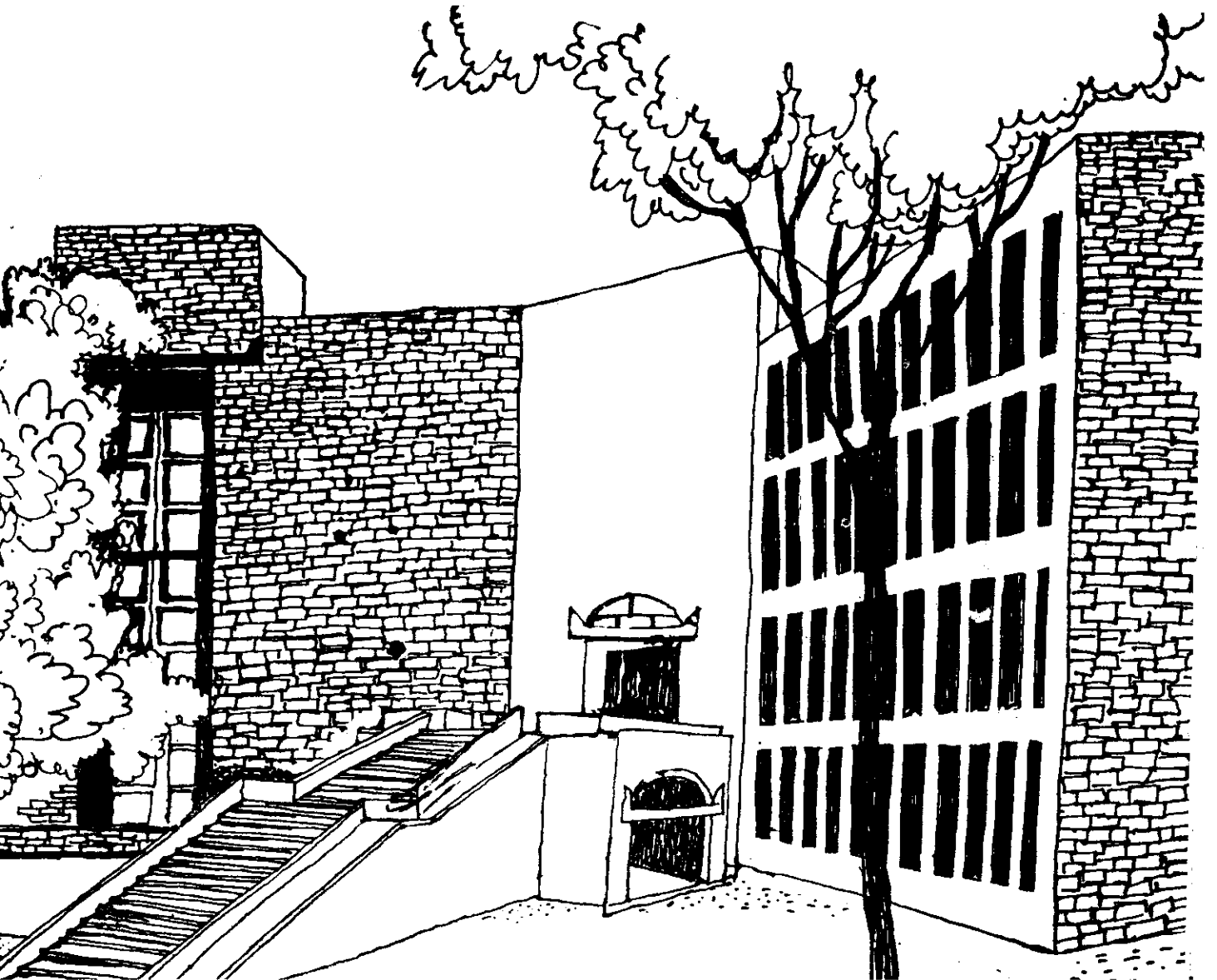


Working Paper



LEASING INDUSTRY IN INDIA :
STRUCTURE AND PROSPECTS

By

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ABSTRACT

The aim of this paper is to critically evaluate the structure and prospects of the leasing industry in India. Financial data of 29 selected leasing companies are analyzed to formulate the strategic groups of the leasing companies. It is argued that the winners of future would be either those leasing companies which are large in size and affect economies of scale or those which are associated with business houses. The options available to new entrants for successful survival are to enter the leasing business either as a large company or a specialized company. Entry on a leasing-cum-manufacturing will pose difficulty in terms of government regulation, raising of large capital and managerial capability.

