

## LEASING FINANCE: A TOOL TO PROMOTE CAPITAL INVESTMENT IN THE SMALL AND MEDIUM ENTERPRISES OF PAKISTAN

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### ABSTRACT

*The performance of Small and Medium Enterprises is a reflection of performance of economy. The developed countries had underlined the development and improvement of their Small and Medium Enterprise Sector. The contribution of the sector towards gross domestic product, value addition, export earning and employment generation helped the developed countries to achieve economic prosperity and growth. In the Asian economies, the Small and Medium Enterprise Sector has played very significant part in economic progress and has provided opportunities to both genders to participate in economic growth of the countries. The same potential also exists in Pakistan, however, the sectoral contribution of Small and Medium Enterprise Sector in the gross domestic product of Pakistan is not appreciable, which reveals that the specific need of financing for the promotion of small and medium enterprises have not been answered in appropriate manner. Consequently, small and medium enterprises of Pakistan are unable to take part in the growing markets of the world because the conventional lending sources cannot meet their requirement of capital investment. A need was felt to arrange finance for SMEs through non-traditional methods i.e., through lease financing. Data were analyzed through buy-borrow and lease financing methods. Results revealed by these techniques show that lease financing is not only convenient method of financing but also more economical than buy-borrow method of financing.*

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### INTRODUCTION

The Small and Medium Enterprises have capability to adjust to the changing business environments, being flexible and easily manageable than the large-scale industry and that's what put the economy on the faster track of development.

Since the inception of Pakistan small scale industry or trade has been documented as the real force of economic growth and employment generation in various policy statements, strategies and

initiatives. In this respect institutions were established for technical and financial support on the premise of the world's most successful economies. These promoters of the sector in Pakistan set the eligibility criteria to fit for targeting purposes in line with the economic development based on fixed assets, employment and sales of industry or trade. Sector's resource allocation is higher particularly in social sector. The sector provides more job opportunities at lower cost in comparison of the large enterprises. "The sector contributes 30% towards the country's gross domestic product, accounts for 35% of the value added in the manufacturing industry and generates 25% of manufacturing sector export earnings" (Government of Pakistan, 2010:53).

"About 3.2 million enterprises are operating in the Pakistan out of which some 2.97 million or 93% business establishments perform in the category of the Small and Medium Enterprises (SME). The sector contributes over 90% of business in Pakistan and being highly labor intensive, provide employment more than 80% of the work force of the non-agricultural labor" (Government of Pakistan, 2009:51). Moreover, the Small and Medium Enterprises have all-encompassing presence across the economy with varying density i.e. "wholesale and retail trade, restaurant and hotel business 56%, being lion share followed by other services 23% and manufacturing sector 21%. More than 65 percent of the small and medium sized enterprises work in the Punjab, 18 percent in Sindh, 14 percent in Khyber Pakhtunkhwa and 2 percent in Balochistan" (Government of Pakistan, 2007:50).

Despite the economic significance of small and medium enterprises in the economic progress, these enterprises face various problems in Pakistan. The main obstacles in growth and expansion of the sector and which become cause of inability to start and maintain business operation cycle is lack of finance. Consequently, Small and Medium Enterprises of Pakistan are unable to take part in the growing markets of the world. The State Bank of Pakistan, SME Finance Development, Quarterly Review, June 2010, provides the break up of the small and medium enterprises credit facilities from 2006 to 2010. Rs.236.23 billion or 74.1 percent out of Rs.319 billion of the total financing facility of small and medium enterprises in June 2010 (SME 2010:4), disbursed under the head of working capital that reflect the need of the of small

and medium enterprises to maintain and recycle their business operations. Rs.45 billion or 14.1 percent and Rs.37.6 billion or 11.8 percent were disbursed for the Trade Finance and Fixed Investment Finance facilities respectively out of total Small and Medium Enterprises portfolio at the end of June, 2010. Although the share of fixed investment in total finance facilities is inadequate and remained in the band of 10 to 15 percent in last five years. While duration wise analysis reveals that Short-term loans up to one year constitute about 75.3% long term loans exceeding 3 years were about 16.8% and the rest was the share of Medium term Loans 1 to 3 years(SME Finance Department, 2010:4).

### **PROBLEM DEFINITION**

Small & Medium enterprises are not operating properly because of the lack of finance. Therefore they can not play their significant role in the economy of Pakistan. Again arranging the finance through traditional means is not only exhaustive & inconvenient but also more costly.

