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Leasehold Financing: A Recent Evolution

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Abstract:

Leasing business has good prospects in India. At present, the leasing industry is growing in almost regulatory vacuum. But, the regulation of these companies is necessary not only to protect the funds of the public and the banks, but also to place the leasing industry on a sound footing. These are found urgently wanting. The present era is known as the "survival of the fittest". So is in leasing industry also. With the advent of specialization as the key to success, it is the high time for leasing industry also to reorient itself to the very needs of the market and lay its sole emphasis on market responsiveness. This is what is called professional outlook. In the US, which has the largest leasing industry in the world, lease financing contributes to approximately one fourth of total business investment. In India, leasing business gained momentum only after 1983. Lease financing has become very popular in India and in western countries. There is evidence that the pressure of competition is already building up and lease rentals have declined. Despite its rapid growth in India, leasing has so far contributed to only a small proportion of the business investment. It is expected that the business of the leasing companies will grow fast and they will be able to make a significant contribution to total business investment in India.

1.Introduction

Many companies, now a days, propose to tap potentials in relatively untapped segments for finance, like hire purchase, equipment finance, venture capital and project financing, factoring and bill discounting etc. The subject matter of the present study is related with financial innovative tool in financial services i.e. lease financing.

2.**Lease Financing Defined**

Lease financing is a recent evolution whereby the assets required by the "User Company" (borrower) is purchased by the "Financing Company" and let on lease over a period, on terms and rentals mutually agreed between them. Few recourses are possible at end of lease tenure:

- The lessee may surrender the asset to the lesser;
- The lessee may renew the lease on a perpetual basis;
- The lessee may take the asset from the lessee and sell it to a third party; and
- The lessor may sell it to the lessee.

The choice of specific alternative is a function of the lease package offered by the lessor at the beginning of the lease tenure.

Lease financing denotes procurement of assets through lease. The subject of leasing falls in the category of finance. Leasing has grown as a big industry in the USA and UK and spread to other countries during the present century. In India, the concept was pioneered in 1973 when the First Leasing Company was set up in Madras and the eighties have seen a rapid growth of this business. Lease as a concept involves a contract whereby the ownership, financing and risk taking of any equipment or asset are separated and shared by two or more parties. Thus, the lessor may finance and lessee may accept the risk through the use of it while a third party may own it. Alternatively the lessor may finance and own it while the lessee enjoys the use of it and bears the risk. There are various combinations In which the above characteristics are shared by the lessor and lessee.

3.Impotance Of Lease Financing

It is a lease financing company that contributes to the industrial development of the economy. The lease financing companies are indirectly helping industrial development and economy development of country. Lease financing being a new mode of financing in India which has been recognized as an attractive alternative to debt financing and that has evolved only in the recent times. It gives many benefits like, avoids restrictions frequently in loan agreement, does not disturb the existing debt equity ratio, provides a cover against the risk of obsolescence to lessee, full services lease with respect to maintenance. Business enterprises prefer leasing because it enables them to acquire the capital equipment and make payments over a period through expected earnings form the use of leased equipment. There are many firms specializing in leasing business and providing consultancy and technical knowledge about the use of lease financing. High interest rates, increasing corporate taxes, inflation, increasing cost welfare measures, etc. have led many industrial ventures in these countries into liquidity problems and leasing as a financing tool has given relief too many entities in improving their liquidity position.

4. TYPES OF LEASE AGREEMENTS:

Generally leases are classified into:

- Financial lease, and
- Operating lease.

However, other types of leases are also prevalent.

