasing has the potential to fill the gap between the micro-loans commonly provided to subsistence enterprises by aid-funded microfinance institutions and the commercial bank loans which are available to well-established and capitalised small-scale enterprises operating in the formal sector.

The experience of Network Leasing Corporation

Operational since January 1995, Network Leasing Corporation (NLC) is a public limited company quoted on all three of Pakistan's stock exchanges. NLC is run by three people: Mr Asif Siddiqui, Managing Director; Mrs Musaret Siddiqui, Operations Director; and Mr Yusuf Sattar, Finance Director. All three are fully qualified accountants, and Mrs Siddiqui was previously a senior manager in another leasing company. Although FMO (Netherlands Development Finance Company) are a shareholder, the remaining shares are held by Pakistani financial institutions; the directors and their families (who have a very significant investment); and a large number of private investors.

NLC was formed to: 'provide lease financing and developmental support services to the small businesses and microenterprises and the small and cottage industries'. The directors and investors believed that this sector would not only be a viable niche for their company, but would also 'strengthen the most productive and promising sector' of the Pakistani economy. To a great extent, their analysis has been proved correct. NLC currently has a portfolio of over a thousand leases and a recent analysis of their books (by the Micro Banking Bulletin Project) revealed the following key statistics:

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| Portfolio at risk (>90 days) | 2.1% |
| Financial self-sufficiency | 94% |
| Operational self-sufficiency | 145% |
| Expenses as a percentage of average portfolio | 10.5% |
| Capital/assets ratio | 61% |

NLC charges a total interest rate of 23-25 per cent to their clients, which includes insurance (see below). In addition, lessees are required to put up a deposit of 10 per cent of the value of the asset to be purchased and to provide two personal guarantors for the lease. In practice, NLC finds that the guarantees are hardly ever called, but they are an extremely effective way to put pressure on delinquent lessees.

Network leasing - access to concessionary funding

In March 1996, NLC received a loan of ChF750 000 and a technical assistance grant of ChF200000 from the Swiss Agency for Development and Co-operation (SDC) (ChFr1.52 = US\$1). The loan was used to directly fund leases made by the company from its head office in Karachi, while the grant was used for institutional and product development within NLC. NLC performed well in repaying the loan, in developing its institutional base and in reaching the target groups agreed with SDC. As a result, late 1998 saw SDC extend a further loan (this time of CHF1 million for five years at 17 per cent) to NLC, along with a smaller ChFI00000 technical assistance grant. Both loan and grant were specifically to assist NLC in establishing leasing operations in Pakistan's North-West Frontier Province. Both SDC loans were convertible into equity at SDC's choice, but neither has been at the present time.

In between the two lots of support received from SDC, NLC was successful in accessing about two million US dollars from the closing stages of the World Bank's MSE project for Pakistan. They are also approved to access funds from the Asian Development Bank's Financial Sector Intermediation Loan, the first tranche of US\$1 million having been recently released.

Network leasing - innovations

NLC have done a good deal more than simply take the standard leasing product and offer it to MSES. On the contrary, their approach has involved a number of significant and highly practical innovations. Use of post-dated cheques. NLC's calculations indicate that the individual collection of monthly instalments would be too costly for them. On the other hand, while Pakistan does have a standing order system, it is not considered practicable for use in the small payments which NLC receives from its customers. Thus, when a client signs a lease with NLC, he or she must also complete and sign 36 post-dated cheques for the 36 payments which will be due under the lease. NLC then bank these as they fall due. About 20 per cent of the cheques bounce, thus incurring an additional administration fee for the errant lessee.

Clients compelled to open a bank account. In order to be able to provide the post-dated cheques, NLC clients must open a bank account if they do not already have one. NLC will assist them in this if necessary. This is considered to have the wider benefit of introducing clients to the

banking system.

Insurance. All NLC leases are covered by insurance on the life of the client, so that NLC does not have to repossess the asset if the client dies. This is both prudent for NLC and very humane for the client's family. Equally ' NLC takes out insurance to cover all risks (fire, theft etc.) on each leased asset as well as a residual value insurance in case a repossessed asset is worth less than the outstanding amount of the lease. All the costs of this insurance are included in the lease payments mad by the client.

Seasonal variation in instalment size. NLC's early experience showed them that many businesses have such great seasonal variation in income that it is unrealistic to expect uniform payments to be made by the lessee throughout the year. They have therefore devised different payment patterns for different sectors, with much larger payments being due at times of plenty and much smaller payments in the low season. Of course, the total payments over a whole year remain unchanged.

