

Leasing In India



Management

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ABSTRACT

This paper focuses mainly on the growth, challenges and prospects of leasing industry in India. It starts with the definition and growth of leasing. The major factors that contributed to growth of leasing companies are no entry barriers, buoyant growth in capital expenditure by companies, tax motivators and optimistic capital markets. Finally, the paper concludes that the prospects of leasing are high because of the high potential in market and expected healthy growth of the leasing industry.

Introduction

The main objective of a business is to maximize the owner's economic welfare. The firm makes investments to maximize stock holders wealth. After identifying attractive projects, the firm considers various methods of financing them. In addition to debt and equity financing, leasing has emerged as a third important source of intermediate and long term financing of corporate enterprises during the recent few decades. It is widely used in western countries to finance investments. Prior to 1950, leasing was primarily concerned with real estate i.e. land and buildings. But to-day, almost all type of fixed assets can be leased. In India, leasing is a recent development and equipment leasing was introduced by first leasing company of India Ltd. in 1973 only. Since then, a number of medium to large sized companies, financial Institutions like ICICI, IRCI, SICOM and GIC have also entered the field of leasing.

Concept of Leasing

Leasing is an arrangement that provides a firm with the use and control over assets without buying and owing the same. It is a form of renting assets. Lease is a contract between the owner of the asset (lessor) and the user of the asset called the lessee, whereby the lessor gives the right to use the asset to the lessee over an agreed period of time for a consideration called the lease rental. The lease contract is regulated by the terms and conditions of the agreement. The lessee pays the lease rent periodically to the lessor as regular fixed payments over a period of time. The rentals may be payable at the beginning or end of a month, quarter, half-year or year. The lease rentals can also be agreed both in terms of amount and timing as per the profits and cash flow position of the lessee. At the expiry of the lease period, the assets revert back to the lessor, who is the legal owner of the asset. However in long term lease contracts, the lessee is generally given an option to buy or renew the lease.

In the words of Miller, M.H. and C.W. Upton. "Leasing separates ownership and use as to economic activities, and facilitates asset use without ownership." Thus, leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a number of contractual, periodic, tax deductible payments. International Accounting standard (IAS-17) has attempted to explain the concept of leasing in a very precise manner. As per IAS-17, lease is "an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time." Leasing therefore enables a firm to avail the services of plant or equipment without making the investment or incurring debt obligations.

Growth of Leasing in India

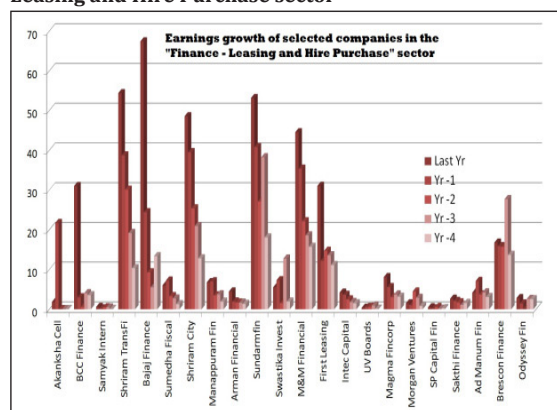
Leasing in India registered unprecedented growth in the late 80's and early 90's as a widely used financial services product by non banking finance companies (NBFCs) as a means to claim the benefits of depreciation and consequent tax benefits. The performance of the sector was adversely affected by changes in the accounting requirements and regulatory changes such as

linking the extent of deposits to credit rating, in late 90s, as a result of which the leasing transactions came under stringent regulatory scrutiny of the underlying intent (financing vs. true lease) and became subject of taxation and legal uncertainties. Further the deterioration in the credit quality during that period also impacted the NBFCs. These uncertainties drove the leasing sector to a period of relative inactivity which lasted over the period 1997-2004. :

The sector has again shown signs of revival since 2005, this time around fuelled by strong economic growth with the following characteristics:

- a high capital investment in several industries,
- an increase in the presence of MNCs which operate on an asset light business model,
- an increasing usage of big ticket plant & equipment that come with high technological obsolescence, and
- emergence of professional lease providers with specialised expertise in asset management and residual value risk management.

