



# Exploring Micro Leasing for Poor People's Enterprises Project

## Key Lessons Learnt

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## Practical Insights Into Developing Micro Leasing in Kenya

### Micro leasing is an active business discipline

When considering leasing of small ticket items to small businesses, a lessor should not expect to passively lease existing equipment in the form in which it exists, and to operate it as it would a loan arrangement. Active interventions may be required in a subsector in order for leasing to work. The lessor needs to understand the business and markets of the lessee, develop flexible payment systems, know the residual risk on the equipment being leased and engage with equipment suppliers.

### Lessor is market-size driven, while private business (lessee) is market share driven

Unlike other forms of micro finance, the object of a lease to the lessor is first the market, then the person who is able to extract lease installments out of the market. This means that, a lessor does not benefit greatly from changes in market share, but rather from increases in market size. This is because the asset is not of fixed ownership, and can move from the custody of one lessee to another in the same market – and still give a return to the lessor. A loan does not have this quality.

### Leasing actively promotes inter-enterprise collaboration

From an economic development point of view, leasing is not just a passive lending process. It can actively promote collaboration among related enterprises. The presence of a vibrant leasing environment can provide a structural framework to support collaboration in existing supply chains.

### Triggering the emergence of micro leasing

Perhaps one of the quickest ways to start off a leasing arrangement is to convert existing assets of small businesses into leases– and use their older equipment to pilot new markets. This means that, for a company which for instance already has several display freezers on its balance sheet, it would replace old coolers in established outlets with a known sales history with new ones on a lease basis. It may then want to deploy its old coolers in new sales outlets in order to establish the sales level of that outlet before entering into longer term lease agreement for new units at that store. This is a quick and reliable method of rolling out leases –and should be tried.

Another option for triggering leases centers around the actual ownership of the leases. By financing different portions of the lease term, lessors can be exposed to different levels of risk and achieve different yields within the life of the leased asset. During the initial part of the lease term, the lessor and lessee are confirming that the lease can pay for itself, and this is the highest risk period. A lease broker may start many leases to stimulate the market, and once the leases are established they could be sold of to another institution which was not prepared to take the initial risk.

### Large asset leases are not necessarily safer for lessors

Formal sector financial institutions are under the mistaken impression that leasing small ticket items to small business is small business, and that larger ticket items are a safer investments. As leased assets become larger and more specialized, the risk of dealing in them as a lessor increases as it becomes more difficult to dispose the asset within the country. A Nigerian leasing company repossessed a textile machine when the textile industry in Nigeria collapsed. Although they deprived



the lessee company of using it, they could not dispose of the equipment in the Nigerian market, and held onto it for one year before they could sell it. Overall they made a huge loss on that one asset. The residual value risk is much less per item at the small ticket item level, where a large number of such assets are required in a market.

#### Leasing on a sector basis maximizes any market research

Sector-based leasing is implicit in the supply chain leasing model. Investment in one form of leased asset may lead to other demands for equipment. This could be by the same enterprises who are becoming more profitable, or by others up or down the supply chain seeing an increase in market size.

Lessors need to know the lessee market and so sector wide approaches can lead to more than one point or technological piece of intervention using similar market research information.

#### Micro leasing will not be developed by lending institutions

There are several reasons for this.

- i. The funds available to a lending institution may just as readily go to a loan as to a lease – and the resulting profit is only compared in terms of yield. Since the initiative in a lending-borrowing deal lies with the borrower, never the lender, it is much more prudent for the lender to keep an open book and wait for the borrower to define the form of advance they prefer. It is when lenders receive increasing numbers of borrowers looking for leases that they will then make special arrangements for leasing. Effort to develop leasing, although a financial service, should therefore focus on business development organizations and not lending organizations. Commercial entities that might drive the creation of lease products by lenders are equipment vendors and leveraging companies. These therefore should be the target of a lease market development campaign.
- ii. Leasing is driven very much by tax incentives, yet most micro finance institutions are not tax-payers and as such cannot avail of these tax incentives.

#### Finance is not a critical barrier to development of micro leasing

The original design of this project required that a financial partner should be found who would commit a certain sum to leasing. The assets of a bank are the loans it gives out. A bank wants and needs to lend to stay in business. The problem is not finance, but the quality of the borrowing, and the cost of administration of small credits. The strategic advantage for the lease developer therefore lies, not in financing a borrowing, but in qualifying a risk. What banks require is a credible institution that will better understand and therefore underwrite the risks of any leasing portfolio.

#### General remarks on development of micro-leasing schemes

Unlike micro credit, micro-leasing is not a passive lending process that reacts to expressed demand of existing small businesses. It is an active business discipline that depends on pro-actively finding opportunities in sectors of the economy where deployment of business equipment is capable of generating sufficient revenue to cover the installment costs on a lease. Moreover, research into opportunities for micro leasing in particular sub-sectors may reveal the need to alter equipment supply chain relationships in order to render such equipment “leasable”. The rigor and specificity of research into business sectors necessary to initiate a viable leasing scheme in that sector should not be underestimated.