LEASING INDUSTRY IN INDIA:
STRUCTURE AND PROSPECTS

It was the First Leasing Company of India Limited in 1973 followed by the Twentieth Century Leasing Company Limited in 1979 which popularised the leasing concept in India. The financial success of these companies prompted a large number of companies to invade the leasing market. Presently, we have about 350 leasing companies in India. The existing leasing companies can be grouped into the following categories: (1) financial institutions (FIs) such as ICICI, NSIC, IRBI, SICOM and GIIC, and subsidiaries of commercial banks (CBs); (2) independent leasing companies such as Twentieth Century, First Leasing and Regency Leasing; and (3) other leasing companies which are either subsidiaries or associates of business houses such as Key Leasing of JK Group and Nagarjuna Finance of Nagarjuna Group, or leasing companies with manufacturing interest such as Bajrang Leasing manufacturing industrial gases or Jupiter Leasing manufacturing drugs. Some of the companies in these various groups have tie-ups with international financial institutions and foreign collaborators. For example, Mazda Leasing has its collaboration with the British Equipment. The International Finance Corporation is providing financial support to a number of companies/banks/financial institutions for the promotion of leasing business in India. A number of other manufacturing

companies are the potential entrants in the leasing business. For example, Reliance Industries will soon set up the largest leasing company in the country with an equity capital of about Rs.125 crores. Orkay Silk Mills also have the similar plans.

In view of the increasing importance of the leasing business in India, we attempt a critical assessment of structure and prospects of the leasing industry in India.

Goals and Strategy

What are the goals, strengths and weaknesses and strategy of each of the group? FIs and CBs have well-defined goals and strategies. ICICI has plans to enter specialized and innovative types of leasing. It will also aim at achieving technology development in the country through lease financing. GIIC and SIMCO have the similar goals. NSIC aims at promoting small and medium size industries in the backward areas, while IRBI aims at the reconstruction and rehabilitation of sick units. To a great extent, the leasing business of FIs will be guided by the plan priorities. For example, NSIC has to provide one-third of its total leasing assets to backward areas. CBs, on the other hand, are poised to offer wide range of equipments on lease and fill in gaps in the availability of industrial finance through leasing. They also intend to improve their profitabilities by taking advantage

of depreciation tax shields. They cannot directly undertake the leasing business; but they have been allowed by the Reserve Bank of India to set up subsidiaries. Some of the banks such as the State Bank of India, the Canara Bank and the United Commercial Bank have already promoted the leasing subsidiaries. The leasing subsidiaries of CBs are likely to be entirely subjected to the goals of the parent banks, and would be primarily interested in implementing priorities laid down by the parent banks. For CBs and FIs, leasing is, however a natural extension of their role as providers of industrial finance. The strengths of CBs and FIs lie in their large resource base, lower cost of funds, familiarity with the business of financing, contacts with customers and large reach across the country. FIs such as ICICI have the additional advantage of their tie-up with the international financial institutions. The necessity of functioning within national priorities and the government rules and regulations can constrain the leasing operations of FIs and CBs. The decision-making can also be slow on account of large, bureaucratic organisation of CBs and FIs.

The leasing companies which are solely engaged in leasing and other financial services will have profitability and market share as their main goals. Their strength lies in providing a wide range of financial services to the lessee.

Once they are able to establish their reputation and show good financial performance, it should be easy for them to raise finance from the capital markets. They can thus go for innovative and specialised leasing to cater to the special needs of users. Since leasing is the primary business of such companies, they are directly hit by the fluctuations in lease rentals. The competitive pressure in the form of reduced lease rentals put by the large, cost-effective leasing companies can adversely affect the profitability of independent leasing-cum-finance-companies. The change in the government's tax policy can also affect them as they may be unable to take advantage of all tax shields.