### **OBJECTIVES OF THE STUDY**

The main objectives of the study are as under:

- To assess the role of SMEs in the economy of Pakistan.
- To study the major problem of Small and Medium Enterprises in Pakistan.
- To assess & compare the role of leasing finance and buy or borrow financing for the development of SMEs.

### **HYPOTHESIS**

Following hypothesis has been designed for this research:

H<sub>0</sub>: Buy-borrow is not more costly than lease financing.

H<sub>1</sub>: Lease finance is not more costly than buy-borrow financing.

### **METHODOLOGY**

Analysis of Formal Financing Sources by way of an appraisal method adopted to ascertain the benefit of asset based financing as against the hire purchase, through the financial formula of present and future value analysis. The advantage of lease financing over the borrow-buy option commonly termed as hire purchase can be

found out through the detailed working with the help of following equation of net present and future value analysis.

$$PV = \frac{C}{i} \cdot \left[ 1 - \frac{1}{(1+i)^n} \right]$$

In the above mentioned formula "C" represents the cash flow or leased amount, "i" presents interest rate and "n" is number of payments. The equation provides the rental payments made during the lease period.

$$NPV = \sum_{t=1}^n \frac{\text{values}_t}{(1+\text{rate})^t}$$

OR

$NPV = \text{Net cash flow} \cdot (1/(1+(\text{interest rate}/\text{frequency}))^{\text{no of payments}})$

#### LITERATURE REVIEW

It has been emphasized that the economic augmentation and improvement is possible with development of small and medium sized enterprise. The world experience shows that an economical and sustainable source of employment generation is through development of Small and Medium Enterprise Sector. This sector is usually acknowledged by the developed economies of world as the faster track of economic development, and the dependence of those economies is based on the Small and Medium Enterprise Sector's functioning. "In most of the industrialized countries Small and Medium Enterprise Sector contributes more than 55% percent in the gross domestic products and more than 65% percent in the total work force" (Meghana *et.al.*, 2003:19). The same, potential also exists in Pakistan like the other prospering economies of the world but unfortunately the large enterprises considered as the real force for the growth of the economy. Though the small scale trade and industry contributes thirty percent to gross domestic product, it mainly remains neglected. The conventional lending sources cannot meet their requirement due to the lack of security and credit history. Even the intermediary's sources of finance such as small and medium enterprise leasing finance are not much promoted to

improve the capital investment of small and medium enterprises. This study is carried out to analyze the financial problem of small and medium enterprise sector in Pakistan such as to financing the project cost of new industrial enterprises, financing to the expansion, modernization, or diversification program of existing industrial units and production process, government support programs, and to study the leasing finance as a small and enterprises financing tool. To study that leasing finance can address their primary obstacle of credit without collateral or guarantee, their need for innovative and flexible financial mechanism increases for availing of new opportunities of production and employment of national resources against the short term borrowing from the conventional lending institutions.

Pakistan leasing sector is a major component of financial services sector and has a key role in the economic progress of country especially in small and medium enterprise segment by making capital formation and fully supporting small and medium enterprises since inception of the first leasing company in 1984.

“The Leasing sector comprises 10 leasing companies, 26 Modarabas and 02 Investment Banks governed by the Securities and Exchange Commission of Pakistan. The Thirty eight players of Pakistan leasing sector significantly contributing to the economic growth despite of adverse business conditions and liquidity crunch. The collective assets of the leasing sector comprising Leasing Companies, Investment Banks and Modarabas was Rs.71,141.00 million as of June 2010, with investment in lease finance of Rs.39,291 million during the same period (NBFI & Modaraba Association of Pakistan, 2010:70)”.

The major financial products offered by the leasing sector are:

- a) Finance Lease
- b) Operating Lease

#### **A) Finance Lease**

“Finance lease is a long term lease on fixed assets; it may not be cancelled by either party. It is a source of long term funds and serves as an alternative of long term financing. In finance lease leasing companies buy the equipment and lease it out to the use of a person known as the lessee. It is full pay out lease involving the obligatory payments by lessee to the lessor that exceeds the

purchase price of the leased property and financing cost (Kamth *et. al.*, 1996: 3-4)".

A finance lease is an agreement whereby the lessor agrees to finance the use of the equipment by the lessee over a period that usually parallels the economic life of the leased assets. Such leases also called full pay out lease because asset cost and returns are covered from the rental payments of lease asset during the economic life of leased asset.

Financial leases are very prominent in the developed as well as developing countries of the world and have assumed major role in financing buildings and equipments. In Pakistan, most of the leases fall under the category of finance lease and the lessor abstains from indulging in any risk.

