State of Indian Leasing Market

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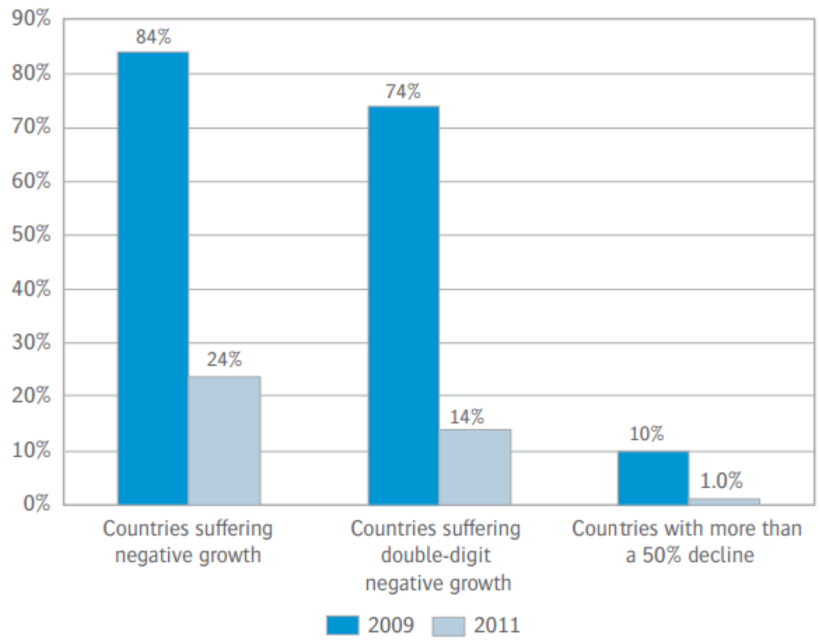
Global Scenario

Global Overview

The global leasing industry started picking up in 2010 after two years of downsized market. In 2011 the business volume increased by 21.9%. The figure below illustrates the breadth of improvement across the top 50 countries over the last two years.



Source: White Clarke Leasing Report 2013

Table 1a: Volume and growth by region (2010-2011)

Rank by volume	Region	Annual volume (US$bn)	Growth 2010-11 (%)	Percentage of world market volume 2010	Percentage of world market volume 2011	Change in market share 2010-11
1	Europe	249.8	7.2	39.2	34.5	–4.7
2	N America	292.5	37.1	35.9	40.4	4.5
3	Asia	134.0	26.9	17.8	18.5	0.7
4	S America	27.5	8.3	4.3	3.8	–0.5
6	Aus/NZ	12.0	10.9	1.8	1.7	–0.2
5	Africa	8.6	34.5	1.1	1.2	0.1
	Total	**724.35**				

Source: White Clarke Global Leasing Report.