Second-hand equipment. Throughout the world, most leasing companies have insisted on only leasing brand new items of equipment. However, NLC found that this was unduly restrictive for MSEs in Pakistan where, for example, virtually all light engineering workshops would use second-hand machines, and they thus decided to allow leases on used machinery. Clearly, this approach requires caution since it is open to abuse through inaccurate equipment valuation. However, Pakistan has a number of reputable independent machinery valuers whose valuations can be relied upon in determining resale values and consequent lease amounts.

Profile of the client group

As part of its agreement with SDC, NLC measures the proportion of its lease portfolio (by value, rather than by number of leases) which is in leases to disadvantaged groups. When last measured, the percentages were as follows:

40 per cent of the lease portfolio is in leases of less than Rs300 000 (US\$6000). This measure of 'microleases' was originally designed to assess the number of leases going to microenterprises, but it became apparent that larger companies also took microleases, thus reducing its value as an indicator. The latest loan agreement also requires the total assets of each lessee to be assessed. Either way, the figure here further confirms that NLC's clients, thus far at least, have not been at the subsistence level, but rather in the upper reaches of micro and in small businesses. Anecdotal evidence from visits to lessees confirms this view.

17 per cent of the lease portfolio is to businesses owned and run by women. Considering the extremely marginalized status of women in Pakistan, this figure is actually pretty good. NLC are nevertheless trying to improve on it and have established a special Women's Leasing Department, staffed by women. Expansion into NWFP, known for its conservatism, will make this particularly challenging.

24 per cent of the lease portfolio is to businesses in rural and semiurban areas. This score reflects the fact that up to now, NLC has concentrated their leasing in Karachi and (to a lesser extent) Lahore and other cities in the Punjab.

Key success factors

There are a number of key factors to which we can ascribe NLC's success, some of which are relevant to all development agencies, not just those in MSE finance or even in the leasing sector.

Quality of management. Most microfinance institutions and other development organizations (especially NGOs) are run by individuals, often individuals whose professional training is in the social sciences. Not only does NLC have a highly professional management team whose particular talents complement each other very neatly, but they are all financially trained (albeit with personal motives which are both profit and socially-oriented) and have serious management backgrounds. This

means that NLC is well managed, not as a strict hierarchy but also not as a place which is so busy being participatory that they never actually do

anything.

Being a for-profit business. In addition to the management issues, NLC also believes that it is critical for their lessees to be dealing with a business which is run in order to make a profit. Lessees must feel that as valued clients and equals they are being treated with respect and courtesy and that is how they should deal with NLC and thus take their repayment responsibilities very seriously. Lessees should never feel that they are dealing with some generous benefactor who may indulge them (for instance by allowing them to avoid loan repayment) providing they are shown sufficient servility. As a result, NLC go to great lengths to avoid their lessees having any idea that aid funds may be involved. Staff are explicitly forbidden from mentioning it.

Financial prudence. A characteristic of NLC's financial management to date has been considerable caution in the stewardship of their balance sheet. For example, their key ratios for borrowing limits, exposure limits, capital adequacy, liquidity and asset/liability matching have all been within the norms suggested by the IFC. Appropriate asset/liability matching is currently of great importance in Pakistan. NLC is one of only two or three leasing companies (out of more than 30) which have resisted the temptation to fund long-term leases out of short-term borrowings. With the economy tightening and a credit squeeze underway, life is likely to become very uncomfortable for the majority of leasing companies, but not for NLC.

Islamic mode of finance. A significant advantage for NLC is the status of leasing, which in Pakistan is an officially recognized Islamic mode of finance. While this is probably of less relevance in an urban centre such as Karachi, it is undoubtedly of great importance in rural areas, which are characterized by strong and widely held opposition towards the paying and receiving of interest. This has been a barrier to the development of banking in many areas of rural Pakistan, but is not a barrier to leasing.

MSE leasing programmes in Bangladesh and Tanzania

Bangladesh's Grameen Bank started an experiment with leasing in 1992. Dowla (1998) provides the following basic statistics on their programme. Leases are up to 3 years, with an annual interest rate of 20 per cent and an average lease size of \$623. By the end of 1997, 1200 clients had received some 8400 leases (implying that clients may have more than one lease at a time) with a claimed repayment rate of 98 per cent. Interestingly, Grameen allows the leasing of livestock as well as of equipment. Unfortunately, no 'harder' numerical information on the performance of Grameen's leasing programme was available at the time of writing this article.

