Financial Leasing as a Funding Instrument: Benefits and Opportunities

S. Y. Salomatina and E. M. Lebedeva

Samara State University of Economics, Samara, Russia

salom771@rambler.ru, liza260512@gmail.com

Abstract. Limited capacity in usage of the borrowed funding sources, high loan pressure, macroeconomical and geopolitical instability and current reorganization of all banking system – these are the reasons why the development of financial leasing in Russia is now discussed at a practice level, and that is why scientific researches in this field are relevant. Currently, as productive state-owned and private capital stocks are being formed or renewed, the organizations experience an extreme lack of financial resources. Financial leasing in this situation seems an adequate and relevant investment tool with high effectiveness rates, financial difficulties aid and possibilities of raising a capital. The goal of the article is to justify the benefits of financial leasing in comparison to other funding tools, and to review current trends in development of leasing services. To achieve the goal mentioned, the authors used a systematic approach in order to analyze the problem in complex and to propose concrete steps for the solution.

Keywords: Bank loan · Financial leasing · Funding · Leasing · Rental

1 Introduction

Current economic circumstances make the successful development of a business impossible without the usage of complementary funding sources. Along with classic bank loan, there are factoring and forfeiting deals, public budget financing, venture funds etc. [6].

Leasing in general, and in particular - financial leasing, is a new funding instrument in developing financial markets, such as Russian. In comparison to traditional funding sources, it has numeral benefits; the key one is an opportunity to run a business only owning a portion of the required financing: the business is being funded with an actual equipment (not with money like in a bank loan), which can be used in production immediately [2].

For the first time modern financial leasing was implemented in the USA by Henry Schoenefeld. In 1952 he ran a leasing company for one specific deal in rail industry. In 1950–60s, financial leasing has started to develop rapidly in Europe.
There were several prerequisites for this rapidity:

1. Technological revolution claimed the necessity for businesses to renovate their capital stocks, and financial leasing has become a useful tool, more beneficial than a bank loan.
2. Financial services market, along with its’ fast growth, has created the newest loan forms; low interest rates and favorable tax system made leasing more attractive for businesses.

In 80s, financial leasing was spread almost everywhere in the world. In the last decades, yearly number of leasing operations has been growing exponentially. According to statistics, of all the leasing operations, more than 80% is financial [10].

However, it is vital to understand that in Western countries the term “leasing” not only involves financial lease, but also the operational one (it refers to the classic rental deal) [4]. In Russia, the term “leasing” involves financial lease only.

Financial leasing is a contract, where a lessor pledges to acquire an asset at a certain supplier, to transfer the asset (as a leasing object) to a lessee for a certain payment, for the certain time and with certain terms of use or ownership. The contract states full (in exceptional cases – partial) refund of all the lessor’s costs and following purchasing of the asset by the lessee. The right of a purchase after the end of the contract is the key difference of financial leasing from the other types of leasing.

In total, more than 20% of European investment in productive capital stocks is led with leasing. Around 80% of the leasing industry in Western Europe is concentrated in the Great Britain, Germany, Italy and France. In Eastern European countries, such as Hungary, Czech Republic, Slovakia and post-Soviet countries, the transition to capitalist markets gave the possibilities for developing the leasing business [10].

2 Methodology

The system approach was used as the main methodological approach in this study. The use of this method allowed us to determine the role of financial leasing in the system of funding sources of the enterprise. The advantages and disadvantages of using leasing not only determine the prospects for its use as a source of funding for an enterprise, but also for the entire leasing services market in Russia.

The key methodological instruments in this research are the principles of functional approach, general academic methods of learning (analysis, syntheses, induction and deduction, abstraction) and statistical analysis tools; this methodological approach helped in enhancing the knowledge about the role of financial leasing in organizational funding.

3 Results

Before reviewing the benefits of financial leasing, it is crucial to keep in mind the existence of mutual interest of the parties in the leasing deal. The main benefits for lessees are:
– fiscal and economic allowances regarding leasing deals,
– reduction of initial financial burden due to balanced and periodical volumes of payments [8],
– for new companies and start-ups, with no initial financing, leasing may be the only source of funding.

The objects of financial leasing in Russia “are any non-consumable goods, such as establishment or other proprietary complexes, buildings, constructions, equipment, vehicles or other movable and immovable property, which can be used in production or business” [4, p.4].

The functions of leasing are similar to the bank loans’ functions, but with slight differences in:

1. Financial function: the possibility of escaping a one-off full payment for the leased asset.
2. Productive function: rapid resolve of the production needs by temporary usage of the expensive equipment (the possibility of escaping a purchase – this is a key function of the leasing as an economic development factor).
3. Sales function: enlarging target groups and entering new markets, using leasing schemes.
4. Fiscal allowances function (the key reason of the usage of leasing):
   – lessee may not mention the leased asset in financial statements: the lessor keeps the ownership rights;
   – the leasing payments are included when computing costs of production; it reduces tax base (in general – corporate tax base),
   – accelerated depreciation (in average, with the depreciation coefficient of 3) helps to fully amortize the asset during the time of the contract, which means lessee will not pay the property tax when repurchasing the asset.