Table 1b: Volume and growth by region – leasing and hire purchase

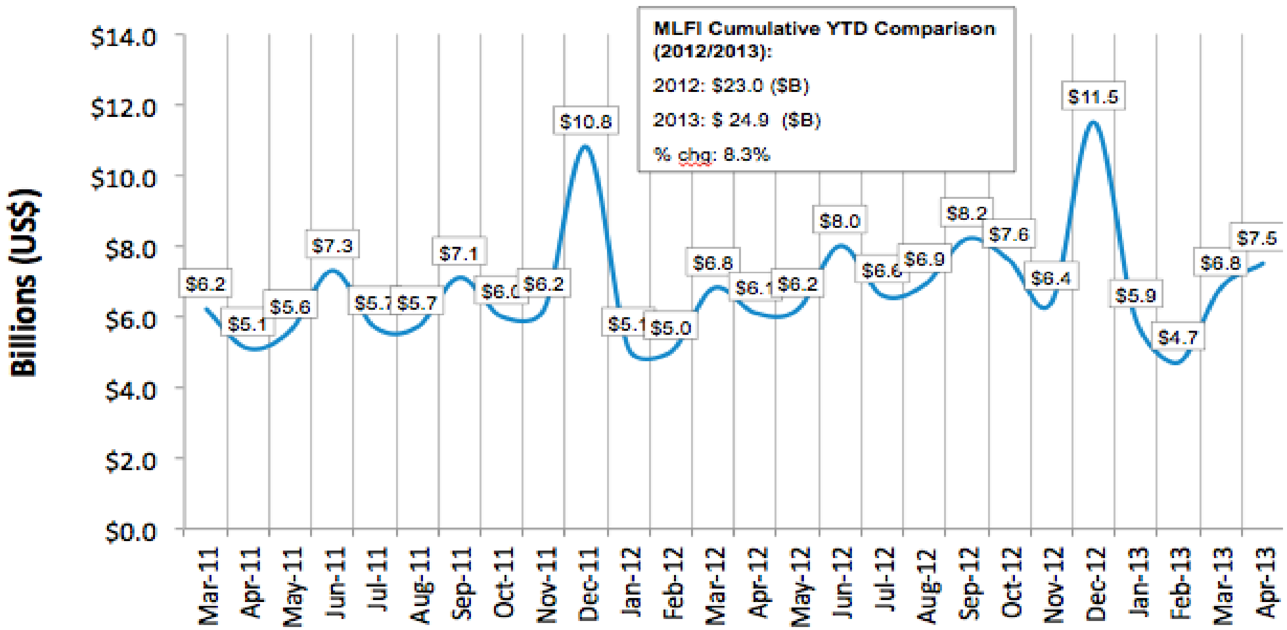
Rank by volume	Region	Annual volume (US$bn)	Percentage of world market volume 2011
1	Europe	302.7	38.0
2	N America	292.5	36.7
3	Asia	153.4	19.3
4	S America	27.5	3.5
6	Aus/NZ	12.0	1.5
5	Africa	8.6	1.1
	Total	**796.70**	

Source: White Clarke Global Leasing Report.

Source: White Clarke Leasing Report 2013

MLFI - 25

- The MLFI-25 is the only index that reflects capex, or the volume of commercial equipment financed in the U.S.
- The MLFI-25 is a financial indicator that complements the durable goods report and other economic indexes, including the Institute for Supply Management Index, which reports economic activity in the manufacturing sector.



MLFI-25 data – new business volume Year over year comparison*

Source: http://www.elfaonline.org/Research/MLFI/?fa=0413#NBV

Indian Scenario

Evolution and Development of Leasing in India

- Indian Leasing volumes touched an astonishing figure of $41 Billion by 2011-12.
- Indian Leasing has reached 4%-5% of global leasing volume.
- India at the 14th largest place in world leasing.
- Sectors include:
  - like consumer finance,
  - small industry,
  - heavy industry to automobiles,
  - railways to
  - electricity boards
- Roughly, annual leasing volume in India is estimated at about USD 3.67 billion