The manufacturing-cum-leasing companies or those leasing companies which have associations with manufacturers will pursue the following goals: (a) in-house financing, (b) tax planning, and (c) setting up down-stream companies. They are likely to help maximisation of the overall profitability of the parent companies by trading tax shields. Such companies will have a number of strengths. They have a primary resource base in the parent company and possess its name; therefore, they can easily raise funds. They can draw on the parent company's experience and expertise for conducting their leasing business. Since leasing is not their only activity to earn profits, they have flexibility in fixing their lease rentals keeping in view outside and in-house users' cash flows,

tax planning or other needs. The manufacturer-lessors will use leasing to maximise their sales and profits, particularly when the buyers need equipment but they have shortage of funds to buy them. Such leasing companies have complete familiarity with product market and technology. Therefore, they shall be able to correctly assess the risk of obsolescence. The major limitations of this group of leasing companies will be their narrow scope of operations and subordination to the rules and regulations of the government regarding manufacturing and big business houses.

Leasing companies with tie-ups with foreign collaborators and financial institutions will have added focus on the maximisation of the foreign exchange earnings. Their international linkages will help them in importing equipments and machineries, maintaining a high resource base and benefiting from know-how and expertise provided by their collaborators.

Competition

The leasing industry in India is to-day characterised by 'cut-throat' competition. Essentially, the competition is price-centred involving undercutting of lease rentals. As a consequence of a large number of companies entering the leasing business, the lease rentals have significantly lowered down. The lease rentals which were around Rs.30-33 per Rs.1,000 worth of asset per month for a 5-year lease had crashed to Rs.15-16

before recovering to around Rs.25 in the recent period. Some new entrants are still quoting lease rentals lower than Rs.25. Companies with large resource base and cheap funds such as ICICI are in a position to quote highly competitive rates. At 6 per cent after-tax discount rate, ICICI can quote as low a rental as Rs.22.15 per month, for a 5-year lease and break-even. The after-tax discount rates of smaller companies is likely to be much higher. They may have to borrow from banks at 18 per cent interest rate. Even if we assume a debt-equity ratio of 10:1, the after-tax cost of funds work out to be around 9 per cent if the average cost of borrowing is 16 per cent and equity holders are allowed a 20 per cent after-tax return (assuming a 50 per cent tax rate). In fact, the leasing companies have much lower debt-equity ratios (Exhibit 1). Table 1 gives monthly rentals per Rs.1,000 worth of asset for a 5-year lease at various discount rates. It is evident from the table that for most of the existing companies the break-even rentals are close to prevailing lease rentals.

Table 1

The intense rivalry among leasing companies has been contributed by the phenomenal increase in their number and relatively slow growth of the leasing business. While the number of leasing companies has increased to about 350 from just 3 or 4 companies, the leasing business has increased to

only about Rs.150-200 crores from Rs.50-60 crores three years ago. If financial institutions and commercial banks are not considered, most leasing companies are very small in terms of financial resources and market share. Exhibit 1 shows the financial data of 29 leasing-cum-finance companies, selected

Exhibit 1

from the Bombay Stock Exchange Directory. It can be seen that 11 companies have paid-up capital less than Re.1 crore each and 25 companies have less than Rs.1.5 crores. The largest company in the group has a paid-up capital of Rs.3 crores. Thus the size of the companies which are not listed on any stock exchange can be expected to be quite small.

The absence of any entry barrier and the opportunity to make 'personal' profits seem to have motivated a number of promoters to set up leasing companies. Unlike in manufacturing, the setting up of a leasing company does not require any licence to carry on business, and it can raise capital upto Re.1 crore (promoter's contribution being Rs.40 lakhs) without the permission of the Controller of Capital Issues. Like hire-purchase companies, leasing companies can also have a debt-equity ratio as high as 10:1. A leasing company also does not require any kind of cumbersome infra-structural

facilities and establishment to do the business. It can start earning revenues and make profits from the very beginning if it can keep its overheads down.

