Stewart K. Pirnie

DEVELOPING LEASING AS A FINANCING TOOL IN MONGOLIA

With a population of less than three million people (35 per cent of which live in the capital Ulaan Baatar) and a land mass three times the size of Spain, developing the leasing sector in Mongolia is not an easy task. It is, however, possible with the correct products and an aggressive approach to the market. The fundamental problem, at the moment, is the general lack of awareness and understanding of finance leasing as a method of financing assets. Mongolians have been leasing cars for several years now, but the penetration percentage for leasing as a means of financing in the equipment sector is still low.

Mongolia is rich in natural resources and this has created tremendous wealth for a limited number of individuals and companies in the mining sector. Unfortunately, much of the equipment required by vast mining companies cannot be leased by the Mongolian leasing sector as the individual cost of the equipment is so high (a Caterpillar dump truck can cost up to US$ 6 million) and there is simply insufficient funding available in the domestic finance sector. Leasing companies everywhere prudently limit their exposure to individual customers (usually to a maximum of 10 per cent of their receivables).

The farmers in Mongolia, with its vast land resources, have traditionally been herdsmen grazing their livestock on relatively poor land, although this is changing slowly with new farming enterprises attempting to grow cash crops.

It may appear that the future for finance leasing in Mongolia is unfavourable, but this is not the case. For example, those farmers mentioned above now present the leasing sector with opportunities to offer finance leasing for equipment, such as tractors and combine harvesters, manufactured by global companies such as John Deere and Challenger, which have authorised distributors operating in Mongolia.

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AUTHOR

STEWART K. PIRNIE
INTERNATIONAL CONSULTANT
EMAIL: STEWART@PIRNIE.CO.UK

There are many sectors using many types of equipment that are suitable for finance lease products and the movement from the use of collateralised bank loans to finance leasing will gather momentum when potential lessees become aware of the attractiveness of the finance lease product.

Most first-time lessees are surprised at the similarities between a bank loan and a finance lease (see Table 1). Organisations such as the European Bank for Reconstruction and Development and the International Finance Corporation promote the "level playing field" approach between the two products on most aspects, including fiscal treatment.

There are, of course, many differences between the two products, many of which make finance leasing appear more attractive than taking a bank loan for customers considering an asset purchase (see Table 2).

It can be seen, from the tables, that although bank loans and finance leases are similar they also differ significantly. The task, therefore, for the Mongolian leasing companies is to explain clearly what a finance lease is (that is, "spread the word") and mainly to the small and medium-sized enterprise (SME) sector of the Mongolian business economy.

Within its remit, the EBRD's SME Leasing Policy Initiative will not only inform potential future lessees about the availability of finance leasing, but will also promote its features and benefits. This initiative will be widely publicised through various Mongolian media platforms, including social media, and by direct contact with SMEs across Mongolia, not only in Ulaan Baatar. The types of SMEs that will be attracted to leasing may not always be the types of SMEs that will be attractive to leasing companies, however, as not all business sectors in Mongolia may have the credit risk profile required by the leasing sector.

TABLE 1 SIMILARITIES BETWEEN BANK LOANS AND FINANCE LEASES

Bank loan	Finance lease
Customer chooses asset	Customer chooses asset
Customer repays asset cost plus interest	Customer repays asset cost plus interest
Loan may be repaid early	Lease may be repaid early
Collateral recovered in event of default	Asset repossessed in event of default

TABLE 2 DIFFERENCES BETWEEN BANK LOANS AND FINANCE LEASES

Bank loan	Finance lease
Collateral (200 - 300%)	Asset is collateral
Complicated process	Simple process
Complicated contract	Simple contract
Slow risk decision	Fast risk decision
Customer visits bank	Lessor visits customer
Customer has ownership rights	Customer has usage rights

All finance leasing contracts that have ever been written, and ever will be, have two elements, namely the customer and the asset, and both must be creditworthy.

As can be seen on the opposite page, the sole collateral for a lease is almost invariably the asset to be financed. The leasing company mitigates its risk by asking the lessee to make a down payment (for example, 20 per cent of the invoice value). This, therefore, means that the leasing company has the legal ownership of an asset for which it has paid only 80 per cent of its value. This may appear, on face value, to create a very secure transaction but some assets have different future values than others (that is, they depreciate at different rates).

For example, an agricultural tractor manufactured by a global company such as John Deere may be worth around 60 per cent of its original cost after four years of use by a Mongolian farmer, but a laptop that a farmer requires for his business may be worth only 10 per cent of its original value after two years. So while the leasing company may consider the farmer to be creditworthy it would not be very positive about offering a five-year lease on a laptop with, say, a 10 per cent down payment.