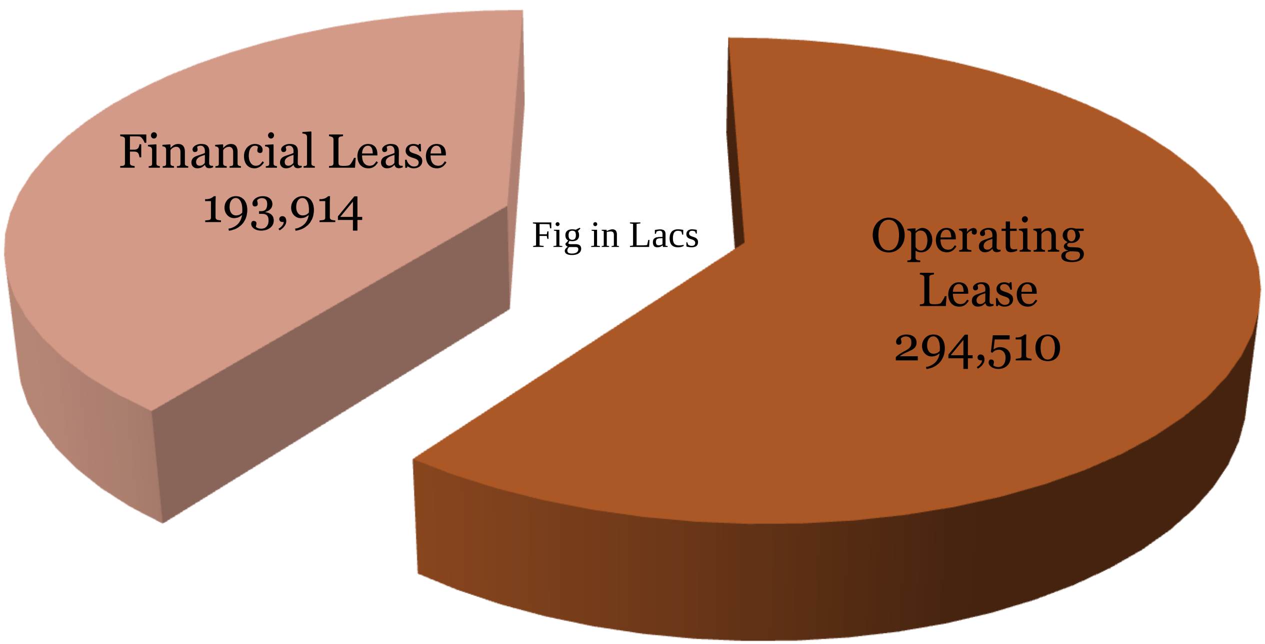
Leasing in India - Scope

- Indian, though being the 10th largest global economy, leasing industry is small in terms of the size of the economy.
- India ranks outside Top 50 while its BRICS peers are well within Top 20 ranking.
- Ample of scope to tap potential markets with an estimate growth level of 25%-30%.
- Largest planned outlays for Infrastructure – a capital intensive sector.
- Entry of leading international brands Siemens, Volkswagen, IBM, Hewlett-Packard to name few.

