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BUSINESS PROCESS IMPROVEMENT IN EQUIPMENT FINANCE

By Charles R. Gowen III, PhD, and James M. Johnson, PhD

Can process improvement methods be used in financial services (leasing) firms? This article describes the experiences of five companies that use process improvement methods successfully to increase performance and reduce costs, thereby gaining more efficiency.

THE OPPORTUNITIES AND CHALLENGES OF EMERGING MARKETS

By Shawn D. Halladay, Jonathan L. Fales, and Rafael Castillo-Triana

Equipment leasing in emerging markets potentially is a major business opportunity for international lessors. Although legal and regulatory frameworks continue to evolve in these markets and there is no single, successful business model, study and preparation will pay off for motivated lessors.

KNOCKING DOWN (GREAT) WALLS: AN UPDATE ON THE CHINESE EQUIPMENT FINANCING MARKET

By Jonathan L. Fales and Jason Zhou

Chinese large-ticket financing and vendor programs both should continue to grow over the next two to three years, even with the current worldwide economic slowdown. This article updates the Great Walls study the Foundation published in 2005.

TRANSPORTATION EQUIPMENT FINANCING: TRACKING THE FORCES SHAPING THE MARKET

By Mark Lauritano

A brighter day is coming for those who can adapt to the current environment and take the long view. Rail and marine should lead the way. But the first signs of a turnaround in transportation financing are not likely to appear until the end of 2009.

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The Opportunities and Challenges of Emerging Markets

By Shawn D. Halladay, Jonathan L. Fales, and Rafael Castillo-Triana

It is clear that anyone seeking a lively debate over whether or not the U.S. leasing and financing market is mature is going to be disappointed. All one has to do is listen in on conversations at any industry meeting or review the Equipment Leasing and Finance Association's *Survey of Industry Activity* data. The competitive landscape is tight, the product is a commodity, and growth is slowing. Recent economic events notwithstanding, the year-on-year declines in spreads and the static share of leasing as a percentage of total financing opportunities serve to reinforce the notion of a mature market.

Indeed, the only source of growth in such an environment is increased levels of equipment acquisition, unless lessors choose to expand operations outside the United States. Even then, opportunities are limited and competition stiff in all but emerging markets. Entering emerging leasing and finance markets, which at first blush appears a logical decision, comes with its own unique set of challenges. This article examines the initial decisions that must be made in each environment when establishing operations outside the United States. The different challenges to be faced, particularly in emerging markets, and how leasing and financing companies can successfully overcome those challenges, also are discussed.

> Equipment leasing in emerging markets potentially is a major business opportunity for international lessors. Although legal and regulatory frameworks continue to evolve in these markets and there is no single, successful business model, study and preparation will pay off for motivated lessors.

ENVIRONMENTAL DIFFERENTIATION

A finance company faces constant challenges even in its own country—the task becomes even greater in another jurisdiction, especially when it is compounded by time, distance, and, in many cases, the nascent legal and regulatory frameworks of an emerging market. As an example, the concept of paying over time, with repeated payments, is a relatively new concept in China. Other structural, accounting, tax, and cultural differences add to the mix of items that must be addressed when entering an emerging leasing and finance market.

Beyond these factors, a U.S. lessor seeking to establish a presence in an emerging market also must consider the developmental stage of the leasing industry it is entering. Many emerg-

Editor's note: In the past year, the Equipment Leasing and Finance Foundation added five international studies to its library of research: *Brazil: The Carnival of Equipment Financing* (July 2008); *Hispanic Latin America: Discovering and Conquering Equipment Financing* (March 2009); *India: How to Navigate the Equipment Finance Marketplace* (February 2009); and *Mexico: Factors for Success in the Mexican Equipment Finance Market* (September 2008). All can be ordered at www.store.leasefoundation.org/department/research_studies_reports/.

ing leasing industries follow similar developmental patterns, starting out small and then growing very rapidly as multiple lessors enter the market. After a relatively short period of growth and prosperity, however, there is an economic adjustment, usually in the form of a major contraction or even, in some cases, a collapse.

A combination of government regulation and more rational business practices generally results in a subsequent period of slow growth, followed by a stabilization of the industry. It is at this point that the emerging leasing industry, strengthened by its trials, is poised to continue its development. The Indian, Korean, and Indonesian leasing industries all followed this pattern. By understanding this pattern, a U.S. investor can avoid losing hard-earned traction in that industry.

On a more granular level, U.S. lessors must make decisions such as whether to act on a cross-border basis, establish a permanent presence in the emerging market, or take on a partner.