Investment in developing micro leasing services could focus on supporting lease brokers in generating viable business proposals based on micro leasing and on marketing these proposals to existing financial institutions.

## **Revision of common assumptions about micro leasing**

Implicit to the planning of this project were certain fundamental assumptions. Understanding these assumptions and how they affected the project are spelt out below.

### Assumption of demand

Micro leasing is in response to demand by MSEs. It was assumed that micro leasing would be a financial service that allows MSEs to meet the equipment financing needs of their businesses as they currently are. It was assumed that, in the course of their current businesses, MSEs encounter the need to acquire certain equipment, and that they are then constrained in finding appropriate financing to meet those needs. The project was launched on the premise of “felt needs of MSEs”. It was postulated that there was a lack of medium term slightly larger finance products appropriate to meeting equipment acquisition needs. As such, micro leasing was going to be a pretty passive and reactive product – moulded around this need, and in reaction to it. The starting point of micro leasing was going to be the “needs of small business” As such one could determine the equipment needs of MSEs by simply interviewing them, and one could then create a financing scheme for the emergent portfolio of equipment. The whole phase 1 of the project was planned around this assumption.

### **Related finding**

Deeper understanding of leasing brought the concerns of the lessor to the fore. We in fact realized that, in micro leasing, the initiative to lease lies more with the lessor than the lessee – and it is the opportunities available to and perceived by the lessor that determine the assets to be leased. The beneficiary MSEs then become those that come forward to lease those assets. It meant identifying opportunities in the economy that could be exploited most effectively using business systems that involved large numbers of small businesses having particular equipment in their businesses. The lessor became, not just a passive lender, reacting to needs expressed by MSEs, but an active business partner seeking out opportunities for deploying capital for a return

### Assumption of financial partner

It was assumed that a particular institutional financial partner was required who would actually operate the leasing scheme. It was assumed that this partner would most likely be a micro finance institution, and would be required to commit to this project fairly early in its life. Tied in with this assumption was another, that the project required the financier to commit a certain amount of money to capitalize the leasing scheme. This money would presumably come from itself, or be raised from donors early in the second year of the project

### **Related Finding**

Micro finance institution are presumed to be the means to advance microleasing because the client group for micro leasing services is the same as they currently serve. It was found however that mere history of serving the same client group is not sufficient reason to target micro finance institutions as developers of micro leasing services. We found in practice that micro finance institutions were not well suited to act as lessors, mainly because the advantages of leasing lie mostly in tax incentives. Most micro finance institutions are non taxpaying, and cannot appropriate those incentives, and therefore pass them on to MSE lessee’s in the form of reduced payments. We also found that there



was no shortage of funds to finance anything locally. We were clearly informed by both formal sector and micro finance institutions, that their assets are actually the lendings they make out to clients. They therefore want to lend. What is a challenge to them is in fact the quality of borrowers or borrowing. If a high quality leasing scheme is proposed to them they would be happy to advance funds to such a scheme. The point here was that the work lay in demonstrating and persuading the lender that one has a scheme that will give good returns to any financial advance laid out in its favour. The process of “finding a financial partner” was then reduced to one of marketing a proposal to a funder. The project therefore de-focused from micro finance institutions to begin with, and also from negotiating a partnership around trying out a principle. The project moved to marketing a proposal to potential funders – and whoever would agree to fund the leasing scheme would then become both the partner and the source of finance. This would also allow the project to seek out the most competitive sources of financing for the leases, which in turn would hopefully reduce the risk of default. Moreover, the notion that a specific amount needed to be “marked, raised, secured or set aside” was rendered trivial. The lessor would make funds available out of the liquid pool of funds it has available for lending according to the demand for it and its continuing ability to generate returns to the lessor.

#### Assumption of capacity building need in partner

It was assumed that the financing partner in this project would develop in-house capacity to actually initiate and roll out leases. As such it was expected that the project would assist in developing the capacity of the staff of the partner to do this. This would apply, both for formal sector and micro finance partners

#### **Related finding**

In practice leasing has been found to be an unusually involving and highly complex form of financial service. As a business model, it was found to be significantly different from the passive and reactive lending that financial institutions, including micro finance institutions are familiar with. Specifically, the appraisal of lease investments requires the lessor to evaluate and make a judgment about future business performance. This is unlike other forms of lending which tend to focus on determining a pre-existing capacity to service a debt by examining past business performance. Leasing also requires a high level of understanding of business equipment. We found the shift in business practice to be so large as to be unlikely to be embraced readily by these institutions. We conceived a specialized institution that would be responsible for originating and structuring leasing business, and then passing these to a financier. This would allow the financier to remain principally a financial intermediary – especially if the asset risk could be taken by another institution. Efforts to house lease brokerage within leading institutions, whose business was similar and who had shown an interest in leasing were unsuccessful. It became clear to the project team that established institutions with proven business models are reluctant to participate in highly speculative ventures. They require ventures to be reasonably proven before joining in. Their reluctance to undertake lease brokerage at this early stage was therefore understandable. Attempts however to enlist their participation cost the project valuable time. The lesson here is that it is unwise to rigidly schedule into a project plan activities whose execution depends on agreement and participation of a private independent business motivated principally by profit.