Owned by an association of self-employed women, SELFINA is a leasing company for women's small businesses in Tanzania. After three years of operation, SELFINA's portfolio currently amounts to some 850 leases. While a baseline survey has shown that SELFINA's lessees are positive about the impact the leases have had on their businesses, SELFINA's corporate experience so far has been rather mixed. However it is currently working hard to strengthen its operations and build financially sustainable leasing company. There is no doubt that leasing has great potential for improving the availability of medium-term finance to MSEs in Pakistan and beyond.

number of outstanding challenges remain, but the overall picture from Pakistan is that this is a financial instrument of considerable and as yet under-exploited potential. What can governments and donor agencies do to promote its development?

How can governments support MSE leasing?

The most important role for governments in the development of MSE leasing is to ensure the existence of an appropriate and conducive legal and regulatory environment. In practice, this is likely to mean:

- Actually having a legal framework for leasing, where leasing is defined and recognized as being different from other forms of asset finance. This particularly applies to clarity on the ownership of assets, but also to taxation issues.
- Having an appropriate regulatory framework for leasing companies. In particular, if a leasing company is not taking deposits, then there is no more reason for it to be regulated than for a biscuit maker to be regulated. If it takes deposits, then something much more like banking supervision is likely to be required.

How can donor agencies support MSE leasing?

There are a number of ways in which donors can support MSE leasing. These include provision of the following.

Technical expertise on leasing. It has taken the development sector a long time to work out how to do microfinance; we do not need to take so long on leasing, because many of the lessons and techniques of larger scale leasing can be transferred to MSE leasing. People have already learned the lessons for us. Organizations who want to do leasing will need to buy in that existing expertise.

Assistance for capacity building. Some leasing companies who currently do larger-scale leasing may be interested in 'trading down' to MSE leasing. Modest amounts of technical assistance for internal capacity building may help them to make the change, with the added carrot of subsequent loan funds if they are successful.

Wholesale funds. Limited funds may be available from the banking sector in some countries, but seldom for the time periods needed. Donors can usefully make medium-term loans to leasing companies, in local currency if possible. This approach may be a worthwhile step in the direction of developing a sustainable approach to wholesale funding.

MSE awareness. Donor agencies need not feel restricted to the supply side of the leasing market. SDC are trying to increase the demand for leasing from MSEs by supporting the Leasing Association of Pakistan in the development and dissemination of a leasing awareness programme which seeks to educate MSEs as to the benefits of leasing.

Making links with microfinance institutions. Many microfinance providers would benefit from being able to offer MSE leasing on top of their existing services, particularly for borrowers who have graduated from a group-based lending system.

Outstanding challenges in MSE leasing

The experience of NLC suggests that there are three key challenges currently facing MSE leasing.

Can we develop leasing for sparsely populated rural areas? The great majority of NLC's leases have been in urban and peri-urban areas where

people are located close together and operations staff can move between lessees quickly and cheaply.

Likewise, most of SELFINA's clients are in Dar es Salaam and Grameen's in densely populated rural Bangladesh. The challenge, therefore, is to devise ways of reducing (or transferring) the costs of reaching clients in more remote areas. NLC's view is that this will require linkages with NGOs or self-help community-based organizations (CBOs). They believe that CBOs are more promising, since they are not infected by the benefactor/recipient social welfare mentality of aid.

Can we find a way of leasing working capital as well as fixed assets? Leases are a way of buying equipment which will stay on the lessee's premises throughout the life of the lease, they are not a way of funding working capital. However, there is a special leasing technique known as 'sale and leaseback', by which the lessee sells an asset he already owned to the lessor, who in turn leases it back to him, thus releasing the sale proceeds for working capital finance. This sounds great in theory, but unfortunately global experience is that an amazingly high proportion of sale and leasebacks end up in default. The challenge therefore is to find secure ways of doing sale and leaseback. NLC are making tentative experiments with doing sale and leaseback with clients who have fully and perfectly repaid their first lease, but even this is giving them some difficulties.

What is the impact of MSE leasing on employment and incomes? As yet, no comprehensive impact analysis has been done on N-LC's clients. NLC keep very sound records of business performance and employment at the beginning and end of leases. It is probably time for a detailed assessment of that impact.

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