On a more granular level, U.S. lessors must make decisions such as whether to act on a cross-border basis, establish a permanent presence in the emerging market, or take on a partner. Special attention also must be paid to languages, technological and physical environment, social organization, geography, labor issues, country history, the concept of authority and political organization, religion, and even the prevailing business and social approach toward time. The many things that are taken for granted in the U.S. business environment now become critical factors for success in an international environment.

In Latin America, for instance, the emphasis is on relationships rather than formal contracts. Another difference from the United States is the inherent instability of an emerging market's economic cycle. This potential instability requires lessors to look even more closely at the social, cultural, and economic fundamentals of the country, including the attitude of the government toward the leasing and finance industry and the role it plays in the economy.

The number and nature of the regulations and rules are another dissimilarity between leasing in the United States and in other countries. Most emerging markets consider equipment leasing and financing as financial activities, so they regulate them with the aim of ensuring transparency, professional reliability, and minimum damage to the public interest. Consequently, regulatory agencies such as the central bank or ministry of finance, have oversight of leasing companies. Some markets also may consider leasing to be a commercial activity subject to regulation by other government bodies, such as the Ministry of Commerce in China.

Lastly, the U.S. leasing and finance company must consider the size of the emerging market it is considering entering. The total leased assets by leasing companies in China as of December 2003, for example, was approximately US$2.6 billion. This figure indicates a leasing penetration rate of 0.44% of capital formation,[1] indicating the tremendous growth potential of the Chinese leasing industry. Other leasing markets, by comparison, include Mexico (with a total portfolio of roughly $5.6 billion) and India (with a total portfolio of roughly $364 million), all the way down to El Salvador's portfolio of $23 million.

ESTABLISHING OPERATIONS

The number of rules and regulations with which financial companies must comply in emerging markets is, as a general rule, much higher than in the United States, including those necessary to establish operations in the country. In spite of this general rule, however, some countries, like Argentina, do not have formal barriers to organizing a leasing company.

Regulation

The regulatory agencies in the vast majority of emerging market countries allow lessors to establish either of two types of leasing companies. These are financial leasing companies (subject to financial company/banking rules) and operating lease companies (generally not subject to financial company/banking rules). Financial leasing companies require a license granted by the authorities, usually the ministry of finance or central bank. Operating leasing companies, on the other hand, do not. This distinction makes it much less burdensome to establish and run an operating leasing company.

Obtaining a license to conduct financial leasing requires a vetting process that includes proving financial capacity plus a minimum amount of capital. China requires $10 million of capital to establish a leasing company, while the number is closer to $4 million in Brazil. There are no minimum capital requirements in Mexico, although the tax rules regarding thin capitalization and the consequences under Basel II of undue leverage must be taken into account.

There also are differences in the types of companies foreign lessors may be allowed, or required, to form. Authorization to establish a foreign leasing company in China, for example, must be obtained from the ministry of commerce. The ability to operate as a branch, representative office, or a permanent establishment may be available only to certain types of companies or require various levels of authorization. Brazil prefers that foreign lessors act as subsidiaries, rather than branches, since a subsidiary is subject to the domestic and regulatory framework, which reduces the number of cross-border regulatory problems more likely to appear in a branch scenario.

Partners

Even though the foreign government may give ownership and/or control over the leasing company to the U.S. investor, the need for local alliances and know-how is critical for success in any emerging market. Local partners offer the following advantages:

- local market knowledge
- existing business relationships
- staffing
- familiarity with the local legal system
- speed to market
- language
- hierarchical interactions

Most international lessors with operations in China today have Chinese partners, due in part to the fact that a local partner was required to obtain a leasing license.

Funding

Funding options available to lessors in emerging markets may be tied both to the lessor's type of leasing license and the terms of the license itself. Lessors with licenses to lease only in foreign currency in China, for example, generally fund offshore. Leasing in China's local currency creates regulatory barriers (generally exchange barriers) along with an exchange risk factor.

Funding options in some emerging markets include domestic bank loans, cross-border loans (subject to foreign exchange restrictions), commercial paper, debentures, and securitizations placed in the domestic capital markets.

According to the U.S. Embassy's *China Country Commercial Guide,*

> Foreign-invested firms, like domestic firms, must register all foreign loans with the State Administration for Foreign Exchange (SAFE). Along with the People's Bank of China, SAFE regulates the flow of foreign exchange into and out of China.[2]

Because of these factors and other regulatory barriers most multinationals tend to self-fund their operations in China.

