

**Challenges and opportunities in  
reaching SME through Leasing**  
**“Egypt Experience”**

Presented by: **Mohamed Amiri** C.P.A., M.B.A., Dipl.  
Vice president  
International Co. for Leasing  
“INCOLEASE”

## **Historical Background:**

Leasing has been an existent phenomenon in the developed world for many years; however, it has only penetrated into the developing spectrum in the latter half of the twelfth century. Transactions of this nature can be traced back thousands of years ago. However, it has only developed a legal framework 40 years ago. In the days of the industrial revolution, mass producers began leasing types schemes as marketing tool that helped them sell more of their manufactured goods. With the approach of the 20<sup>th</sup> century, producers had the resources to finance the production of the assets; however, their clients were short on finance their payments. This in addition to the fact that, the majority of the clients did not qualify for the bank financing. The producers were then left to pass their goods in return for deferred payments with a markup to cover their cost of capital. The idea if deferred payments enabled producers to increase the number of clients, volume of output, and the gain significant competitive advantage in the market.

With the increase in the number of deals, this selling technique broke into a separate type of business and leasing developed financial service. In 1952, the first independent leasing company in the United States was founded, "United States Leasing Corp.". The company was originally established to administer one specific lease. Soon, the founder realizes that leasing has a lot of uncovered capabilities. The industry then extended to Europe in the 1960's and spread to developing countries since the mid 70's. By the year 1994, leasing had been established in 80 countries including 50 developing countries.

Leasing in developing countries has grown enormously from a 15 Billion to a USD 44 Billion industry, between the years 1994 and 1998. Leasing as shares in the private investment context has been more than doubled in the developing nations during this period. South Korea has demonstrated the most growth in the scenario, opening a leasing market in 1975 and becoming the fifth largest leasing market in the world by 1994. Leasing has increasingly improved itself to be one of the only suitable forms of long to

medium term financing for purchase of capital available in developing countries. It is more suitable to developing nations' small and medium enterprises' (SME') markets due to their weak collateral laws, and the fact that the funds can not be diverted for other efforts. Overall, leasing in these nations provides financial sector stabilization.

### **Leasing Overview:**

Leasing can be defined as a set of property relations, where one party (lessor) provides assets for use by another party (lessee) for a definite period and in exchange for payment. More specifically, leasing is a medium-term funding facility in the form of an agreement by contract between a “lessor” and a “lessee” upon which the latter is entitled to use the lessor’s asset in return for regular payment to him/ her for a fixed period of time. At the end of the leasing period, the lessee has the right to buy the equipment. The lessee is usually allowed to deduct the cost of lease rentals from taxable income (operating expense).

### **Operating structure:**

The operating structure of leasing business defines the different types and forms of leasing available. The relationship between the lessees and the lessors highlights the advantage of leasing to each party as well as the disadvantages of the leasing business, the risks affecting the leasing business; including both the general risks, and specific risks associated with the leasing industry and its components.

### **Financial Leasing:**

Financial leasing is the most common form of leasing. Through financial leasing businesses can finance the eventual ownership of equipment, unless they have not fulfilled all payment of the contract period. During the leasing period, the lessee should make periodical payments of the contract period. During the leasing period, the lessee should make periodical payments, which consists of the principle amount plus interest representing the return on investment. The amount and structure of the payments are tailored between the lessee and the leasing company to reach a pattern that is compatible to both. The payments over the fixed time frame, eventual should cover the cost of asset itself, and at the end of contact the lessee can purchase the asset for a nominal value.

Unlike the case with commercial banks, lessors place less emphasis on the security beyond the leased asset itself; in other words, leasing doesn’t

require tedious financial records or collateral provisions. Leasing finances fixed assets for a business and deletes the probability of funds diversions, rather than working capital that would be sold off by the business. Therefore, it ensures long term use.