Leasing in India – Business Models

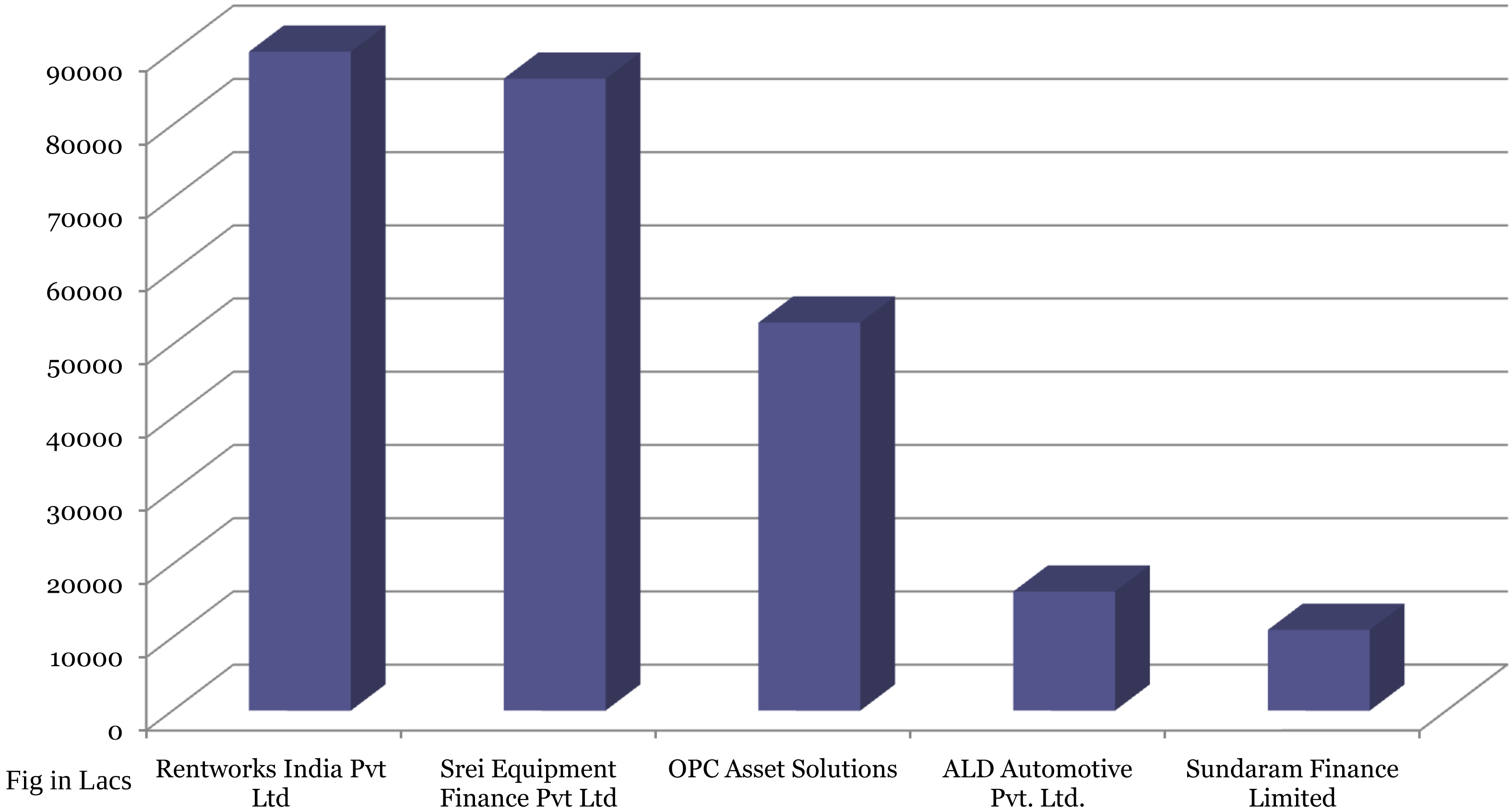
- Third Party Financiers or Non Banking Finance Companies (NBFCs)
- Asset Life Cycle Management (ALCM) Companies
- Captive Leasing and Financing Arms of leading manufacturers
- Rental Operators

Major Lease Types in India



Source: All figures are obtained from the Annual Report of respective companies available at public domain with few exceptions as mentioned in notes below