Onshore funding options are limited in some countries, so bank loans represent the only real funding opportunity. This is particularly true for operating lease/independent companies that, although less regulated, also have fewer funding options as a result of less regulation. It is not unusual for the commercial paper market to be underdeveloped in emerging markets as there is little available credit information on most companies. Some emerging markets such as Chile have sophisticated funding options, however.

Funding options in some emerging markets include domestic bank loans, cross-border loans (subject to foreign exchange restrictions), commercial paper, debentures, and securitizations placed in the domestic capital markets. There are, however, potential obstacles of which lessors need to be aware. Argentina[3] and Colombia,[4] for example, require that a cash reserve be deposited at the Central Bank together with the filing of cross-border loans.

Although these requirements make the effective cost of cross-border loans more expensive than their original terms, these countries have good domestic capital market conditions for funding leasing companies. In Argen-

tina, securitization is the preferred vehicle for funding leases. Argentine lessors tend to establish equipment leasing trusts and issue securities or paper out of such trusts. Colombian companies use the commercial paper, medium term notes, and bond markets extensively. Chilean pension funds are very important investors and have enormous potential to funnel funding into leasing and equipment financing companies.[5]

Independent leasing companies, however, are not allowed to raise funds from the public, so they must obtain funding elsewhere. According to a recent survey made by the Chilean Leasing Association, 53% of leasing company funding comes from banks and 17% from the placement of bonds. Since the average equity of the leasing companies is 15%, the remaining 15% of funding comes from vendors and other sources.

Staffing

Human resources are critical to the success of the leasing and finance company no matter the locale. The challenges in this area, however, vary based on the market. Mexico, for example, has an adult literacy rate of 92%, whereas other Latin American countries have rates as low as 70%. Although a U.S. company may use expatriates to a certain extent, U.S. financiers ultimately will have to depend primarily on local talent. This necessity has a cost benefit associated with it, though, since local employees work at a lower cost (around 20% of expatriate wages in China, for example).

> The employment systems in many emerging markets can be very complex, highly protected, and rigid.

Attitudes toward the workplace also are important. Brazil has a literate and generally well-educated workforce, but most leasing staff have been raised in an environment in which innovation is not encouraged. This tendency is exacerbated by the inherent bureaucracy associated with prevailing business practices in Brazil.

The employment systems in many emerging markets can be very complex, highly protected, and rigid. Some employment contracts are subject to minimum statutory benefits and conditions stipulated by collective bargaining agreements with employment unions, even at the professional employee level. Other employment regulations create additional costs. In Mexico, for instance, nonmanagement employees must have the right to share up to 10% of their employer's profits before taxes. Mexican lessors address this burdensome requirement by creating special-purpose, service provider companies.

RISK CONSIDERATIONS

As previously mentioned, being a successful lessor is a challenge even in one's own market; thus it is even more so in an emerging market. An international expansion strategy, therefore, also must be supported by a very solid risk management culture and organization. The strategy must assess unique market risks, including country, operating, currency, and funding risks. Lastly, a prudent lessor will analyze and define a sound exit strategy.

Sovereign Risk

Sovereign risk is a prime example of the type of unique risks that U.S. lessors may face internationally but do not have to contend with at home. One aspect of sovereign risk is political risk, which encompasses political violence and revolution, expropriation, and other factors such as government breach of contracts.

The likelihood of arbitrary nationalization of foreign companies is fairly low in many emerging markets while very high in certain others such as Venezuela, Nicaragua, Ecuador, and Bolivia. Although the size of the leasing portfolios at risk in these countries is not that large, the risk still exists, as evidenced by Venezuela's nationalization of Venezuela's largest lessor, the Banco de Venezuela (from the Spanish Grupo Santander). As a result, a careful study of the risk of expropriation should be undertaken before investing in an emerging market.

It should be noted that there are protections against expropriation. For example, Mexico, under the North American Free Trade Agreement (NAFTA), may not expropriate property, except for a public purpose and only on a nondiscriminatory basis. In China, there have been no cases of outright expropriation of foreign investment since China opened to the outside world in 1979, although the U.S. State Department believes that there are several cases that may qualify. U.S. lessors may obtain protection against political risks through the Overseas Private Investment Corporation or the Multilateral Investment Guaranty Agency, a World Bank Agency that

provides political risk insurance to international investors.

Market Size

Another market entry risk to be considered is the size of the market itself, as it does not make sense to incur the costs of entering a market in which there is little incremental business to be gained. This decision is easy for some markets, such as China, in which the potential is great, although market size can be deceiving. India, for example, has as much potential as China in terms of population and growth. The leasing market in India, however, is still plagued by uncertainty and regulatory hurdles that should be considered in the market entry decision.