A number of promoters took advantage of the recent boom in the stock market and raised funds to carry on the leasing business without a real commitment. The funds so raised were used to provide for hire-purchase and other financial services. Some of the recently floated companies have started paying dividends of 12-15% to shareholders from the very first year of their inception. A number of other new companies have also promised payment of dividends from the beginning. They can do so by using the funds raised in providing hire purchase and other financial services and at times lending in the inter-corporate investment market. Most of these companies have a very limited interest in leasing business. Their cost of raising funds is high and their overheads are also high. It is, therefore, doubtful that they would remain viable to pay handsome dividend in future. The small size companies are not cost-effective, and they also earn lower return on capital employed (ROCE). It is clear from Exhibit 3 that for companies in Exhibit 1, size (in terms of total revenue) and expense ratio have a negative rank correlation (coefficient being -0.638), while size and ROCE are positively correlated (rank correlation coefficient being $+0.680$). Most of the leasing companies also have low debt-equity ratios, and they borrow

mostly from banks which charge 17.5% rate of interest on funds lent. Thus, the advantage of financial leverage is not available to them, particularly to the small size companies. The average debt-equity ratio for companies in Exhibit 1 is only 0.83:1; seven of those companies do not have any debt while six companies do not have any long-term debt. It is significant to note that those companies which employ lower net worth to finance their assets (which implies higher debt ratio) earn higher return on equity. The rank correlation coefficient between return on equity (ROE) and net worth to total assets ratio is -0.632.

Exhibits 2 & 3

Yet another factor which has accentuated the intensity of rivalry among leasing companies is the strong bargaining power of users (lessees) who can shop around from a large number of lessors. Since most of the leasing transactions are standard arrangements, lessees can easily switch without much cost and inconvenience. Also, users can be found integrating backward by creating their own in-house leasing companies.

In order to survive in the wake of intense competition, a number of leasing companies are aiming at high turnover and low overheads strategy. It is for cost-effectiveness

that groups like Reliance and Orkay are planning to float very large size leasing companies. It is noteworthy that the largest leasing company so far is Twentieth Century with a net worth of about Rs.3.50 crores. Some companies have adopted the strategy of going for specialized leasing as a way to distinguish their 'product' for pricing and to keep overheads to the minimum and improve profitability. For example, Standard Medical Leasing is focusing on medical equipment and Dhanalakshmi Consolidates Trust Limited on 'inventorial' leasing, i.e., leasing of raw materials to manufacturers with spare capacity against firm orders booked by the company or its associates.

WINNERS OF FUTURE

Leasing companies in India are mostly integrated finance companies engaged in a variety of finance services such as hire purchase, investment, merchant banking etc. To quote from the speech of the Chairman of Investment Trust of India: "Apart from commercial banks and entry of new hire purchase operators, competition is also being faced from leasing companies which too have started taking up hire purchase operations. In fact, there is hardly any pure leasing company as such. Almost everyone of them has entered hire purchase field at least to a limited extent."

The competition in the industry is essentially based on undercutting of lease rentals; therefore, cost of operations

and funds would shape the competitive strategy and competitive edge of a leasing company. Similarly, diversification into manufacturing or association with manufacturing companies would help in obtaining assured business and stabilising the flow of income. The three strategic groups in which leasing companies can be classified are: Group I consisting of financial institutions and subsidiaries of commercial banks; Group II consisting of independent leasing companies without any association with manufacturing companies; and Group III consisting of the leasing companies either with their own manufacturing activities or set up by business houses.

Group I institutions will look upon leasing as a new financial instrument. Their goals will be industrial and technological development, rehabilitation of sick units, protection and promotion of small scale units and so on. These institutions will also have the advantage of raising large sums of money either from the government or foreign financial institutions at low cost. In spite of their large size and cheap sources of funds, they are unlikely to pose a big threat to Groups II and III leasing companies since their 'areas of operations' and 'markets' are well defined. There can be exceptions; ICICI, for example, may be seen as a competitor by other companies.