Top Five Operating Lease Providers in India



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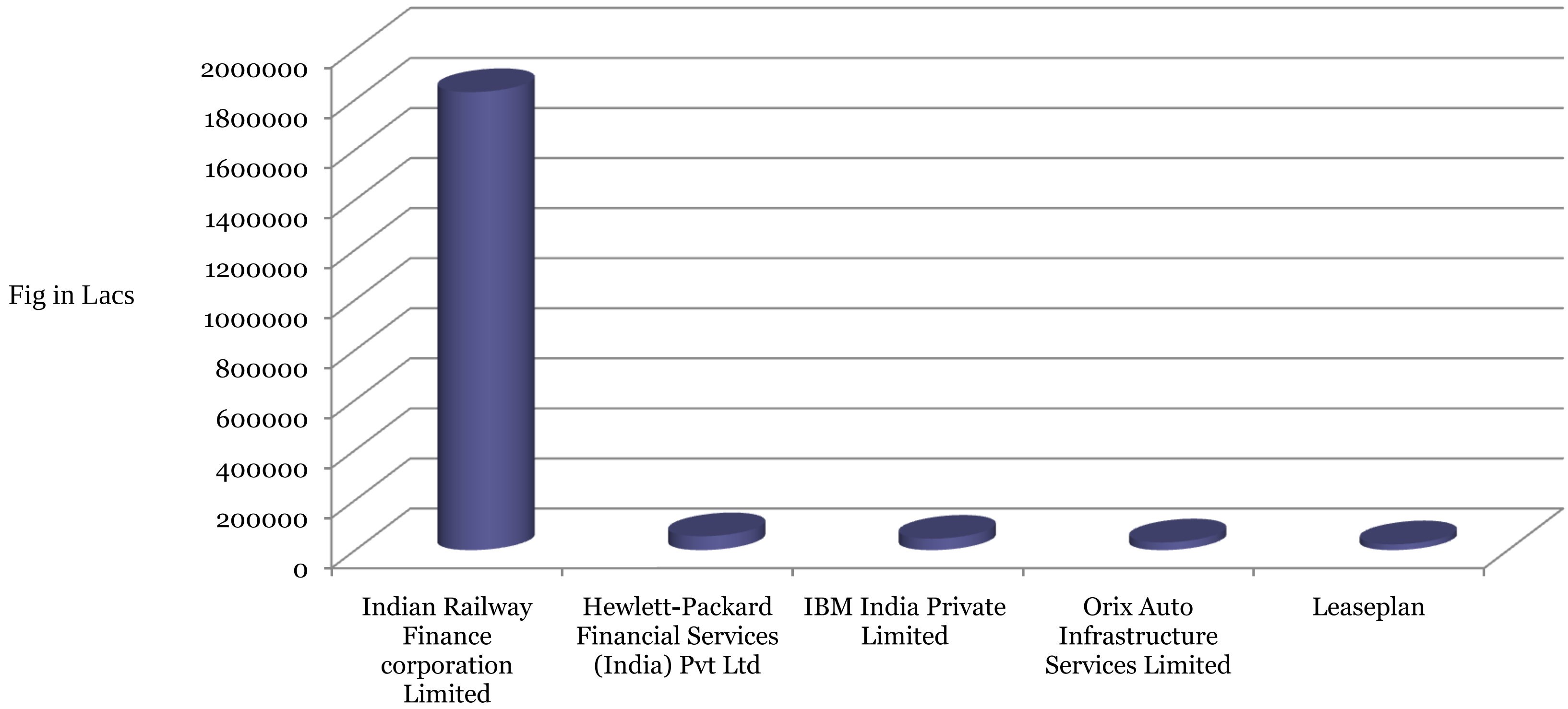
Top Five Finance Lease Providers in India



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Potential Leasable Products

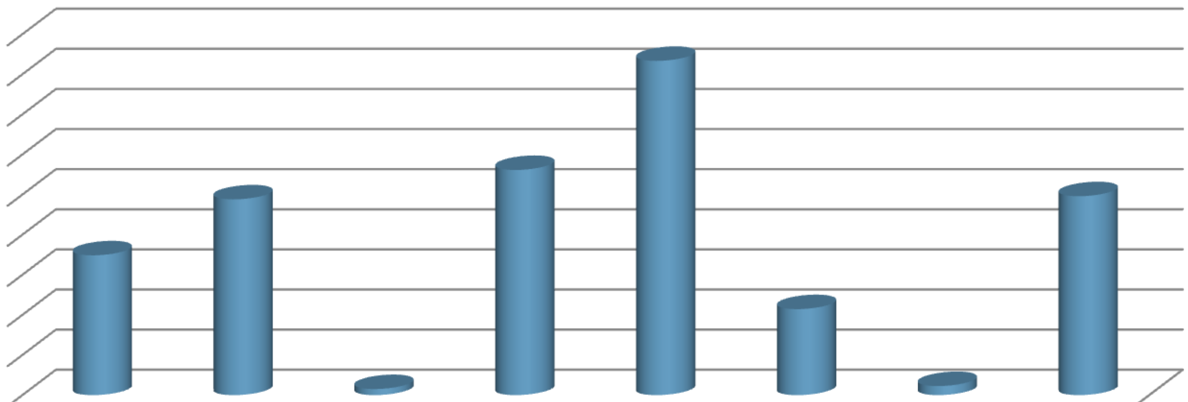

Fig in Lacs

	Plant & Machinery	Equipment (Construction/ Office)	Computer Software	Car	Commercial Vehicles	Computer Hardware	Furniture & Fixtures	Others
Series1	17,433	24,411	757	28,074	41,680	10,723	1,129	24,803

If a lessee prefers an on-balance sheet method he will rather opt for a loan, Why? Because there are too many indirect tax issues in leasing.