### **Operating Lease:**

In the case of operating lease (also called leasehold), the lessee doesn't finance equipment purchase, but pays for a terminal use and maintenance of the asset again by installment amounts ( not adding it to the balance sheets), and since these are short term leases, the lessor will seek to, successively, loan out his/her asset. In other words, the lessee makes leasing payments over the whole leasing period against the rights to use the leasing asset. Upon expiry of the leasing period, the leasing asset is returned back to the leasing company or, if the parties agree on the price, it may purchased by the lessee. The tenor of the operating lease contract is designed as such to be terminated prior to the full depreciation of the asset.

### **Hire Purchase:**

Hire Purchase, sometimes called Lease Purchase, is very similar to a financial lease in terms of operation. Payments are made at an agreed rate for an agreed duration, but the important differences are that ownership of the asset gradually passes to the customer with each lease payment. This method of leasing also entails handing over the ownership of the asset in question, yet the ownership is directly transferred at the end of the agreed upon payment period. For the slightly higher risk to the hirer, the costs are somewhat higher.

This type of leasing is most commonly found in the retail sector with smaller scale assets. In the tax context, the customer, once the lease is started, is the owner, who can claim capital allowance.

### **Leverage Leasing:**

Leverage leasing has almost the same set up as the previous types of leasing. However, it entails three parties where the lessor arranges to borrow part of the required funds (third party lender), generally giving the lender the first

mortgage on the asset. The lesser still receives the full amount on the investment tax credit.

### **Sale and Lease Back:**

A sale and lease back takes place when a company sells an asset it owns to another firm and immediately leases it back. The advantage of this type of leasing is that the lessees' receives cash from the sale of the asset and the lessee makes periodic payments, thereby retaining use of the asset.

### **Relationships: Lessees and Lessors:**

#### **- Advantages of leasing to the lessees:**

- The lessee doesn't need to include the leased asset in the accounting records and disclosure in the balance sheet.
- Fairly often, the company has limited money resources and they cannot a large amount for the selected asset at once. In such a case, leasing is more helpful, as it doesn't require a large amount of money, and additional resources may be invested in other projects.
- In case of using operating lease, the lessee has the opportunity to avoid risk connected with physical outdateding of the asset.
- Operating lease is more beneficial than other types of financing, also in situations, when the asset is necessary only for the execution of some specific projects.
- Leasing is important for rapidly growing companies, which need to realize several projects at once.
- Leasing provides hedge against inflation.
- The asset cannot be withdrawn once the contact is signed and its conditions complied with.

#### **- Disadvantages of leasing to lessees:**

- It is generally not possible to dispose of the asset before the end the lease.
- The asset is not owned.

- Funds must be found from the cash flow generation to pay the lease throughout its duration.

- Advantages of leasing to Lessors:

- The lessor directly purchases the equipment from the supplier or the vendor, once the lessee has settled on the desired equipment. Thus, the lessor is eliminating the probability that the lessor utilizes the funds in other means. This indirectly guarantees the payback of the lease installments due to the presence of the source of the cash flow generation.
- The leasing companies (lessors) aren't "deposit taking" institutions, hence can't be treated as banks. This allows them higher leverage in comparison other financial institutions, where they aren't subject to lending mandates and quotes dictated by the government polices as is the case with banks.
- The lessor, as the owner of the asset, is expected to enjoy a strong security position, where enforcement of asset repossession, in case of non payment, is simpler.
- The tax advantages that the lessors enjoy, where they have the luxury as the owners of the assets financed to considered the depreciation expense a shield against the taxes realized on the revenues generated from the leasing business. In the case normal debt finance through loans offered by the banks, banks don't realize this benefit.

**Leasing to Small and Medium Enterprises (SME):**

It is important to highlight the increasing focus of the government, in both developed and developing countries, in Small and Medium Enterprises SME' segment, a focus the resulted from the recent realization of the important role of this segmenting fostering socioeconomic development. The huge size of this segment in the different economies and the changing perceptions about the state, market society are having a substantial impact on the political economy of development and putting more emphasis on the role of SME. Currently, the SME' segment is seen as the most important alternative source of employment creation in the future. Government started to take serious actions supporting this segment and allowing it to play its potential role. Developed countries were more active in this regard and started from more than 5 decades to provide this segment with serious and

organized support and assistance. Some of the developing countries took the lead in supporting this segment of their economies as per South Asian and South American countries. It was through these approaches that these countries were able to achieve high development rates and rank high among the other developing countries.

