Leasing in India- Poised for Growth

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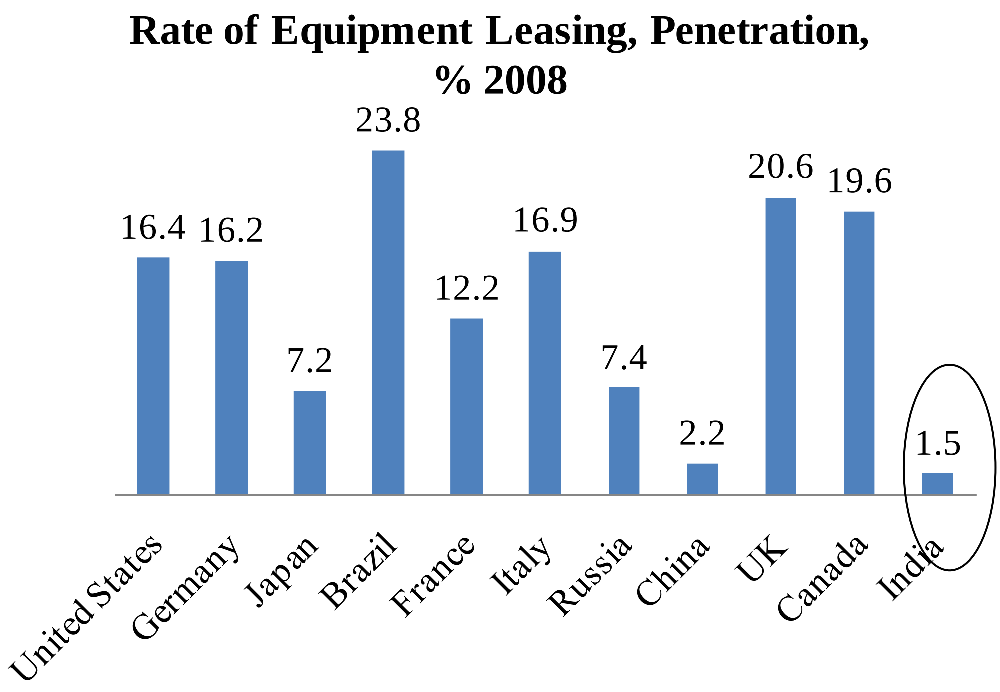
ICRA Management Consulting Services Limited

LEASING SECTOR IN INDIA

Leasing of equipments and real assets is a prominent source of private capital formation and contributor to GDP in many developed and developing economies across the world with equipment Leasing (excluding real estate and consumer asset financing) as a % of private capital formation estimated at 16.4% for US, 16.2% for Germany, 23.8% for Brazil, 20.6% for UK and 2.2% for China in 2008. In contrast, leasing penetration in India is abysmally low and is estimated at 1.5% of private capital formation in FY10 which roughly translates into Rs 20,000 crore of annual leasing volumes.



Source: Global Leasing Yearbook 2008, IMaCS Analysis

EVOLUTION AND GROWTH DRIVERS

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.

At present, 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.

Key Factors expected to shape the Leasing sector in India

Constraints

1. Uncertainties in the legal and taxation environment governing leasing transactions continue
2. Enablers for emergence of an efficient leasing market under-developed; secondary market, asset valuation, service backbone for equipments such as in construction
3. Mindset of the Indian customer of pride in owning an asset. This is showing gradual changes with MNC culture and business imperatives

Enablers

1. Strong Customer Demand Drivers in place- Emergence of Asset Lite MNCs and significant capital investments across all sectors of economy and infrastructure
2. Entry of Large OEMs with specialised equipments across multiple industry segments
3. Emergence of Organised Lease providers with specialised skills in asset management
4. Anticipated changes in the legal and taxation framework expected to bring clarity fort the sector

Source: Industry Discussions, IMaCS Analysis

Information Technology equipment, vehicles and construction equipment are the primary segments where leasing has shown significant growth and these segments are estimated to constitute around 40% of all leasing volumes in India in FY10. Other sectors where leasing is prevalent and/or is expected to gain momentum are aircrafts, containers, railway wagons, office equipment, temporary power, renewable power and medical equipment.

REGULATORY AND LEGAL CONSTRAINTS

Historically, the growth potential of leasing market in India has been constrained by inefficient and uncertain tax environment for leasing transactions which resulted in difficult operating conditions for the lessors. Several legal and taxation related issues that have restricted the growth in the sector and continue to prevail are:

- discrepancy in the treatment of depreciation for leasing transactions - tax benefit on account of depreciation under finance leases is available to lessor as opposed to accounting treatment where it is available to the lessee,
- subjectivity on part of the tax authorities with regards to the allowance of taxation benefit on depreciation to the lessors,
- levy of an additional level of VAT on leasing transactions vis-a-vis a hire purchase transaction
- lease rentals being subject to dual taxation - VAT and Service Tax.
- disallowances in claiming input tax credit on various components of tax including VAT, Service Tax and Central Sales Tax
- disallowances in claiming set off for Life Time RTO Tax imposed by various states which makes the inter-state movement of construction equipment unviable.
- the anticipated implications of the proposed IASB standard under which leases will be reflected on the balance sheet of the lessees.