Laws and Acts Governing Leasing in India

- Reserve Bank of India Act 1943 in case of involvement of NBFCs
- FEMA Laws
- FDI Rules in case of companies having FDI
- Sale of Goods Act, 1930
- Indian Contract Act, 1872
- Transfer of Property Act, 1882
- Income Tax Act, 1961
- Limitation Act, 1930
- Indian Stamp Act, 1899
- Arbitration Act, 1940
- VAT Rules

Direct Tax Issues

- Lack of clarity on charging Depreciation in Financial Lease by the Lessor
  - Supreme Court ruling in the case of ICDS permitting depreciation to the to the lessor. However, practically tax officers don not allow it.
  - Low depreciation rates in India;   mostly 15% on WDV basis.
- Dependency on the clauses of the agreement to claim tax benefit on lease rentals by the Lessee.
- In Leasing by consortium of companies depreciation is not allowed to be claimed by the Lessor
- No clarity on meaning of a true lease for tax purposes.

Indirect Tax Issues

- Tax structure in India is a mix of Central and State laws
  - There is no comprehensive GST law still applicable
- All lease transactions are liable to VAT
- In addition, certain transactions come for CST as well
- Several states have imposed entry tax too
- CST paid is not off-settable
  - Hence, adds to a net cost
- While VAT is generally off settable, but some states have specifically disallowed offset
  - UP, Gujarat, Kerala.
  - Recently Maharashtra also disallowed, in case of car lease transactions
- If VAT is not off-settable, it adds to the cost of the transaction
- In addition, in view of state-level administration, there is a huge cost of compliance
- Since lessors have to compete with thin NIMs, VAT becomes a very serious challenge.

Accounting Issues

- Indian accounting standard AS 19 is largely in tune with IAS 17
- Hence, international rules are applicable in India
- IFRS still not implemented in India
- Distinction between operating and financial lease done on the same basis as internationally
  - Mostly by applying PV of MLPs test

Difference between a lease loan and hire-purchase

Lease Loan and HP

Legal		Financial lease	Operating lease	Loan	Hire purchase
	Nature of the contract	Renting out the asset	Renting out the asset	Loan of money	Renting out the asset with an option to buy
	Nature of the income	rental	rental	Interest +principal	Hire charge = rental
	Ownership	Financier	Financier	Borrower	Financier
	Residual value	Can be client-guaranteed	Cannot be client-guaranteed	Question does not arise	Usually Re 1
Accounting	Books of the finance company	Asset to be treated as current asset	Asset to be treated as fixed asset	Asset to be treated as current asset	Asset to be treated as current asset
	Book depreciation (finance company)	Not to be charged	To be charged	Question does not arise	Not to be charged
	Books of the client	Asset to be capitalized; liability to be recorded	Off the balance sheet	Asset to be capitalized; liability to be recorded	Asset to be capitalized; liability to be recorded
	Book depreciation (client)	To be charged	Not to be charged	To be charged	To be charged

Comparison between lease loan and HP -2

Income tax (country specific)	Income-tax (financier)	Rentals taxable. Depreciation claimable	Rentals taxable. Depreciation claimable	Interest taxable. No depreciation	Interest taxable. No depreciation
	Income-tax (client)	Rentals tax deductible; depreciation not claimable	Rentals tax deductible; depreciation not claimable	Interest tax deductible; depreciation claimable	Interest tax deductible; depreciation claimable
Financial regulations	Capital requirements	Regular capital requirements	Basel II capital requirements distinguish between asset risk and lessee risk	Regular capital requirements	Regular capital requirements
	Financial entity regulation	Applicable	Not applicable	Applicable	Applicable
	Concentration norms	Applicable	Not Applicable	Applicable	Applicable
	Provisioning requirement	Applicable	Not Applicable	Applicable	Applicable