### **Definition of SME:**

The size of the firm (in terms of number of employees and the magnitude of the investment it represents) is the most commonly used indicator for the type of firm. While the simplicity of this approach makes it attractive, it does not tackle two important aspects of any businesses; fixed assets and sales.

One of the important issues of SME in Egypt is the lack of one definition of Micro, Small and Medium businesses. There are more than 27 definitions in the country and each institution, organization or governmental body is using its own definition. For this study we are applying the definition of the Ministry of Finance that focuses on the number of employees, fixed assets and sales, as factors of definition and differentiates between “Manufacturing and Construction Sectors” and “Services and Trade Sectors”.

(EGP 000's)

	<b>Labor No.</b>	<b>Fixed Assets</b>	<b>Sales</b>
<b>Manufacturing and construction</b>			
• <i>Small</i>	5-49	5,000,000	10,000,000
• <i>Medium</i>	50-99	10,000,000	20,000,000
<b>Service and Trade</b>			
• <i>Small</i>	5-9	500,000	1,000,000
• <i>Medium</i>	10-19	2,000,000	4,000,000

### **SME' Role in Economic Development:**

Similar to other developing countries, SME development has been gaining the attention of the government as a means of addressing the countries dramatic unemployment problems as well as a poverty alleviation tool.

There are hundreds of thousands SME throughout Egypt, where in 1998 it was reported that SME constitute around 99.70% of the private sector,

excluding agriculture in Egypt, and produces about 80% of the value added. The SME is also accredited for 75% of private sector employment.

For decades this segment suffered serious problems and lack of attention from the government, where the restrictive policies and indifference to their needs contributed to keeping this segment poor and under-developed. The segment was not viewed by the policy makers as an essential component of the economy. The structure of the private sector was not incorporating this segment and the system of the banks could not facilitate provision of credits to SME. These, in addition to other factors, were behind the ineffective impact of this segment in the economic development of the country.

However, and during the last two decades, the government started to exert serious effort in developing this segment and currently the SME receive strong support from the government and it appears on the top of its agenda.

### **Main Characteristics of SME in Egypt:**

It has been noticed that, the majority of SME are concentrated in whole sale and retail trade, as well as in the vehicle and maintenance sectors. It is interesting to note that regardless of the concentration of SME in the above mentioned sectors, the services, trade, finance and transport sector are the ones experiencing the most significant job growth rates; 60%,30%, 28% and 28%, respectively, over the period of ten years from 1988 to 1998. It should be mentioned that over the same period of time, 1,848,000 jobs have been created in the services sector, versus 584,000 jobs in the trade sector, 72,000 jobs in the finance sector, and 206,000 jobs in the transport sector ( source : profile of the SME in Egypt, Ministry of Foreign Trade”.

### **Main Problems of SME in Egypt:**

It is very important to identify the real and main problems of this segment prior to the start of any corrective action. Thorough analysis, studies and surveys were conducted in this regard with the support of different donors' organization:

- Limited access to capital and financial services.
- Constraints on the inputs needed by SME.
- Information and technology.

- Low competitive advantage.
- Informal sector and the regularity constraints imposed on SME activity.
- Limited managerial and accounting skills.
- Declining effective demand on SME products.
- Missing middle-sector syndrome.
- Poor marketing channels.

### **Constraints to the expansion of SME leasing in Egypt:**

#### **Macroeconomic constraints:**

The devaluations of Egypt's currency have been negatively affecting the Egyptian economy; the budget deficit, inflation and the limited GDP growth are all examples of unfavorable macroeconomic conditions.

#### **Deficiencies in the legal environment:**

The two major obstacles facing the legal environment are the lengthy time taken to issue the court order of repossession and the impossibility implementation, were in this case the lessee refuses to return the equipment, and hence, the lessor would resort to the court again in an endless attempt of acquiring his equipment.

