MicroSave Briefing Note # 35

Microleasing: An Alternative Way of Financing Productive Assets

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Background

Many entrepreneurs in developing countries find it difficult to expand their businesses because of limited investment capital. A lack of collateral and poor business records makes it difficult for them to establish relationships with financial institutions.

Leasing[1] helps clients and financial institutions overcome these difficulties. Leasing is a contract through which an owner of an asset (the lessor) allows its use by another party (the lessee) in exchange for regular payments over a fixed term[2]. The attraction of leasing over traditional lending is that the asset itself acts as collateral and the lease focuses on the future cash flows to be generated by the financed asset. Despite the attraction of leasing it is much more common in developed rather than developing countries - many factors contribute to this, and these are explored below.

Constraints to Microleasing in Developing Countries

Legal and Regulatory Environment: Many developing countries have no clear policy on leasing. In East Africa institutions use laws governing conventional lending for leasing. However these laws do not address ownership of the financed asset, treatment of taxation and capital allowances.

Weak Economic Conditions: The low productive capacity within the economies makes it difficult for borrowers (lessees) to generate sufficient cash flows to repay lease rentals.

Institutional Factors: There are often limited technical skills within developing countries to design and operate a large leasing scheme. Leasing requires close collaboration: linkages need to be established with suppliers, maintenance services providers and financiers. Lack of credible partners has hampered the progress of some initiatives.

Client Related Factors: Clients limited business skills can affect their ability to realise projected cash flows from the financed asset. Awareness of leasing is often limited making marketing more difficult.

Experience from Two African Leasing Schemes

Despite these constraints, several experiments have been conducted in developing countries – including Grameen Bank in Bangladesh and Network Leasing Corp. in Pakistan. Below we outline two perhaps less well-known African leasing schemes and their experiences:

1. FINCA Tanzania, East Africa

In collaboration with *MicroSave*, FINCA Tanzania developed a microleasing product called "*Uvibiashara*". It was pilot tested for a year in Dar es Salaam and rolled out in August 2004. Lease amounts range from $500 to $10,000. Clients are expected to identify their own suppliers that FINCA Tanzania pay directly. As at October 2004 FINCA had disbursed US $635,000 to more than 200 clients. The median loan is US $2,300. Assets financed include commercial cars, freezers, fridges, computers, photocopiers, brick making machines, sewing machines and cookers.

FINCA learned that introducing a microleasing product is particularly challenging because of complications specific to leasing products. These included tax considerations, ownership of the financed asset, and compliance with legal and regulatory requirements. Dealing with suppliers was also demanding and it was tempting to finance similar, larger assets in order to reduce administrative requirements.

2. GIE Hari Goumo in Timbuktu, Mali

GIE Hari Goumo leased irrigation motor pumps valued at $6,700 each with the help of the Belgian NGO "Îles de Paix". The pumps were rented to farmers at $670 per season. The leasing scheme failed because:

- The European manufactured motor pumps were not designed for the African environment and were too expensive to be viable.
- Farmers overused their pumps and used cheap, dirty oil, which caused them to break down quickly.
- Lessees were expected to pay half the season's rent in advance, and half at harvest, but most failed to pay the final instalment.
- When pumps broke down, backup pumps were not available for farmers to use during repair.
- The lessor had no system to monitor the proper use of rented equipment.

Measures proposed by GIE Hari Goumo to make their leasing scheme viable included:

- Standardisation on a single brand of irrigation pump, with a range of sizes.
- Creation of rental agencies to ensure that the user obtained a pump appropriate for his/her farm size.
- Assistance by third parties to create the necessary support for client training and parts/service.
- Standardisation of lease rates among all lessees of power pumps, with insistence on advance lease payments.

[1] **Deelen**, Linda, Mauricio Dupleich, Louis Othieno and Oliver Wakelin "Leasing for Small and Micro Enterprises", *ILO*, 2003

[2] This Briefing Note focuses on financial lease and hire purchase.

Risks Associated With Leasing

Microfinance Institutions engaged in microleasing schemes face many challenges some of which are detailed below:

Liquidity risk: High demand for asset finance and higher average loans sizes create liquidity problems for undercapitalised MFIs. FINCA Tanzania is experiencing this problem with demand exceeding its ability to finance the supply of leases.