The SME Leasing Policy Initiative must, therefore, be careful about the message it sends out to Mongolian SMEs, as it may create demand for a product for which there is no supply. Basic errors were made by the nascent leasing sector when the "wrong types" of assets were leased partly due to the sector's lack of knowledge and partly to its sales approach that was effectively an open-door approach; that is, the leasing companies opened their office doors in the morning and waited for customers. The problem with doing this is that every potential customer was a surprise; the leasing company neither knew the potential lessee nor did it understand most of the assets that the lessee wished to lease. Also, the potential customer was very often, too often actually, not a good credit risk and had already been rejected for a bank loan by all of the banks in town.

"It should be noted that leasing companies do not accept higher risks than banks, only that their credit risk policy is different."

Mongolian leasing companies can control the potential customers that walk through their office doors. In the same way that hospital staff perform triage on patients, the receptionist at the leasing company can assess the type of potential customer arriving at its premises just by asking two questions:

- Which type of asset would you like to lease?
- Who is supplying the asset?

If the type of asset is not on the leasing company's list of approved assets then the receptionist can politely inform the potential customer that the asset cannot be leased (by that leasing company).

If the supplier is not on the approved list of suppliers then the answer to the customer will be the same.

This approach may appear brusque but it is, above all else, prudent. Leasing companies, not just in Mongolia, but all leasing companies should only offer leasing for assets that they understand and that comply with the following criteria:

- movable
- identifiable (for example, serial number, chassis number)
- supplied by a known vendor (although this vendor may be located outside of Mongolia there should be a local supplier of service and spare parts)
- have known future value (the leasing company should be able to calculate the depreciation of the asset over (at least) the duration of the lease)
- be resalable (in the event of repossession, the leasing company should be able to sell the asset to a third party or back to the original supplier)

The last two points are worth expanding on.

THE LEASED ASSET'S FUTURE VALUE

As the asset is (usually) the only security/collateral for the lease, the leasing company should understand how its value will change in relation to the outstanding capital on the lease (that is, the amounts still to be repaid at any moment in time). Although these future values are seldom 100 per cent accurate they should be calculated using real data, much of which is available on the internet. Most leasing companies use "gap analysis" as a visual aid for making risk decisions. This procedure simply plots two sets of values on the same graph: outstanding capital over the duration of a lease and the future value of the asset.

EXAMPLES OF GAP ANALYSIS CHARTS IN A LEASING CONTRACT

1 BASELINE SCENARIO: INADEQUATE COVERAGE

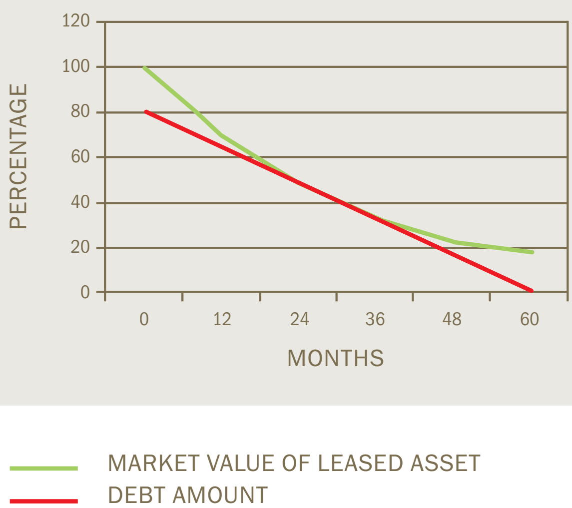
In this example it can clearly be seen that the future value of the leased asset is less than the outstanding capital from the start of the lease to around month 43. If the leasing company finds this to be an unacceptable amount of risk (as most leasing companies undoubtedly will) then the leasing company has two options. In practice most leasing companies will use a combination of the two.

> "The best risk mitigant for all leasing companies is the down payment. This is, effectively, the lessee's own 'investment' in the asset."

THE LEASED ASSET MUST BE RESALABLE

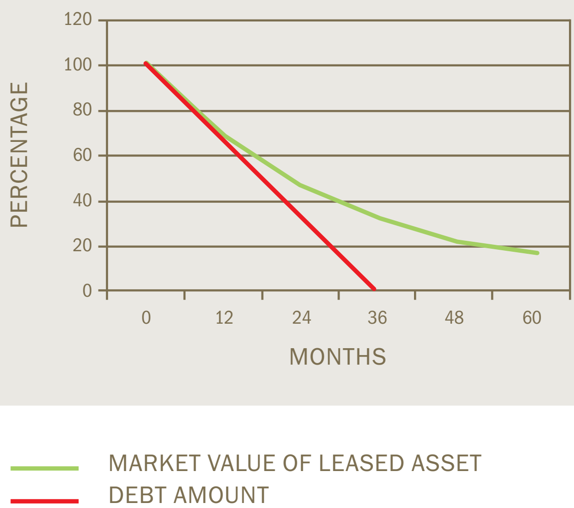
The second point (the leased asset must be resalable) accepts that not all leases will be repaid by the lessee and that some assets will have to be repossessed. It is important that the leasing company be able to quickly resell the repossession for a fair price; that is, at a fair market value. The speed of this sale will depend on there being willing buyers for this asset. The more specialised the asset, the fewer the buyers. As Mongolia has a very small population (in other words, few potential buyers of repossessions) it is very important for the leasing company to know, at the commencement of the lease, how difficult it could be to dispose of a repossession.