5. Lease Agreement

- Financing lease
- Operating lease
- Direct leasing
- Sale and leaseback lease
- Leveraged leasing

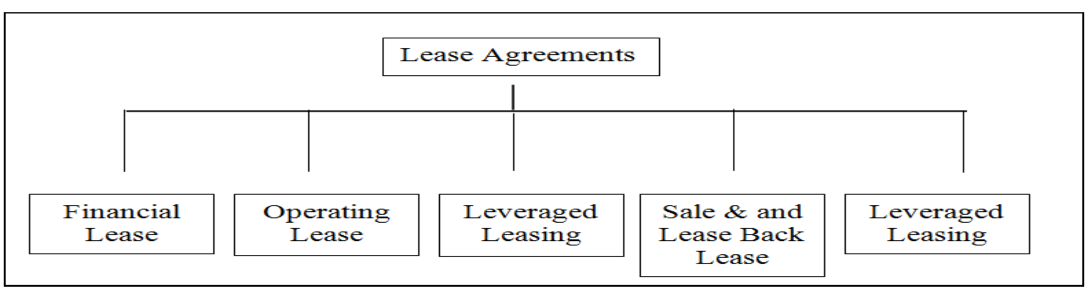

Figure 1: Types of Lease Agreement

5.1.Financial Lease

In financial lease, the lesee may select the equipment; settle the price and terms of sale and arrange with a leasing company to buy it. This type of lease transfers substantially all the risks and rewards incident to ownership from the lessor to the lessee. The contractual period in a financial lease can be split up into two or there periods over the life of the equipment.

Long-term, non-cancellable lease contracts are known as financial leases. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. At lease it must give an option to the lessee to purchase the asset he has used at the expiry of the lease. Under this lease the lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising there from are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as ‘capital lease’. In India, financial leases are very popular with high-cost and high technology equipment.

5.2.Operating Lease

An operating lease is also known as short – term services or maintenance lease. In this type of lease, the lease period is generally less than the full expected economic life of the equipment. Unlike financial lease, the contract is cancelable with proper prior notice. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

5.3.Direct Leasing

Under direct leasing, a company acquires the use of an asset it did not own previously. The major types of lessors are manufactures, finance companies, banks and independent leasing companies. For leasing arrangements involving all but manufactures, the vendor sells the asset to the lessor, who in turn, leases it to the lessee. A lessee firm may also lease an asset from the manufacture.

5.4.Sale and Lease Back

Under this type of lease arrangement, a firm, that owns a given asset sells it to the leasing company and gets it back on lease. Usually the asset is sold at approximately its market value. The fir, received the sale price in cash and the economic use the asset during the primary lease period. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets, which are not subjected depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease arrangement. The sale and lease back transaction can be expressed with the help of the following figure.

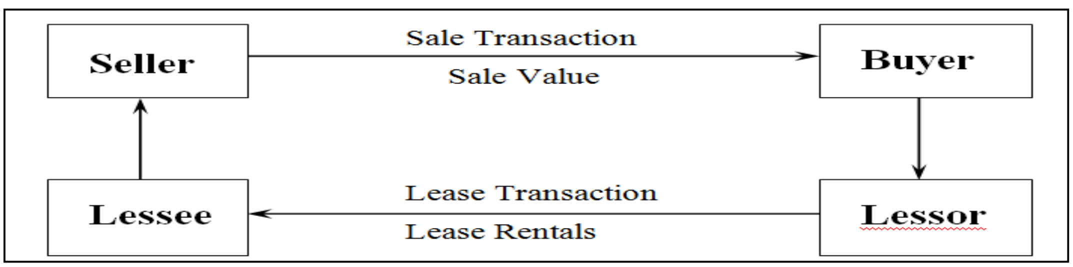

Figure 2

Under this transaction, the seller assumes the role of a lessee and the buyer assumes the role of a lessor. The seller gets the agreed selling price and the buyer gets the lease rentals. It is possible to structure the sale at agreed value (below or above the fair market price) and to adjust difference in the lease rentals. Thus the effect of profit/loss on sale of assets can be deferred.

5.5.Leveraged Leasing

Under leveraged leasing arrangement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

The equipments taken under leveraged leasing include aircraft, rail road, coal mining, electric power, generation plants, pipelines; ships etc. three parties are involved in leverage leasing. They are:

- The Lessee,
- The Lessor, and
- The Lender.

The lesser acquires the asset in keeping with the term of the lease arrangement and finances the asset in part by an equity investment. The remaining parts are financed by a long-term lender or lenders. Thus, the lessor is the borrower in this type of lease.