Factors for growth of Indian Leasing Industry

- 1990s : good decade for Indian leasing industry
- Average rate of growth on compounding basis works out to 24% from 1991-92 to 1996-97
- Factors for growth
  - No entry barriers
  - Buoyant growth in capital expenditure by companies
  - Fast growth in car market
  - Tax motivations

- Optimistic capital markets
- Access to public deposits
- A generally go-go business environment

Current problems of Indian Leasing

- In the year 1996-97, profits of Indian leasing came down
  - Year of minimum alternative tax
- 1997-98
  - Year of debacle
  - Lost public confidence; caused by collapse of CRB Capital Markets Asset liability mismatch
- Generally bad economic environment
- Poor and premature credit decisions in the past
- Tax based credits
- Extraneous problems-frauds, closures and regulation

Motivations of an Indian Lessee for Leasing

Your business needs leverage, as size does matter

- Business in general needs leverage:
  - Capital is the foundation of the business; leverage is the structure built on it
    - Business without leverage is inefficient use of capital
  - There a definite relation between capital and leverage:
    - The relation is unique for each business, primarily having to do with the volatility of assets
      - Businesses with lower asset volatility can tolerate higher leverage
    - While proper leverage ratio needs to be carefully worked out for each business, regulations/lending practices put mechanical limits to leverage powers
  - Therefore, it is necessary quite often to search for ways of extending the leverage

- Off balance sheet financing, in general, refers to the ways by which leverage can be increased beyond on-balance sheet means
  - The word has been smeared by excesses done by several corporates in the past
  - Properly used, it is only bonafide arbitrage devices that fill the gap between economic leverage and regulatory leverage

Leasing, an off balance sheet method of funding

- Over the last 5 decades, growing businesses have been searching for methods of creating off balance sheet leverage
  - Leasing
  - Sale and leasebacks
  - Securitisation
  - Factoring and inventory refinance
  - Synthetic real estate leases
  - Off balance sheet vehicles for securities, trade receivables, etc
  - Credit derivatives
- Leasing is one of the oldest of the off balance sheet methods:
  - Has survived last 50 years or so
  - In the meantime, it has been shaped by
    - Accounting standards
    - True lease litigation
    - Tax regulations, etc.

How is leasing different from traditional financing?

- Leasing in rented capital:
  - The capital equipments you need for fairly long term are
    - identified by you
    - Bought by the leasing company
    - And provided on lease to you
  - Generally for a fixed period
  - At the end of the term, typically a leasing company allows:
    - Purchase option at a fixed priod
    - Purchase option at fair market value
    - Renewal at a fixed rental
    - Renewal at a fair market rental
    - Return of the asset
- Effectively, it is no different from owning the asset yourself

How leasing is different from traditional borrowing?

- Leasing is necessarily asset-backed:
  - There is an identified asset that you need for a fairly long period
  - In case of sale and leasebacks, the funds released may be used for normal business purposes like working capital
    - But generally, leasing is tied to acquisition of assets
- The asset should be
  - Durable
  - Detachable
  - Should have predictable residual values
  - Should not be a component/ part of an integral process

Implications of leasing vis-à-vis borrowing

- Accounting implications
  - If it is properly structured lease, it would be off your balance sheet
    - The asset as well as the financial liability will not show up on your balance sheet
    - You will be expensing the rentals, and not depreciation/interest
  - If it is off balance sheet:
    - Your D/E is reduced; RoA is up

- Tax implications:
  - You don't claim depreciation for tax purposes; instead, you claim rentals as expenditure
    - In most cases, this would mean a tax benefit

- VAT implications
  - Instead of paying VAT on the purchase of the capital asset, you will be paying VAT on the lease rentals
    - This also, in most cases, would mean a deferred payment of VAT
    - Given the fact that VAT set off for capital goods is staggered over several months, this also means an advantage

- Service tax:
  - If it is financial lease, there will be service tax on the interest component