Exhibit 1 has categorised the leasing companies registered at the Bombay Stock Exchange into Groups II and III. They

exhibit marked differences in terms of share capital, size of income, operating efficiency, use of debt and profitability (see Exhibits 1 and 2). It is revealed from Exhibit 2 that on an average Group III companies employ high debt, have high share capital, income, ROCE and low expense ratio. Differences in average operating expense ratios and debt ratios are very significant. Group III companies expense ratio is only 26 per cent as compared to 43 per cent of Group II companies. The low expense ratio gives Group III companies a high ROCE and coupled with high leverage, Group III companies' investors earn a very high return of 25 per cent (as compared to 13 per cent for Group II investors). Group II companies' income is not only low it also shows wide fluctuations.

It is thus apparent that Group III is a better strategic group than Group II. This explains the behaviour of some leasing companies diversifying into manufacturing (e.g., Progressive Leasing going for bus body building; Bajrang Leasing into industrial gases, or Jupiter Leasing into drugs). In this context, the mobility barriers between groups become important. Since Group I consists of essentially the Government-owned institutions, there is hardly any possibility of mobility between this group and other groups. However, mobility barriers exist between Groups II and III. Unlike leasing which does not require any industrial licence, entry

into manufacturing sector is subject to a lot of government regulation (e.g., licensing, approval of foreign collaboration, approval for import of capital goods etc.). Also, entry into manufacturing requires technical and marketing skills while the independent leasing activity requires only financial (and tax) skills. The capital requirement for entering the manufacturing is also high.

Thus the winners of future would be either those leasing companies which are large in size and affect economies of scale or those which are associated with business houses. The options available to new entrants are to enter the leasing business either as a large company or a specialized company. Entry as small, integrated finance company would not be sound decision as new entrant will have to face the uncertainty of functioning in diversified areas, and because many companies that have entered the industry in this manner have not done well. This has reduced their credibility and made further raising of funds a difficult proposition. The competition among such companies would continue to be price based and the new entrant will find it very difficult to compete with existing companies.

As stated earlier, entry as a leasing-cum-manufacturing company will pose difficulty in terms of government regulation,

raising of large capital and managerial capability. Further, it would be unwise to enter into manufacturing merely because a company wants to enter the leasing industry.

A new entrant may safely choose the option of entering into specialised leasing business. In India, there are a very few specialised leasing companies. Speciality leasing offers an opportunity to indulge in non-price competition because of the opportunity of product differentiation that specialisation offers. This will involve the additional costs of finding skilled manpower, but the future lies in this area of the industry.

Table 1Monthly Rentals at Different Rates of Discount

Discount rate	Monthly rentals
6%	Rs.22.15
9%	25.03
10%	26.00
12%	28.00
15%	31.06

Note: Monthly lease rentals have been calculated using the following formula:

$$NPA = -A_0 + PV [TDep_t] + PV [(1-T)L_t] = 0$$

T is assumed to be 55% and discounted rate is compounded monthly for finding out the present value factor. Written-down depreciation is calculated at 30%. For explanation of lease evaluation, refer to my article, Myths and Realities About Leasing, Vikalpa, Vol.11, No. 4, October-December 1986.