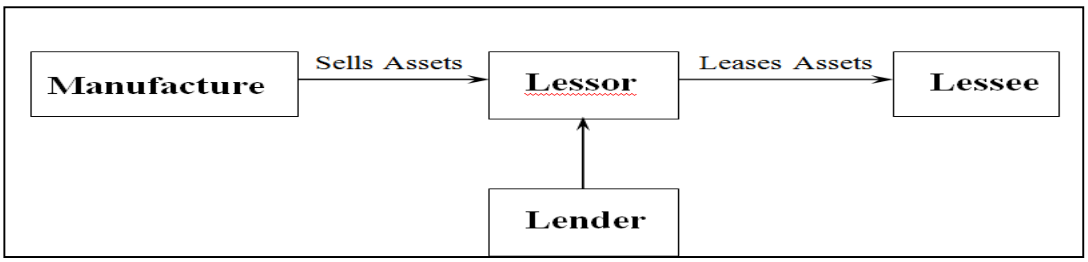

Figure 3

6.Advantages Of Lease-Financing

There are several extolled advantages of acquiring capital assets on lease:

6.1.Saving Of Capital

Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes e.g. purchase of inventories.

6.2.Flexibility And Convenience

The lease agreement can be tailor- made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

6.3.Planning Cash Flows

Leasing enables the lessee to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

6.4.Improvement In Liquadity

Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

7. Lease Financing In Indian Perspective

In India the pioneer in the field of lease financing has been the first leasing company of India Ltd., Madras whish commenced its business in 1973. It has been followed by several leasing companies like, Twentieth Century Leasing Company, Sundaram Finance, Motor and General Finance, Nagarjun Finance, Mazda Industries, pressman leasing, H.B. Leasing and Finance, Mehta Finance and Leasing, Larswin Business, Empire Finance, Ashok Leasing, Sterling Lease Finance, Ross Morarka Leasing Company, etc. according to the annual report of the twentieth century leasing company as many as 400 leasing companies were in operation during 1985-96 and many of them were associated with the nationalized scheduled commercial banks. Further, according to the Economic Times Survey, most of these companies, despite an increase in competition, successfully concluded and disturbed with a wide range of clients at fairly good profit margins. There has been a considerable expansion in their gross block comprising mainly of the leased out equipments which also reflects upon the large and quick benefits of the leasing business.

Public sector financing institutions and commercial banks have also started entering into the field of lease financing. Industrial Finance Corporation of India started encouraging the companies financed by it to lease out the industrial equipments to the small- and medium- scale industrial enterprises. Similarly, the Industrial Credit and Investment Corporation of India has directly entered into the field of lease financing since 1983 and has been focusing on the enterprises in the medium- and large scale sector. ICICIs leasing operations expanded substantially as the cumulative total amount sanctioned for the acquisition of the equipments to be leased out by it has been over Rs. 130.00 crores till 1986, the total sanction for the leasing business by ICICI has been Rs. 13.74 crores during 1983 when it started the lease financing. It rose to Rs. 65.20 crores during 1986. The disbursement also rose from Rs. 3.16 crores to Rs. 17.40 crores during the aforesaid period. At present in 2010, leasing business accounts for Rs. 98.76 crores.

The equipments leased out by the ICICI covered a wide range including the earth moving equipments, computer, machines and equipments for modernization of the textile enterprises. Certain commercial banks have established their subsidiaries for carrying on the leasing business with the financial assistance to be obtained from them.

Leasing has grown by leaps and bounds in the eighties but it is estimated that hardly 1% of the industrial investment in India is covered by the lease finance, as against 40% in USA and 30% in UK and 10% in Japan. The prospects of leasing in India are good due to growing investment needs and scarcity of funds with public financial institutions. This type of lease finances is particularly suitable in India where a large number of small companies have emerged more recently. Leasing in the sphere of land and building has been in existence in India for a long time, while equipment leasing has become very common in the recent times.