We believe that there is relief in sight for the sector, with quite a few changes expected to reduce the level of subjectivity and inefficiencies in the existing taxation norms for leases in India. The changes are expected to be a mixed bag for the leasing sector, with a few changes which though might reduce the level of uncertainty, are expected to adversely impact select segments of the sector in the short term and several changes that are expected to bring in positive structural changes for the sector. While the new Direct Tax Code, which is expected to be introduced by April 2012 proposes to take away the tax benefit on account of depreciation for equipment on finance leases from the lessor and shift it to the lessee, makes a finance lease unattractive to the lessor, it is not expected to have any significant impact on operating leases. Further, issues such as levy of an additional level of VAT on leasing transactions, subjectivity on the classification of leases as finance lease or operating lease, imposition of one time Life Tax by RTOs are expected to continue.

On the positive side, the issue related to imposition of double tax- VAT and Service Tax on a single lasing transaction has been resolved by a recent Supreme Court ruling which has ruled that Service Tax will be charged only on the interest portion of a finance lease transaction. Further, the expected introduction of a unified Goods and Service Tax over the next 1-2 years may effectively address the issue of claiming input tax credit amongst various tax components such as service tax, VAT and Central Sales Tax and largely reduce the level inefficiencies in the taxation norms for leasing transactions.

COMPETITIVE LANDSCAPE AND KEY SUCCES FACTORS

Anticipating the potential, several specialised lease providers with deep pockets and ability to write big ticket size leases have emerged in the sector which in return is expected to contribute further to the sector growth. Currently, leasing sector in India is characterized by the presence of a few organised medium to large scale lease providers, which can be segmented into four business models.

- Third party financiers/Non Banking Finance Companies (NBFCs)-Examples are Srei Equipment Finance, Magma Leasing, GE Capital which offer leasing to the customers largely as an alternate means of financing.
- Emerging Asset Life Cycle Management (ALCM) companies-Examples are Operating Lease Companies such as Rentworks and OPC Asset Solutions which offer operating lease structures with interest in the residual value.
- Captive leasing and financing arms of leading manufacturers such as IBM, Xerox with a primary mandate of facilitating the parent's product sales through financing and leasing support and take on residual value risk on their balance sheet. In this category, there are companies that are registered as NBFCs and also companies that function as an Operating Lease company.
- Rental operators such as Quippo, GMMCO, Gear which provide equipment on rental for periods ranging from few weeks to years to the end customers.

Access to low cost of funds, extensive industry domain knowledge, understanding of the technical aspects of equipment, access to secondary markets for equipment, strong relationship with manufacturers and customers are the key factors to succeed in the sector. Each of above categories of lease providers operate with a distinct set of capabilities, business model and challenges in the sector. For instance, third party financiers compete on the strength of their balance sheet, access to low cost funds and relationships with customers. However, they lack capabilities to take significant residual value risk on their books especially in equipment segments where they do not have strong operations and domain expertise, which in contrast is the key competitive strength of ALCM companies with interest in the Residual Value. Captive lessors have significant expertise on technical aspects of equipments, have extensive industry domain knowledge and are well positioned to manage residual value risk, but are viewed by customers as a sales and financing arm for the parent and not really capable of meeting customer requirements from multiple vendors.

GROWTH POTENTIAL IN THE SECTOR

Going forward, we believe that the market for simple finance leases may slow down further with the impending introduction of new Direct Tax Code and would get limited to special situations where the lessor has a need to resort to leasing as a structure to better secure his ownership rights on the equipment as compared to debt financing or hire-purchase transactions. However, we firmly believe that strong customer demand drivers for operating leases are falling in place in several business segments, which are likely to result in high annual growth rates of 25-30% over the next five years. Leasing of construction equipment is expected to rise with introduction of large ticket size sophisticated equipments from International OEMs and significant demand for capital investments across all infrastructure sectors. Leasing of information technology and office equipment are expected to be driven by high pace of technological obsolescence, trend towards outsourcing of non-core assets and rise in MNC culture of operating on an asset light model. Medical Equipments is another segment where leasing is expected to pick up significantly, driven by introduction of equipments with rapidly changing technology from international manufacturers and emergence of corporate hospital chains.. As the changes in the taxation laws and regulations kick in over the next 12-24 months, we may even witness a higher growth rate for the leasing industry which has already found a strong business case in the emerging economic scenario.

About ICRA Management Consulting Services (IMaCS)

ICRA Management Consulting Services Limited (IMaCS) is a multi-line management/development consulting firm headquartered in India. IMaCS is a fully-owned subsidiary of ICRA Limited (ICRA), one of India's leading credit rating agencies. We have an established track record of 15 years in consulting and a diversified client base across various sectors and countries. Our clientele includes multilateral and bilateral agencies, banks & financial institutions, manufacturing and service organisations, Governments, Government-owned organisations, investors, and regulators.

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