Exhibit 1

Financial Data of Selected Leasing Companies

	Date of in- corporation	Share capital (Rs.lakhs)	Total income (Rs.lakhs)	Exps. to total income (%)	Return on capital emplo- yed (%)	Return on net worth (%)	Net worth to total assets (%)	Borrow- ings to net worth (times)	Divi- dend (%)
Group II									
1. Bangalore Leasing	June 1983	190.1	83.1	37.4	15.8	13.7	43	.76	12
2. Express	May 1983	248.9	31.1	8.2	(10.33)	(11.5)	96	0	-
3. HB Leasing	March 1982	142.9	72.0	69.9	14.7	18.8	64	.30	15
4. HIFCO	Dec. 1983	78.6	16.4	25.3	5.6	9.9	28	1.97	8
5. Jindal Leasing	Oct. 1983	95.8	26.2	10.1	19.5	18.6	89	1.61	10
6. Madhusudan	Oct. 1983	24.5	0.9	75.6	7.4	6.5	99	0	-
7. Maharashtra	Nov. 1982	22.5	5.0	61.7	7.9	5.5	65	0.50	-
8. Midwest	July 1983	379.4	143.2	47.5	11.2	13.6	51	0.63	12
9. Motha	Sept. 1982	119.2	57.9	14.8	17.6	19.7	43	1.00	16
10. New Century	Sept. 1983	124.0	5.0	83.2	2.9	2.9	99	0	-
11. Pressman	July 1983	226.2	152.1	3.9	28.5	35.4	62	0.44	22
12. Progressive	Aug. 1983	24.0	1.2	140.0	5.4	5.4	99	0	-
13. Sundaram	1979	300.0	1921.1	12.2	14.8	23.9	7	9.5	20
14. Sancheti	Aug. 1979	100.1	20.3	37.3	9.6	11.3	77	0.23	9
15. Sterling	Nov. 1983	64.2	7.3	47.9	7.7	8.7	78	0.16	10
16. Twentieth Century	Aug. 1979	130.0	549.0	8.0	15.5	30.8	16	3.89	21
Group III									
1. DCL Finance	July 1983	193.15	53.27	26.3	12.51	16.1	51	.54	15
2. First Leasing	Sept. 1973	124.59	381.42	8.4	15.62	26.8	24	2.56	21
3. Integrated Finance	Aug. 1983	99.33	31.52	35.4	6.7	10.7	23	1.97	10
4. Kothari Oriental	Aug. 1983	49.64	23.75	27.4	9.0	15.0	27	2.53	12
5. Larswim	April 1983	104.59	50.56	25.4	12.5	18.1	29	1.66	14
6. Mazda	Nov. 1983	119.68	67.55	24.0	16.0	32.7	43	1.17	18
7. Midland	Jan. 1984	39.40	-	-	6.9	-	79	-	10
8. Nagarjuna Finance	March 1982	149.72	348.00	23.6	21.0	41.5	9	4.00	20
9. Oswal Leasing	June 1983	46.90	24.02	63.5	15.3	15.0	78	0	12
10. Parvidhgaar	Jan. 1983	101.06	160.57	21.6	8.7	10.0	33	1.56	-
11. Ross Murarka	Sept. 1983	148.04	278.04	29.0	17.8	47.8	23	2.91	21
12. Sanmar Financial Services	April 1983	27.00	141.44	8.8	20.1	39.2	22	3.39	15
13. Standard Medical	Sept. 1983	196.75	139.20	15.6	17.2	27.2	28	2.01	18

Source: The Official Directory of Bombay Stock Exchange.

Exhibit 2Average Financial Performance of Groups
II and III Leasing Companies

	Independent Leasing companies Group II	Mfg./Associate Leasing companies Group III	All Leas- ing Compa- nies Groups II and III
Average:			
Expense ratio (%)	42.7	25.8	35.4
ROCE (%)	10.9	14.4	12.4
ROE (%)	13.3	25.0	18.3
NW/TA ratio	.64:1	.33:1	.50:1
Share capital (Rs.lakhs)	141.9*	113.4	129.7
Total income (Rs.lakhs)	193.2*	141.6	171.1

* Total income (average) of Group II is biased by the large income of Sundaram Finance. If we exclude the income of this company, the average total income of Group II is only Rs.78 lakhs. Similarly, the average share capital is over-estimated because of the inclusion of two companies, viz., Midwest and Sundaram Finance.

Exhibit 3Relations Between Financial Characteristics of
Leasing Companies

	Indepen- dent leas- ing com- panies Group II	Mfg./Asso- ciate leas- ing com- panies Group III	All leas- ing com- panies Groups II and III
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Rank Correlation Coefficient:

Share capital & total income	+ .836*	+ .468	+ .672*
Total income & expense ratio	- .701*	- .217	- .638*
Total income & ROCE	+ .776*	+ .610**	+ .680*
NW/TA & ROE	- .534**	- .493	- .632*

* Significant at 1% level.

** Significant at 5% level.