Fig 1: Earning Growth of selected companies in the Finance-Leasing and Hire Purchase sector



The order in the EPS graph shown above is with the highest EPS growth company at the left and those with lower EPS growth as we move to the right. The Y axis as such is the EPS per share data. Only the top few companies are shown here.

At present, it is clear from the figure1 that the Indian leasing sector is witnessing a transition from being a nascent market dominated by simple finance lease structure to an evolving market, marked by emergence a strong market for operating leases.

Factors that contributed to growth of Indian leasing

With the exception of 1996-97 and 1997-98, the 1990s have generally been a good decade for Indian leasing. The average

rate of growth on compounding basis works out to 24% from 1991-92 to 1996-97. Broadly, the following factors have been responsible for the growth of Indian leasing, in no particular order:

- No entry barriers - anyone could float a leasing entity, and even an existing company not in leasing business can write a lease purely for tax shelters.
- Buoyant growth in capital expenditure by companies - The post-liberalization era saw a spate of new ventures and fresh investments by existing venturers. Though primarily funded by the capital markets, these ventures relied upon leasing as a source of additional or stand-by funding. Most leasing companies, who were also merchant bankers, would have funded their clients who hired them for issue management services.
- Fast growth in car market: Needless to state with facts, the growth in car leasing volume has been the highest over these years - the spurt in car sales with the entry of several new models was funded largely by leasing plans.
- Tax motivations: India continues to have unclear distinction between a lease that will qualify for tax purposes, and one which would not. In retrospect, this is being realized as an unfortunate legislative mistake, but the absence of any clear rules to distinguish between true leases and financing transactions, and no bars placed on deduction of lease tax breaks against non-leasing income, propelled tax-motivated lease transactions. There was a growing market in sale and leaseback transactions, which, if tested on principles of technical perfection or financial prudence, would appear to be a shame on everyone's face.
- Optimistic capital markets: Data would establish a clear connection between bullish stock markets and the growth in both number of leasing entities and lease volumes. Year 1994-1995 saw the peak of primary market activity where a company, even if a new entrant in business, could price itself on unexplainable premium and walk out with pride.
- Access to public deposits: Most leasing companies in India have relied, some heavily, on retail public funds in the form of deposits. Most of these deposits were raised for 1 year tenure, and on promise of high rates of interest, at times even more than the regulated rate (which was lifted in 1996 to be reintroduced in 1998).
- A generally go-go business environment: At the backdrop of all this was a general euphoria created by liberalisation and the economic policies of Dr. Manmohan Singh.

Challenges to Leasing Industry

As 2010 comes to a close, many players in leasing industry have arrived at the same conclusions: A better understanding of clients, combined with a vast knowledge of products on the market are the main drivers of growth in our industry and must be placed at the heart of each player's strategy.

Any growth initiative must integrate:

- An analysis of the company best-performing market segments based on a substantial and detailed knowledge of its business; from clients to marketed products via physical and online distribution channels
- An optimised management of client-related risk
- Value addition and a better quality of service

Business knowledge and understanding

Each player must establish an internal management tool to identify the profitability of its products, as well as its customer structure and major account structure. Performing an advanced ROE analysis allows the removal of unprofitable products from the range, while defining which products are suitable to each customer segment in order to cement future customer loyalty.

Client Risk Management

The drawback from this strategy may be an increased exposure to client-related risk. It is therefore necessary to have a comprehensive overview of the client's environment. From an operational perspective, it is important to move from a "contract" management to a "client" management model, using optimised risk management.

Value addition

Improving the quality of service is the key distinguishing factor in such a competitive environment as the leasing industry. Each player must innovate and generate added value without lowering its operating margins.

Three approaches are currently emerging on the market:

- The risk-based tariff: using detailed portfolio segmentation it is possible to keep the margin while lowering the client rate.
- The increase of margin with additional value-added services.
- Cross-selling: the opportunity to evaluate and assess customer requirements for new financial products and services help optimise marketing campaigns and foster additional sales.

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