In a number of articles regarded the effectiveness of leasing deals, the necessity of financial leasing in comparison to other funding methods is viewed as the key issue. The main argumentation defending the benefits of the financial leasing involves [3]:

1. Tax optimization; the leasing offers next possibilities:
   – eliminate the property tax (due to depreciation during the leasing contract),
   – corporate tax optimization (leasing payments are stated as costs, thus reduce the tax base),
   – VAT refund.
2. Simplicity in avoidance proceeding: if due to a certain reason the leased asset has become irrelevant, lessee may terminate the lease and return the asset to the lessor. In comparison to the loan, where a borrower has to sell the asset to stop the loan payments, the leasing scheme seems less complicated.
3. Wide range of usage: the leasing offers more variations in assets than loans (for example, specific equipment, production technics etc.).
4. Balanced insurance payment schedule: insurance and necessary technical services are involved in leasing payments, thus costs are evenly distributed by the time of time of the contract.

5. Possibility of exchanging the leased asset to the new one due to the simplicity in avoidance proceeding.

6. Simplicity in receiving the asset: the lessors normally trust the lessees more than banks do, because the ownership for borrowed assets belongs to the lessor until all the payments are made. This is the reason why the leasing scheme may be used by the companies with questionable loan experience.

Along with the above-mentioned benefits, financial leasing has the number of disadvantages:

1. In comparison to a bank loan, the leasing deal is more complicated due to the larger number of parties.

2. Lack of the ownership rights for lessee: however, it is more likely psychological issue.

3. Initial contribution needed: it is necessary for the lessor to trust the lessee; For the new companies and start-ups, or for the companies which have no free cash flow – it is inconvenient to pay 30–40% initially.

4. Dual formalization of the property: the changes in ownership rights when using the leasing scheme should be reported twice.

5. In extreme cases, financial leasing may be more expensive, than the loan: it happens when the leasing company increases rates for a lessee due to specific reasons (financial instability of the lessee, questionable loan/leasing experience, low liquidity of the leased asset, small initial contribution (under 15%) etc.).

Meanwhile, from the economic prospective, financial leasing is the most optimal method of funding the business entities. To prove this, it seems adequate to compare two most used financing sources – bank loan and financial leasing. The key criteria in this case will be the sum of discounted cash flows (loan-regarded and leasing-regarded) of a company.

To choose the funding source, the entities often compute the sum of the leasing payments and compare it to the sum of loan payments; the companies do not take in account the tax avoidance in both computations. However, the above-mentioned tax allowances of financial leasing are its’ main benefit, that leads to lower costs in proceeding the leasing deal.

In addition, it is vital to compute every cost that a company may have using any funding method. In particular, when acquiring an asset on credit a company will face extra costs of paying the property tax; when leasing the same asset, it would be formalized by lessor, thus the lessee-company do not pay the property tax. It is vital to keep in mind other additional costs, such as insurance, custom payments, delivery, registration, transportation taxes etc.

Also note that leasing payments involve VAT; that means that in the future a company may credit of these payments to the other taxes. Therefore, if the criteria of the payment flows does not include tax allowances and additional costs of every funding method, the outcome of the comparison will be incorrect [9].
4 Discussion

Russian leasing market, throughout 2019 has been demonstrating lower growth ratio than in the period from 2016 to 2018; nevertheless, this market still takes its’ place in TOP-5 biggest European leasing markets [5]. According to 2019 full year statistics, the volume of the “new business” (the price of the transferred within the period leasing assets according to the methodology of Leaseurope: New business is the total value of assets provided during the period, excluding VAT and finance charges) was 1.5 trillion rubles (+15%): it clearly demonstrates the slower growth ratio for 2 years in a row, due to decline in a volume of huge corporate deals in rail and aircraft industries. Other segments, vice versa, grew by 30% in average: the leading drivers were vehicle industry, building and construction works, oil and gas production and recycling.

The main financing source for leasing companies are bank loans: their share in total funds invested in leasing market had not been lower than 60% over the last 4 years [7]. According to Russian Central Bank data, in November 2019 the number of loans disbursed to resident companies increased dramatically – amounting in the equivalent of 63 billion rubles; along with the increase (from 2.5% in 2018 to 10% in 2019) in a share of the currency lending, it led to the growth in a number of corporate deals [1]. The currency lending increase, against the stabilizing rate for ruble and lowering interest rates in 2019, claims for the realization of the catch-up demand for deals with foreign equipment. Over the previous periods, the volume of such deals has been declining; in most cases the deals only occurred either in the short periods when the rate for ruble was stable, or due to extreme necessity equipment with no local analogues. Taking in account the devaluation of ruble in March 2020, such loans now have higher risks for the companies. The issues with paying for currency debts will occur in aircraft industry (because of lower passenger traffic), in coal and oil production industries – the prices and the demand are currently declining [5].