#### **Limitations on the types practiced in Egypt:**

According to the leasing law of 95/1995, the only type of leasing that is allowed to be practiced in Egypt Financial Lease. Existing leasing companies that have well established themselves with the SME' sector in the financial lease are keen for the law to include operating lease as well. The will enable them to expand their cliental base with a diversified portfolio of assets.

#### **Difficulty in implementation of the tax and customs incentives:**

Despite their presence in the leasing law, the leasing companies encounter some difficulties in applying these incentives when dealing with customs and tax authority.

### **Lack of credibility in market information:**

The Egyptian economy is severely lacking information. Bureaucracy and stringent lengthy official governmental regulation are other-burdening lessors.

### **Difficulties in client investigation procedures:**

Such a problem is more highlighted in the SME clients due to the absence of a credit history or banking history for this sector. Hence, they resort to informal methods of investigation that mainly depend on reputation of the prospective lessee in his area of work and residence and feedback from his circle of acquaintances.

### **Administration problems in the leasing companies:**

This is due to the nature of the lessee and the need to adjust and modify the companies' internal software and follow up systems to serve SME segment in an attempt to minimize the risk of default.

### **Difficulties in raising funds:**

43% of the leasing companies in the Egyptian market have banks as a major shareholder, such a shareholding structure is a valid mitigation to minimize this difficulty.

### **Conclusion:**

In conclusion, it is discernable from the analysis that there is a good potential for the involvement of the leasing companies in providing their services to the SME sector in Egypt. Still, there are some companies, which are worried about the high risk, that can be involved in SME financing which may result in high pricing strategies or need for initial deposits.

On the other hand, SME' awareness of leasing activities in Egypt was not very remarkable, as almost half of the SME interviewees were not even aware of the existence of leasing companies in Egypt. Despite such lack of leasing awareness, SME' interviewees demonstrated interest in leasing activities, highlighting a great potential for SME Leasing success in Egypt,

as they have assessed the conveniences leasing provides as an oppose to bank lending. In other words, leasing financing was found to be more attractive to SME than banking financing in Egypt.

On the legal horizon, the Egyptian law, although provides incentives for leasing companies to operate in the Egyptian market, there are still some deficiencies-which are mostly related to default as per the interviewees-in need to be revisited and amended. These regulatory and legal deficiencies were also evident in Ukraine, and was one of the main reasons hindering the development of the leasing market there despite the suitability of the economic conditions. Moreover, since the only type of leasing, which practice is allowed in the Egyptian leasing market is financial lease, it would be, therefore, beneficial to assess the possibility of introducing new types of leasing activities.

Lessons learned from the encounter of the international experience of leasing to SME should be taken in consideration, while developing the leasing and SME' market in Egypt. Pakistan has placed boundary limits to limit the number of leasing companies entering the market. This is to acquire better capitalized leasing providers. This possibility should be investigated in the Egyptian leasing market to account for the high percentage of inactive leasing companies in Egypt. Lack of funding and absence of guarantees still represent an obstacle towards the development of the leasing market worldwide. Issuance of bonds is a major source of medium term funds in Pakistan. Government guarantee was another alternative approached by the Canadian government, and in Bangladesh the funding issue still represents a major problem. Diversified means of guarantees will be proposed in the action plan to guarantee the risk of the defaulted SME' clients with the leasing companies in an attempt to replicate the successful model presented in Canada. The utilization of leasing second hand equipment has proved its success in Pakistan. Examination of the means of applying this system in Egypt will be investigated.

Finally, it could be concluded that there is a good potential for the leasing market in Egypt. However, there are still several constraints, both on the leasing as well as the SME levels. They need to be overcome so as not to hinder the success/effectiveness of the leasing activities with the aim of facilitating SME financing and promoting their growth/development.

This document was created with Win2PDF available at <http://www.win2pdf.com>.  
The unregistered version of Win2PDF is for evaluation or non-commercial use only.