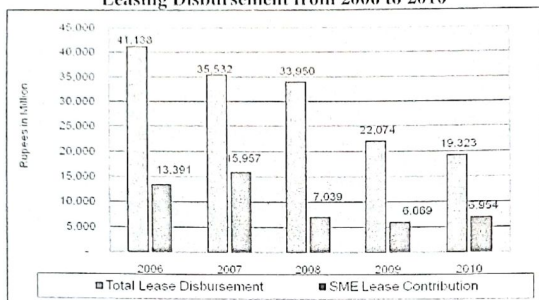
#### ***B) Operating Lease***

An operating lease is commonly a short period lease whereby a user obtains the assets for a short term. The lessor covers the cost of asset by leasing it out the asset to various operators and retains the sale proceeds of the asset on its disposal. The lessor usually provides the maintenance and insurance and recovers these costs from rentals

"Operating leases are therefore not fully payout leases. The lessor can not recover investment made on the assets in single operating lease contract the asset is leased out to different users for the period shorter than economic life of an asset. This enables the lessor to recover the full cost of the asset through subsequent lease renewals, releasing the asset to some other lessee or by out-right sale of the asset. An operating lease is usually a cancelable lease hence lessee can cancel the lease at his option, when he is no longer in need of the asset (Verma, 1995: 41)".

An operating lease is much flexible and thus convenient from the lessee's point of view. Operating leases are attractive to an enterprise if the equipment is required for a short period. However, in a well developed economy where secondary markets exist for the leased assets, the operating leases are equally convenient to the lessor, as he can release the assets to some other lessee.

**Figure-1**  
**Leasing Disbursement from 2006 to 2010**

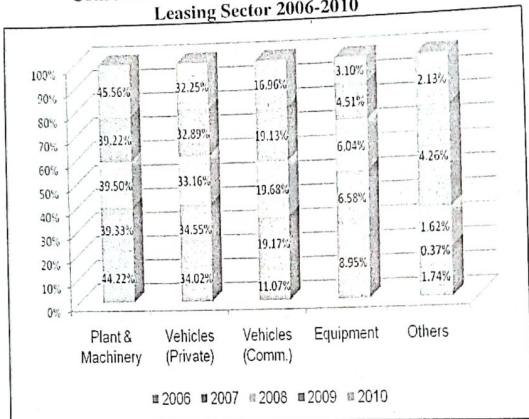


**Sources:** (i) Leasing Association of Pakistan, Pakistan Leasing Year Book, 2008:31 (ii) Leasing Association of Pakistan, Pakistan Leasing Year Book, 2009:37 (iii) NBFI & Modaraba Associations of Pakistan, 2010:74

It can be envisaged from the Figure no.1 that leasing sector has made asset based funding to small and medium enterprises and generally distributed over plant and machinery, vehicles, and equipment. The volume was Rs.6,954 million at the end of year June 2010 as against Rs.6,069 million in the preceding year and that constitutes 35 percent share in the total disbursement. While Rs.15,957 million were financed to the small and medium enterprises for assets in the year 2007 being 45% of total financing. Rs.13,391 million were financed during the year 2006-2007 out of the total disbursement of Rs.41,138 million to the small and medium enterprises.



**Figure-2**  
**Consolidate Asset wise Investment of Pakistan**  
**Leasing Sector 2006-2010**



Sources: (i) Leasing Association of Pakistan, Pakistan Leasing Year Book, 2008:31 (ii) Leasing Association of Pakistan, Pakistan Leasing Year Book, 2009:37 (iii) NBFI & Modaraba Associations of Pakistan, NBFI & Modaraba Associations of Pakistan, 2010:74

Figure No.2 depicts that leasing volume was largely derived from the asset based funding to the small and medium enterprises over the plant and machinery, vehicles and equipments. The leasing sector has invested 45.56 percent in plant and machinery, 32.25 percent in private vehicles, 16.96 percent in commercial vehicles, 3.10 and 2.13 percent in business equipment and for others in the year 2010 respectively.