#### Assumption of a equipment types

It was assumed at project inception that a pilot leasing scheme would be designed after determining the equipment needs of MSEs through a market assessment. The market here was considered to be the MSE lessees themselves.

#### **Related finding**



Things turned out radically different at implementation. Micro leasing was conceived as being driven, not by expressed demand of MSEs, but by opportunities for “self funding” existing for small scale equipment deployed among willing MSEs in a particular sector. The MSEs would thus, not propose the equipment to lease, but come forward to appropriate equipment offered on lease, and based on a market opportunity confirmed by the lessor in a particular supply chain. This means that a scheme would initially be focused on perhaps only one sector, and would “appear” to be more about developing that particular sub-sector, rather than developing micro leasing. It is the agglomeration of such “sector specific leasing” that would then amount to a scheme such as was initially conceived in the project. The rigour with which a particular sub-sector must be analysed before a scheme can be developed and successfully marketed was grossly underestimated. As such it was not possible within this project to spread into a sufficient number of subsectors to underline micro leasing as the common denominator for the various the efforts of the scheme. The project was able to reach a very advanced state of analysis in the dairy sub-sector, and to point the way to a large and sustainable leasing scheme in that sub-sector. This effort continues post funding through Development Outcomes Ltd.

#### Assumption of readily available equipment

An assumption of this project was that research into a particular subsector will throw up for micro leasing equipment which is ready for leasing as it is. It was not foreseen that it may be necessary to alter the way equipment is deployed within the sector in order to render it “leasable”

#### **Related finding**

In practice, the key to successful micro leasing was found to lie in business systems that lock small businesses into a supply chain that is fairly unchanging and sustainable. In this project for instance, it became clear that, the most strategic equipment requiring to be leased in the dairy sector would be, first and foremost, milk dispensers. Although the project team could conceive the potential of a milk dispenser from the market research conducted, there were in practice no milk dispensers in use in Kenya! The project then interested a vendor to invest in designing and manufacturing a milk dispenser which would subsequently be the subject of micro leases. The project similarly proposed attachment of pre-paid gas meters to gas bottles as a means to introduce leasing of Liquefied petroleum gas equipment. The key lesson here is that those interested in developing leasing should not be surprised when they find themselves having to intervene in the sector either through technological interventions or by altering how a particular supply chain operates.

## **Conceptual Insights Into Development of Micro Leasing**

#### Leasing diminishes the importance of availability of capital as a barrier to investment by poor people in enterprise.

Lack of capital is commonly considered an important barrier to poor people working their way out of poverty. There is much evidence to suggest that, one of the principal impediments to poor people working their own way out of poverty, is their inability to draw in other forms of capital resources. These would complement those they already have in order to be able to work the resulting whole into income.

The concept at the heart of leasing, which is the separation of ownership from possession and economic use, provides the structure, at least in part, for resources owned by different people to congregate and function together. Appropriate lease legislation ensures this structure by defining and protecting the rights and responsibilities of all parties. Backing this up by the force of law builds the



certainty and confidence that then enables assets owned by one party to come into the possession, and be employed for economic purposes by some other person.

Leasing enables poor people to work themselves out of poverty without needing to “own” capital resources. It enables those who have the capital to gain a reward for ownership without using the asset themselves. This joint assurance of return then depends mainly on an ability to find a ready market for any resulting product. In this way, leasing enables the hurdle of lack of capital resources to be surmounted.

The key to successful leasing is the finding of a market for a particular finished product, rather than simply ensuring a supply of capital is available for asset finance.

#### Supply of capital versus utilization of capital

Leasing is a mechanism that allows assets in an economy to migrate. Underutilization of assets results in low productivity in the economy. It should be the responsibility of the government to provide mechanisms to stimulate efficiency and productivity, ensuring utilization of assets in the economy is high..

#### Leasing and employment creation

Assets are at the very center of employment, job creation and economic development.

In Africa, unemployment is a growing problem and large amounts labor are staying idle because resources are in short supply. Leasing does have a role to play in allowing better mobilization of resources and the resulting employment creation this would generate.

#### The reasons for investing in an effective regulatory structure for leasing

Sound lease legislation enables and even actively encourages owners to release their assets to users without fear of losing them. People are known to view with great concern any arrangement that might deprive them of ownership as ownership of assets has a security value to the owner.

#### A vibrant leasing industry can increase asset utilization rates

A strong leasing industry is likely to lead to higher levels of specialization across the economy, as companies own a narrower range of asset types, and come to rely more on leasing other assets. The key to economic development then would be determined and understood more in terms of business opportunity, rather than supply of capital for assets.

#### The place of government and large companies in promoting leasing

The government should encourage economy-wide gains in productivity. It can do so passively by strengthening legislation that facilitates pooling of assets at minimum risk to individual interests, such as leasing – and actively by offering fiscal incentives supporting leasing. Private companies stand to gain from improvements in the efficiencies of the supply chains in which they are involved. Larger companies need to support the small businesses that are an integral part of their supply chain – for they are collectively, only as efficient as the least efficient of them in the supply chain.