Financial lease and Operating lease

- Accounting standards define financial lease and operating lease
  - There is definition in service tax law
  - Direct Tax Code also contains a definition
- Off balance sheet treatment is given only to operating leases
- As per broad accounting standards:
  - A financial lease is one which in substance is a funding transaction
  - Illustratively, it has the following features:
    - Transfer of title
    - Bargain buyout option
    - Present value of non-cancellable lease rentals is 90% or more of the fair value of the asset
    - Lease period covers 75% or more of the economic life
  - Most important test in reality is the present value test
  - Present value is computed at the IRR of the lease, or the lessee's incremental borrowing rate
    - Usually, the incremental borrowing rate is used
- It is not difficult to structure operating leases, e.g.
  - The lease carries a cancellation option
  - Or has a substantial residual value

Does the lessor charge more for an operating lease?

- Operating lease carries an option to cancel:
  - Either during the term of the lease
  - Or at the end of the lease where the residual value is still substantial
- It is an option with the lessee; which means the lessee will always exercise it to his advantage
- Therefore, the option has a cost for the lessor, and lessor is expected to charge for it
- The more volatile the expected residual value of the asset, the more is expected to be the cost of the option
  - This is understandable by the classic Black Scholes option pricing model

Can it be an operating lease for the lessee and financial lease for the lessor?

- Yes, main reasons for the distinction:
  - The lessee’s discounting rate may be different
  - In computing the present value of lease rentals, for the lessor, guaranteed residual values are also taken into account
  - In case the lessor has any third party residual value risk hedging devices in place, the lease may be financial lease for the lessor
- This is nothing unusual.

Some popular misconceptions about leasing

- Leasing is a costlier option
  - Proper pricing of a lease by the lessor is done based on:
    - Cost of capital of the lessor
    - Credit risk premium
    - Residual value risk premium
  - The first two are common in case of any financial product
  - The last item is a major advantage to the lessee:
    - In a fast changing technological world, it is a pity to be burdened with decrepit assets
      - Many a times, we pay hugely at the time of disposal of an old asset
  - In fact, what a lessee needs to evaluate is the post-tax cost of the lease after considering the tax advantages
- I get depreciation in case of a financial lease
  - This is true only in case of hire purchase
  - If it is financial lease and not hire purchase, for IT purposes, depreciation is allowed to the lessor and not lessee
  - Lessee may, as usual, claim rentals as expense

Some popular misconceptions about leasing

- Leasing means duplication of service tax
  - Service tax is applicable only in case of hire purchase and financial lease
  - The entire amount paid is offsetable
- Leasing means loss of residual value:
  - Not at all, as you are usually given the option to buy
- It is too complicated:
  - Most complications are perceptional than real
  - If it is complicated but beneficial, you would rather do it

How to evaluate whether to lease in?

- Financial evaluation:
  - Post tax evaluation is a must
    - Just looking at the lessor's IRR does not tell you anything
    - First of all, the IRR has a limited relevance to the lessor
    - What matters to the lessee is the cost, not the IRR
    - In most cases, there will be a tax advantage:
      - Present value of capital repayment claimed as an expense will be more than the present value of depreciation
    - Therefore, the only valid method is to compute the post-tax cost
- Accounting evaluation:
  - D/E is reduced
  - Operating profits are impacted:
    - Interest and depreciation are replaced by flat rentals
    - Normally, interest+ depreciation are front heavy; rentals are equal
    - This also means the operating profits look better
- Non quantitative benefits:
  - It is an add-on funding, your existing lines of funding are not affected
  - It is typically 100% funding; so you save your precious equity
  - Etc.

Leasing as a tool of financial restructuring

- Proper use of sale and lease backs, combination of financial and operating leases may
  - Reduce on-balance sheet leverage
  - May be excellent devices of financial restructuring
- Most of these are structured solution: there is no one-size-fits-all

From here on, where?

- Having gone through a very bad 1997-98, there is nothing that points to a better time.
- Business sentiment remains depressed.
- Business investments are not picking up.
- One sees lots of foreign players entering India.