In 2019 the key trends were lowering interest rates and increasing the volume of financing against the stabilizing ruble rate. Currently, COVID-19 pandemic and disbalanced oil markets changed crucially global geopolitical and macroeconomical conditions; the prognoses are diametrically opposite to 2019: there are two pathways in the development of leasing industry in 2020 – the one and the crisis one.

“Expert RA”, when making a prognosis, based on the moderately-negative scenario: the yearly average cost for barrel of the Brent oil should be around $40–50, declining rate for ruble against the cheap oil should lead to the increased inflation ratio. As a result, the interest rate should be increased by 1–1.5 points; the growth ratio of Russian economics should slow down at a nearly 0 point. The leasing market, consequently, should demonstrate the decline after 4 years of growing. Meanwhile, “Expert RA” does not exclude the possibility of the crisis scenario [5].

5 Conclusion

Nowadays, more and more researches about the effectiveness of leasing schemes occur in Russia. However, only a small share of them is based on the strong analytics and actual business data: most of the information is provided by leasing companies
themselves in their PR articles. This statement may be proven if we take in account the purposely hidden disadvantages of leasing, such as:

- no time factor (changes in values throughout the certain period) is analyzed,
- shortening duration of leasing payments; the effect of each form of investment throughout the project is being purposely shortened,
- defiance of the industrial features: when comparing leasing to the other financial sources, the specifics of pricing and taxation in each industry are being ignored,
- only computing the costs of charge back schemes: it is assumed that the “tax shield” of every type of financing will be used completely.

In conclusion, we can state that the financial leasing is profitable for every business in general – due to the possibility of tax optimization – and in particular for the companies, that do not benefit from having the equipment on their accounts. Basically, when running a certain project, a company has to analyze and compare every funding pathway before choosing any – including leasing.

When comparing volume and dynamics of the leasing industry with banking loans, it is vital to analyze the “new business” volumes not against total corporate debts disbursed, but against the investment crediting. Typically, investment loans are used to develop and renovate the production – they are more likely to be used instead of leasing. Due to the fact that data on such loans in Russia is not provided, the closest analogue of investment crediting is bank loans, borrowed to invest in capital stocks. Last year the volume of the loans mentioned was 1 874 billion of rubles [1]; the growth dynamics correlates strongly with the volume of the “new business” – which ratios depend crucially on general investment activity. Throughout the last years leasing has been chasing the volume of investment crediting, however never exceeded it, exceptionally in some countries like Poland – the volume of leasing deals is greater than the investment crediting.

Obviously, next several months will be lifechanging for development of leasing industry in Russia. If the arrangement of the OPEC+ will not occur, the oil prices should face the decline period; as a result, the support of the current ruble rate should be economically unprofitable for the Central Bank of Russia – otherwise the reserve funds may be drained dramatically. No exchange controls, against low oil prices, should lead to severe devaluation of the national currency and activate all the conditions of crisis scenario – it will occur with yearly average Brent price $35/barrel. In such case, the drop in the “new business” volumes in 2020 should reach over 20%, and the amounting equivalent of the market should not exceed 1.2 trillion of rubles [5].

References

1. Bank of Russia: Loans granted to resident legal entities and individual entrepreneurs (in the Russian Federation as a whole) (2019). https://cbr.ru/statistics/bank_sector/sors/. Accessed 15 Apr 2020
2. Banki.ru: Leasing market (2014). https://www.banki.ru/news/bankpress/?id=6447631. Accessed 15 Apr 2020
3. Dai, W., Dong, Y., Zhang, X.: Competitive analysis of the online financial lease problem. Eur. J. Oper. Res. **250**(3), 865–873 (2016)

4. Expert RA: International practice of leasing activities (2019). https://raexpert.ru/researches/leasing/leasing2002/part2. Accessed 15 Apr 2020

5. Expert RA: leasing market forecast for 2020: zeroing growth (2020). https://raexpert.ru/researches/leasing/leasing2019. Accessed 15 Apr 2020

6. Konovalova, M.E., Kuzmina, O.Y., Salomatina, S.Y.: Transformation of the institution of money in the digital epoch. In: Ashmarina, S., Mesquita, A., Vochozka, M. (eds.) Digital Transformation of the Economy: Challenges, Trends and New Opportunities. AISC, vol. 908, pp. 315–328. Springer, Cham (2020). https://doi.org/10.1007/978-3-030-11367-4_31

7. Nikitina, O.: Leasing market is tired of growing (2019). https://www.kommersant.ru/doc/4047667. Accessed 15 Apr 2020

8. Nuryani, N., Heng, T.T., Juliesta, N.: Capitalization of operating lease and its impact on firm’s financial ratios. Procedia – Soc. Behav. Sci. **211**, 268–276 (2015)

9. Ron van Kints, R.E.G.A., Spoor, L.L.L.: Leases on balance, a level playing field? Adv. Acc. **44**, 3–9 (2019). https://doi.org/10.1016/j.adiac.2018.11.001

10. Zhang, Y., Zhai, L., Sun, H.: Does the level of financial leasing matter in the impact of bank lending on economic growth: evidence from the global market (2006–2016). Financ. Res. Lett. **30**, 352–359 (2019)