2 FIRST OPTION: TAKING A DOWN PAYMENT



It can take a down payment from the customer (in this example, 20 per cent)

3 SECOND OPTION: SHORTENING LEASE PERIOD



Or it may reduce the tenor of the lease from 60 to 36 months.

Unfortunately, the current law on leasing is very detrimental to a leasing company being able to repossess and quickly dispose of the asset, as a lessee must be three months overdue on its leasing repayment before temporary repossession may take place and then the leasing company must store the repossession while allowing time for the lessee to repay the overdue leasing repayments. If the overdue repayments are paid then the leasing company must return the asset to the lessee.

Leasing laws should be fair to both lessors and lessees and it is hoped that the above problem will be solved by the amendments that will be proposed by the EBRD team, which will take on the task of drafting changes and improvements to the current law in 2015.

The three most important issues when it comes to leasing laws are: (i) definition of a lessor, the lessor's rights in a leasing contract and its obligations to a lessee; (ii) definition of a lessee, the lessee's rights in a leasing contract and its obligations to a lessor; and (iii) the repossession process. These definitions should be clear, simple and unambiguous, so much so that they could be used in the marketing of finance leasing. The most important right within a law should be that, in consideration of a lessee making his lease rental repayments in a timely manner, he will be allowed continuous and uninterrupted use of the asset. This right can then be explained within the terms and conditions of the lease contract.

Leasing companies want lessees to repay the lease rentals on time. They do not want to repossess assets. This is very much a last resort scenario and usually only happens after many attempts have been made by the lessor to persuade the lessee to pay overdue lease rentals. The period of time between a lease rental becoming overdue and the leasing company being able to repossess the asset should not be governed by a law, but should be agreed within the terms and conditions of a lease contract. If the lessee does not believe the term or condition related to this time period to be fair then he should not sign the lease contract.

If the asset must be repossessed, then the preferred method of repossession for a leasing company is commonly known as "self-help". This operates on the fact that the leasing company owns the asset and that the lessee is in default, so the leasing company can locate the asset and remove it from that location to a place of storage of its own choosing. No courts are involved in this process.

THE EBRD'S SMALL BUSINESS INITIATIVE

The SME Leasing Policy Initiative is inspired by the EBRD's Small Business Initiative (SBI). This is an organisation-wide initiative to provide comprehensive support to small businesses through access to finance, business advice and policy dialogue.
The SBI has five pillars:

- **Indirect financing** – Financing of financial intermediaries for on-lending to micro, small and medium-sized enterprises; investments in equity funds with a focus on SMEs.
- **Co-financing/risk-sharing** – Co-financing SMEs or risk-sharing with local partners, whether they be banks or equity funds (for corporations).
- **Direct financing** – Direct, tailor-made debt and equity financing of SMEs with strong potential for good return on investment.
- **Business advisory** – Various business advisory activities in support of SMEs.
- **Policy dialogue** – Policy dialogue initiatives aimed at improving SMEs' business environment and access to finance.

If this method is considered too aggressive for Mongolia then the leasing companies will accept the need for a court official, granting permission for repossession, on the condition that this process is consistently simple, free and quick (a few days). The leasing company should present the court official with proof of ownership and proof of default, and there should be no requirement for the lessee to be present at this time.

"If changes to the legislation can be made then the leasing sector in Mongolia can safely grow in the future and this will mainly benefit the SME sector."

The disposal of the asset at a fair market price may be open to abuse by an unscrupulous leasing company (for example, repossessions may be sold to "friends" for a price much less than the asset's real value). This problem can be covered in several ways, such as the leasing company being obliged to advertise the asset for sale on a public site; being required to find a minimum of, say, three offers and also informing the lessee of the proposed sale price; and allowing the lessee a period of time (for example, 14 days) to find an alternative buyer prepared to pay a higher price.

If these changes to the legislation can be made then the leasing sector in Mongolia can safely grow in the future and this will mainly benefit the SME sector by bringing access to finance to this important part of the Mongolian economy.