8. Probless Of Leasing Business

There are several constraints in leasing business. These are:

- Cultural traditions that have emphasized asset ownership seem to have inhibited increased recourse to leasing in a few countries.
- There is general lack of clarity, consistency and transparency in the fiscal treatment of leases in many countries.
- There are several presumably unintended anomalies in the taxation of lease transactions.
- No specific legislation that defines clearly the rights and obligations of lessor and lessee exits and to facilitate quick enforcement of the available remedies.

The constraints not withstanding there is considerable scope for the growth of leasing in developing countries in the region. In particular, leasing can play an increasingly important role in promoting productive use of machinery and equipment by small and medium sized enterprises in the private sector. Many of these enterprises would find leasing more suited to their requirement than conventional back borrowings.

8.1.Sources of funds

- Commercial Banks,
- Financial Institutions,
- Financial Services Corporates.

8.1.1.Commercial Banks

Large commercial banks have become increasingly interested in lease financing, either directly or through the use of holding companies. A bank will make arrangement to purchase equipment and lease it to a customer.

8.1.2.Financial Institutions

ICICI was the first institution to introduce institutional lease financing. State financial institutions have also entered into the field of lease financing.

8.1.3.Financial Services Corporates

Commercial finance companies and leasing companies are important sources of fund for specialized equipment and machinery. Investment Banker, Investment Trust and manufacturing industries are other important providers of lease. Insurance companies in India also enter into leasing, especially in building or real estate.

9.Concept Of Hire Purchase

Hire purchase is a type of instalment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last installment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as "an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

- The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic installments.
- The property in the goods is to pass to such person on the payment of the last of such installments, and
- Such person has a right to terminate the agreement at any time before the property so passes.

Hire purchase should be distinguished from installment sale wherein property passes to the purchaser with the payment of the first installment. But in case of HP (ownership remains with the seller until the last installment is paid) buyer gets ownership after paying the last installment. HP also differs from leasing.

10. Difference Between Lease Financing And Hire Purchase

Bases	**Lease Financing**	**Hire Purchase**
Meaning	A lease transaction is a commercial arrangement, whereby an equipment owner or manufacturer conveys to the equipment user the right to use the equipment in return for a rental.	Hire purchase is a type of installment credit under which the hire purchaser agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase.
Option to user	No option is provided to the lessee (user) to purchase the goods.	Option is provided to the hirer (user).
Nature of expenditure	Lease rentals paid by the lessee are entirely revenue expenditure of the lessee.	Only interest element included in the HP installments is revenue expenditure by nature.
Components	Lease rentals comprise of 2 elements: (1) finance charge and (2) Capital recovery.	HP installments comprise of 3 elements: (1) normal trading profit (2) finance charge and (3) Recovery of cost of goods/assets.

Table 1: Difference Between Lease Financing And Hire Purchase

11.Summing Up

Lease financing is an innovative tool for financing investments. It is widely used in western countries to finance equipments. In the US, which has the largest leasing industry in the world, lease financing contributes to approximately one fourth of total business investment. In India, leasing business gained momentum only after 1983. Lease financing has become very popular in India and in western countries.

Leasing business has good prospects in India. At present, the leasing industry is growing in almost regulatory vacuum. But, the regulation of these companies is necessary not only to protect the funds of the public and the banks, but also to place the leasing industry on a sound footing. These are found urgently wanting. The present era is known as the “survival of the fittest”. So is in leasing industry also. With the advent of specialization as the key to success, it is the high time for leasing industry also to reorient itself to the very needs of the market and lay its sole emphasis on market responsiveness. This is what is called professional outlook. The past success does not guarantee the future prosperity. Growth and success in leasing business requires for well planned marketing efforts in identifying the right opportunities and prospects, designing a suitable and realistic lease proposal and properly educating the clients on the pros and cons and modalities of a lease agreement.

The leasing industry is likely to become very competitive. There is evidence that the pressure of competition is already building up and lease rentals have declined. Despite its rapid growth in India, leasing has so far contributed to only a small proportion of the business investment. It is expected that the business of the leasing companies will grow fast and they will be able to make a significant contribution to total business investment in India.

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