Other factors to be considered include the level of competition in the market and the types of products offered. There are over 10,000 domestic leasing companies in China, for instance, although most of these companies offer relatively unsophisticated leasing services and concentrate on financing simple, commodity-type equipment such as automobiles. Such companies lack any funding strength and are, in general, relatively unstable.

The primary leasing product offered in emerging economies is the finance lease, in which there is little if any residual position taken. Residual management is very poor, such that residuals are not even on the horizon in some markets.

The primary leasing product offered in emerging economies is the finance lease, in which there is little if any residual position taken. Residual management is very poor, such that residuals are not even on the horizon in some markets. On the surface, this would appear to present a great opportunity for U.S. lessors to offer operating leases. Unless the U.S. lessor has global—or at least regional—asset management capabilities; however, this is not an advantage as the secondary equipment markets in developing economies do not exist.

Credit Risk

Credit risk always is of primary concern whenever a lessor enters a new market. Listed companies typically provide the best source of information through the firm's filings with the stock exchange. Credit reporting agencies, though, are not well developed, if they exist at all, in many emerging leasing markets. As a result, most leasing and finance companies rely on informal sources of information and local partner knowledge.

This being said, Mexico has an increasingly effective credit information system through Buro de Crédito, a privately owned company. In addition, a legal bureau tracks lawsuits against credit applicants, which is a valuable tool for credit evaluations. Credit reporting agencies such as Veraz in Argentina, Datacredito in Colombia, and Serasa in Brazil have existed for many years. The information provided by these agencies is not yet comparable with what is available in the United States, as the coverage is not very comprehensive, both in terms of quantity as well as in quality.

Exit Risk

Finally, exit risks should be an important element of the analysis to conduct business in emerging countries. Joint ventures, while allowing foreign lessors to shorten the learning curve, also are more difficult to terminate, as they require the parties to work out satisfactory terms if the structure is unwound. Repatriation of capital also is of primary concern. Mexico and China do not have any restrictions on repatriating capital, but other countries do. U.S. financiers should be aware of any withholding taxes on repatriated profits, or any other government restrictions.

OTHER CHALLENGES

It is fairly obvious that a lessor operating internationally will face differing tax, accounting, and legal rules and regulations. These differences can be reduced to a set of common differences, however. As an example, although legal systems differ between countries, they generally may be classified as either common law or civil law systems. Common law systems are present in all former British colonies and protectorates such as India. Civil law systems, on the other hand, are present in countries colonized or influenced by continental European cultures, such as Spain, Portugal, France, and Germany.

Legal Challenges

The legal ownership of equipment subject to a lease in the emerging economies is determined on either a form or a substance basis. Legal ownership in Mexico, for example, is based on the form of the transaction rather than its economic substance, as is the case in Brazil and most other Latin countries. In a form country, the lessor always is the owner of the equipment for legal purposes. As a result, the legal definition of a lease may not exactly match the accounting or tax definition of ownership.

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Once legal ownership of the asset is established it also is important to be able to enforce the lessor's ownership rights in the event of disagreement. The components necessary to enforce leasing transactions in any economy include (1) the rule of law, (2) a corruption-free environment, and (3) an efficient legal system. U.S. financiers entering emerging markets should, therefore, be fully aware of the time and cost to resolve legal disputes. Commenting on this concern, Karel van Laack, of Atradius Seguros de Credito in Mexico, has stated, "Mexico's sluggish legal system is a known problem; trying to execute security like personal guarantees and mortgages can take years."[6]

The time and cost to resolve legal disputes in selected emerging economies is shown in Table 1, which also includes the United States as a benchmark.

Table 1.

Resolving Legal Disputes

Country	Days to resolve	Cost to resolve (% of claim)
United States	300	9%
Brazil	616	17%
Russia	281	13%
India	1,420	40%
Venezuela	510	44%
China	406	11%
Mexico	415	32%

SOURCE: *Doing Business in 2008.* Washington, D.C.: World Bank, Sept. 2007.