# **RESULT OF LEASING FINANCE VERSUS BUY BORROW AGAINST SHORT TERM FINANCING**

**Table-1**

Buy-Borrow versus Lease Finance

Buy-Borrow Option				
Period	Interest Expenses	Cash Out Flow	Tax Advantage	Net Present Value
1st year	315,000	646,714	334,950	615,517
2nd year	195,001	764,164	97,500	629,647
3rd year	75,001	684,073	57,600	496,994
<b>Total</b>		<b>2,094,951</b>	<b>490,051</b>	<b>1,742,158</b>
Lease Finance				
Period	Lease Rentals	Cash Out Flow	Tax Advantage	Net Present Value
1st year	755,600	719,652	255,948	694,634
2nd year	755,600	528,920	226,680	441,149
3rd year	755,600	528,920	226,680	389,680
<b>Total</b>		<b>1,777,492</b>	<b>709,308</b>	<b>1,525,463</b>

Advantage due to Leasing

Difference Between Buy Borrow Option-Lease Finance Option	317,459	219,257	216,695
(%)	15%	45%	12%

Source: Appendix-I

The Table No.1 presents that lease financing of rupees two million at the interest rate of 18% p.a. for a term of three years is comparatively profitable against the buy-borrow option or conventional bank financing option of rupees two million at the interest rate of 18% p.a. for term three years. Advantage of total net cash out flow of leasing over buy-borrow option is 15%, Tax advantage of leasing over buy borrow option is 45% and 12% over in net present value. Thus, Leasing facilitates a borrower to get asset based financing or capital investment from medium to long term easily to start up new business and for the modernization to keep the business cycle operational being cash flow oriented institutions.

On the basis of this analysis we reject null hypothesis and accept alternative hypothesis, i.e., lease financing is more economical than buy-borrow financing.

## CONCLUSION

In the Small and Medium Enterprise Sector of Pakistan, the major problem of the country is availability and higher cost of funds and mismatch of demand and supply. Small and medium enterprises are unable to raise funds from the commercial banks due to lack of security and financial data, while the limit of financing of specialized and microfinance banks is not enough to meet demand of small and medium enterprises. Consequently, the Small and Medium Enterprises fulfill funding requirement to keep the business cycle operative and for upgrading their machines cycle with their own saving or borrowing from relatives and private lenders on high cost. In the credit delivery role of The Development Financial Institutions in financing to Small and Medium Enterprises is very meager and weak and at the same time the commercial banks lend for short tenure only for the working capital against the security or guarantee. Both are not facilitating the government policy to lend the small and medium enterprises.

The financial institutions of Pakistan can play key role in the promotion of small and medium enterprises and can put the economy on faster track of development by supporting the sector financially and by making available low cost finance to cater to the requirement of modernizing and upgrading plants to match changing technological developments. In this regard, Pakistan's leasing sector is major component of financial services and fully supporting the small and medium enterprises by making asset based financing in the long term and have contributed significantly over the year despite several impending factors such as general recession in the economy, high interest rates and etc. Despite these factors, the role of leasing companies in supporting small and medium sized enterprises has also been admirable. The Pakistan's leasing institutions have potential to play the role comparable to the one played by the leasing industry of Japan during the sixties to meet the thriving demand of Japanese enterprises to make new capital investments.

In Pakistan there appears no governmental initiative related to the leasing industry. Still the government has not recognized the role of leasing companies particularly in the capital formation of Small

and Medium Enterprises. Consequently, the share of the leasing sector is very low as compared to other countries in the region of Asia and number of the leasing companies has reduced from 32 to 18 in 2010, and sector has not spread across the geographic areas (i.e. it is only in the urban areas). The leasing sector financing is asset based and no need of any security and have more concentration of lease financing in the plant and machinery that constitute 2/3 share of total lease disbursements of the leasing sector. However, the leasing sector is an imperative part of the financial sector of every country. Pakistan's leasing sector has contributed much from their origin. Despite several impending features for instance the period of recession, high funding cost in comparison to that of the commercial banks and tough competition from the commercial banks.

There is much to learn from the experience of the developing and developed countries of Asia, particularly from the leasing sector of the Japan where the leasing companies had become strong financial institutions with diversified product lines offering real estate finance, venture capital, project financing, stock market investment consumer finance they contribute to every segment of economy of the country.

### **SUGGESTION AND RECOMMENDATIONS**

Institutional credit for the capital investment can be made possible through the establishment of more leasing companies both in the public and private sector for strengthening and development of small and medium enterprise sector by popularizing leasing finance, attracting small and medium enterprise entrepreneur's attention to the equipment leasing finance, to create awareness and understanding of finance lease benefits as a real mechanism for modernization of their existing plants.

The existing leasing sector should expand the network / scope of their services and products and should extent advances to clients in the small towns instead of concentrating on major cities only. The real growth would occur when the driving force of leasing actually goes to the doorsteps of the small and medium enterprises and concentrate or target non-traditional areas such as agricultural, livestock. In other words, leasing companies should endeavor to expand their operations in the semi urban and rural areas of the country to attempt to foster rural industrialization in agro-based activities. A strong and effective rural industrial base could be an important tool to employment and to reduce poverty.