Credit/Business risk: Leasing assumes that lessees can generate sufficient additional cash flow to repay lease instalments. However, clients' ability to generate cash flows can be affected by many factors such as shortage of raw materials, inadequate sales and insufficient working capital.

Equipment obsolescence risk: Assets once purchased can depreciate rapidly. This can result in loss to the lessor if the asset needs to be repossessed.

Equipment maintenance risk: As shown by GIE Hari Goumo, the lack of sufficient, affordable maintenance services, can reduce the performance of the financed equipment thus decreasing clients' income and thereby ability to repay.

Equipment deterioration risk: In developing countries, many suppliers sell second hand or low quality equipment. Leasing second hand equipment requires technical competence to determine the condition of assets. Without this, the lessor and lessee risk premature deterioration of the asset.

Second hand market risk: Where defaulters' assets have been recovered, microlessors must either sell assets commercially or lease them to other clients at a price reflecting current value. Second hand markets are often not well-established making it difficult for microlessors to realise fair value.

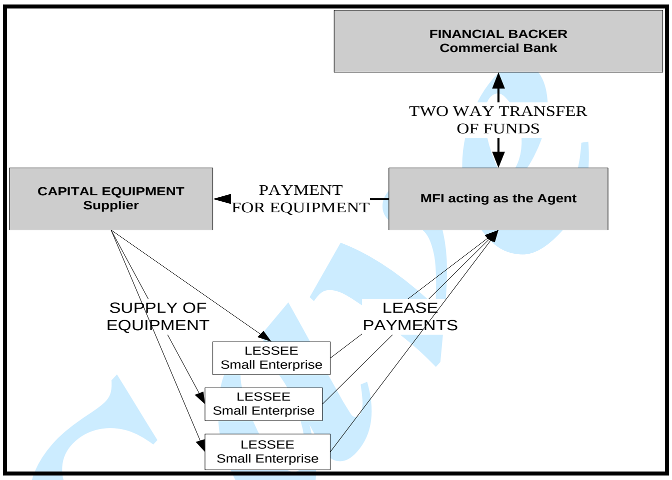
Lessons and Opportunities in Microleasing

Microleasing initiatives require strategies to manage operating risks, possible strategies are outlined below:

Business Assessment: Microlessors must assess clients' ability to generate sufficient cash flow from the assets to fund rental payments.

Processes and systems: Leasing requires processes and systems that accommodate asset ownership and residual value, specific taxation, accounting and legal requirements[3]. Standard banking software is unlikely to meet these requirements.

Agency Arrangements: Capital constraints and lack of technical competence by MFIs combined with limited capacity to lease small assets by banks and leasing companies can provide suitable conditions for strategic collaborations. The diagram below illustrates how this arrangement can work.



Asset insurance: Leasing companies require clients to take out comprehensive insurance on leased assets. Collective insurance of leased assets can reduce the costs for clients whilst reducing transaction costs for the leasing company.

Upfront payments: Upfront payment of 20% to 30% of the asset value demonstrates clients' commitment to the lease and minimizes potential loss to the lessor. In case of default deposits supplement sale proceeds.

Linkages: Lessors can create linkages with suppliers, maintenance service providers, insurance companies, technical service providers and financiers, to maximise flexibility and competitiveness.

Collateral: Some microlessors fail to differentiate between leasing and conventional lending by requiring clients to provide collateral in addition to the financed asset. This practice can lock out poorer clients from accessing leasing services.

Sectoral knowledge: There are considerable risks in funding start up businesses. To minimize these risks, lessors and lessees should have specific knowledge of the sector.

Financial Resources: A voluntary deposit base may be either insufficient or too volatile to provide long-term funds. A lessor often needs to obtain medium to long-term financial backing due to the longer length of lease terms.

[3] Potential for Leasing Products: Asset Financing for Micro- & Small Businesses in Tanzania and Uganda; By Leonard K. Mutesasira , Sylvia Osinde, Nthenya R. Mule; *MicroSave*, 2001