Taxation

The tax systems of the various countries of the world also share common threads. The particulars will differ, but each country has a tax on income, some form of cost recovery, and a tax on consumption. U.S. lessors nonetheless must be cognizant of the differences in application of the tax laws. Top managers of enterprises in China, for example, may be held criminally liable if the company's tax returns are deemed as concealing or evasive.[7]

There are a range of taxes that must be considered in other jurisdictions, many of which are a mix of federal, state, and local taxes. Although every country has a tax on income and consumption (value-added tax, or VAT) additional types of taxes not found in the United States are imposed. In addition to these basic taxes, the U.S. financier may encounter the following taxes, depending on the country:

- stamp duty
- central sales tax
- lease rental tax
- service tax
- cross-border lease tax
- lease development tax
- alternative minimum tax
- vehicle tax
- business tax

Like the variety of taxes, corporate tax rates between countries. Most income tax rates fall somewhere between 30% and 35%, although they may range from a low of 10% in Paraguay to upward of 40% in Brazil. As a general rule, however, U.S. lessors can expect a tax burden similar to the United States's as it relates to income taxes. The rates for VAT, withholding, and other taxes must be determined on an individual country basis. How the taxes are applied also will vary as, for instance, the VAT paid on transactions between states in India may not be reclaimed. Suffice it to say that U.S. financiers will encounter a wider variety of taxes in emerging countries than in the United States.

U.S. lessors establishing operations in emerging markets will find that tax ownership of leased assets is determined based on one of two systems. In form countries, such as Brazil, the lessor always is considered the tax owner. In other countries, such as India, tax ownership is based on the economic substance of the transaction, which is similar to the methodology used in the United States. Lessors in emerging markets also are allowed to depreciate their assets, typically on a straight-line, rather than accelerated, basis.

Accounting

Accounting regulations are always an issue in any international expansion, but there is not much divergence in the accounting for leases between countries. At the present time, all countries make a distinction between finance leases and operating leases, whether that distinction is based on either a form or substance concept.

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Many emerging markets now follow International Accounting Standard No. 17 (IAS 17) or a local lease accounting standard based on IAS 17 or FASB 13. Interestingly enough, several countries, such as Colombia, Argentina, and Uruguay, prohibit application of international accounting standards. Even so, and although accounting requirements still may be different in line with the local legal systems and business cultures, there is a continuing trend toward international harmonization of these rules.

This unification may create localized operational issues. U.S. lessors in Brazil, for instance, will need to have the systems capability to adjust leases classified as finance leases for accounting purposes to reflect the legal ownership required for fiscal and tax-reporting purposes. This also will require an integration process with the U.S. lessor's legacy lease management system. In this regard, there are few to no local lease management and reporting systems available in emerging leasing markets.

CONCLUSION

Equipment leasing in emerging markets can become a major business opportunity for international lessors in the coming years. To be sure, these economies pose a number of significant risks that must be managed to be successful. Furthermore, there still is much market development activity to be done before leasing is accepted as a mainstream financial product in some of the developing countries. U.S. financiers can compete successfully, however, if they enter the target market with sufficient study, preparation, and rigorous execution.

As U.S. lessors consider entering these emerging markets, they should be aware of these significant factors:

- There is no single, successful business model.
- Identifying and managing the risks of doing business is the critical factor to success, but the task should not be overwhelming.
- The lack of trained local personnel should be factored into the business plans.
- Leasing may be a new concept for many businesspeople in these markets.
- The used equipment market is largely undeveloped, but it could be a huge opportunity for certain assets.

As a final note, successfully entering a new market does not happen overnight, so lessors should plan on everything taking longer than anticipated. The opportunities, however, are there for the prepared.

Endnotes

1. This number does not include hire-purchase agreements. Including hire-purchase transactions pushes the rate closer to 40%. Source: *Knocking Down (Great) Walls: Identifying Factors for Success in the Chinese Equipment Leasing Market,* by The Alta Group. Washington, D.C.: Equipment Leasing and Finance Foundation. www.store.leasefoundation.org/product/chinarpt/

2. "China Country Commercial Guide FY 2004. A Guide to Doing Business in China & Information on Current Economic Conditions," prepared by the U.S. Embassy, Beijing.

3. The amount of the deposit is 30%, pursuant to Comunicación A 435 of the Central Bank of the Argentine Republic, effective Oct. 6, 2005.

4. The amount of the deposit in Colombia is 40%, pursuant to Resolution 8/2000 of the Board of Directors of the Banco de la Republica, as amended in 2007.

5. Further details about the capital markets in Chile can be found in the study "Capital markets in Chile: from financial repression to financial deepening," available at www.bis.org/publ/bppdf/bispap11g.pdf, and in the Capital Markets Reform paper posted www.buyusa.gov/chile/en/capital_market_reforms.pdf

6. InsideARM: Report: Mexican Legal Collection System Provides Poor Protection to Creditors, March 12, 2008. www.insidearm.com

7. Article 201 of the Peoples Republic of China Criminal Law, as amended in March 1997.

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