The success to develop and to strengthen small and medium enterprises sector of Pakistan depends on the soft and flexible short term and long-term financial products. As such, a borrower should be able to make partial or substantial payment of the borrowed amount at any time. This allows the borrowers to take advantage of an improved market condition. The financial products should be structured in order to accommodate seasonal variations and trade cycles.

The most essential is a clear and well-defined legal framework for both lender i.e. lessor and borrower, and lessee in respect of lending and obtaining the equipment or machinery through the leasing finance and financing. The legal protection by the state through clear and well defined legal environment will be beneficial for both leasing companies to promote and expand leasing finance operations far and wide and for the small and medium enterprises to startup new business and to modernize their equipment through financial leasing products.

The Leasing companies need to diversify instead of remaining a single product industry, for which they will have to provide more customized and innovative products to their management of cash flow from being a simple product-oriented industry to becoming a service industry. Innovative strategies to attract consumer segments like lease financing to joint marketing with corporate institutions can also provide leasing companies with a competitive advantage over their counterparts. Resultantly the small and medium enterprise sector in the country would make progresses and would make contribution to the capital formation and add to the pace of industrialization and creation of employment.

Pakistan has to learn lesson from the experience of regional economics giants specially from Japan's small and medium enterprises sector industry and should establish a research group and special commission on the basic issues faced by the sector with the co-ordination of Japan Finance Corporation and with other economic grouping such as European Union and ASEAN to study for the development of the sector to achieve the economic objectives.

## COMPARISON OF EL BORROW AND LEASING OPTIONS

## Appendix-1

COMPARISON OF BUY, BORROW AND LEASING OPTIONS

Appendix-1

ASSUMPTION BORROW BUY OPTION					ASSUMPTIONS FOR TAX CALCULATIONS					ASSUMPTION LEASE OPTION				
PERIOD	PRINCIPAL	LOAN REPAYMENT		TOTAL	DEPRECIATION	TOTAL TAX		NET CASH	NET	LEASE	OTHER	TAX		NET
		YEARLY	PRINCIPAL			EXPENSE	ADVANTAGE					ADVANTAGE	NET CASH	
OCCURRING	(a)	(b)	(c)	(d)	(e-f)	(g-h)	(i+j-k)	(l+m)	PRESENT VALUE	(n)	(o)	(p-q)	(r+s)	PRESENT VALUE
Borrower					Lender					Borrower				
Asset					MACHINERY					MACHINERY				
Cost of Asset					Rs. 2,000,000					3 Year				
Interest Rate of Term Loan (p.a.)					15.00%					10%				
Term of Loan (Years)					3					10%				
Yearly Payment at made Quarterly					3					15%				
Percentage of Financial Quarter					4					15%				
REPAYMENT OF FINANCIAL QUARTER					YEAR 3					Number of Periods Per Annum				
0	2,000,000	99,000	166,666	266,666		99,000		216,666	216,666	155,900			155,900	155,900
1	2,000,000	99,000	166,666	266,666		99,000		216,666	216,666	155,900			155,900	155,900
2	1,935,314	91,250	166,666	257,916		91,250		216,666	216,666	155,900			155,900	155,900
3	1,869,645	83,500	166,666	250,166		83,500		216,666	216,666	155,900			155,900	155,900
4	1,803,976	75,750	166,666	242,416		75,750		216,666	216,666	155,900			155,900	155,900
5	1,738,307	68,000	166,666	234,666		68,000		216,666	216,666	155,900			155,900	155,900
6	1,672,638	60,250	166,666	226,916		60,250		216,666	216,666	155,900			155,900	155,900
7	1,606,969	52,500	166,666	219,166		52,500		216,666	216,666	155,900			155,900	155,900
8	1,541,300	44,750	166,666	211,416		44,750		216,666	216,666	155,900			155,900	155,900
9	1,475,631	37,000	166,666	203,666		37,000		216,666	216,666	155,900			155,900	155,900
10	1,410,000	29,250	166,666	195,916		29,250		216,666	216,666	155,900			155,900	155,900
11	1,344,371	21,500	166,666	188,166		21,500		216,666	216,666	155,900			155,900	155,900
12	1,278,742	13,750	166,666	180,416		13,750		216,666	216,666	155,900			155,900	155,900
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