THE SIGNIFICANCE AND ROLE OF LEASING IN CORPORATE FINANCING IN REPUBLIC OF CROATIA

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Abstract

Financing business activities of any company requires the availability of adequate sources of funding in the required amount and in a timely manner. The structure of the funding sources or capital structure, which finances business assets, is one of the main factors, which determines the competitive position of the company on the market and influences growth opportunities and expanding abilities of the business. In today's complex business conditions, characterized by globalization processes and dynamic socioeconomic relations that prevail in the market, there are a significant number of funding sources that are available to businesses in accordance with their requirements. Those funding sources are different in terms of types, maturities, interest rates, and other contractual terms. Strong competition and market conditions demand a continuous restructuring of the company's capital structure as well as finding the most appropriate financial mix between owned and borrowed funds of a certain maturity. Available data show that besides the usual external sources of funding, such as different types of bank and commercial loans, the companies increasingly are using alternative funding sources such as leasing.

The concept of leasing implies a financing of business activities through lease rather than purchase of the necessary business assets. A lease is an agreement in which one party (lessee) gains a long-term rental agreement for the use of some fixed asset, and the other party (lessor) provides that asset and receives a series of periodic contractual payments in return from the lessee. The leasing is particularly important for small and medium business enterprises that very often do not have sufficient financial resources to purchase the necessary assets nor can they get bank loans at favourable terms. There are numerous advantages of the leasing compared to other asset financing methods such as simplified management and planning of current and future cash flows, better costs control, flexibility and ease of contracting, tax treatment (benefits) and many others. Therefore, the paper provides an overview of the basic characteristics and types of leasing as an alternative way for financing businesses and indicates the significance and role of leasing for business activities in modern market conditions. Additionally, the paper presents structure and basic features of the leasing market and leasing companies in Croatia.

JEL Classification: G32

Keywords: leasing, asset-based financing, leasing market

1. Introduction

The capital structure of any company consists of owned and borrowed funds. In today's globally competitive markets it represents one of the key factors that determines current position and influences growth and development opportunities. There are many funding sources that are available to companies under virtually any conceivable terms. The main objective has become finding the most appropriate mix between owned and borrowed funds. Available data show that besides the usual external funding, the companies are increasingly using alternative sources such as leasing. The concept implies a financing of business through lease rather than purchase of the necessary assets. Leasing represents a hybrid type of financing used to finance different forms of fixed assets. A lease is an agreement in which one party (lessee) gains a long-term rental agreement for the use of the asset while the other party (lessor) provides that asset and receives a series of periodic contractual payments in return. The leasing is particularly important for small and medium businesses (SMEs) that often do not have sufficient financial resources to purchase the assets nor can they get loans at favourable terms. It has a widespread use in everyday business and numerous advantages if compared to other asset financing methods. Therefore, an overview of the basic characteristics and types of leasing is presented in the paper, indicating its significance in today's modern markets. Also, the paper presents the structure and basic features of the leasing market and the leasing industry in Croatia.

2. The types of leasing and their characteristics

Leasing is defined as a contractual agreement between the enterprise (the lessee), which takes the lease for a certain asset, and the finance company (the lessor), which provides asset for leasing and gets lease payments in return. A lease is a rental agreement that extends for a year or more and involves a series of fixed payments (Brealey & Meyers; 2003:729). Generally, the property of the leased asset remains with the leasing company while the lessee obtains the right to use the asset by paying lease rentals for the life time of the leasing contract. After the contract expires there is a possibility of asset ownership being transferred to the lessee at a certain cost. The ownership and the use of the asset are separated, the lessee generates earnings from the use of assets, while the lessor receives rental payments and retain the security of asset ownership (Deelen; 2003:3). Leasing can take many forms depending on complexity of business transactions and contractual relations. According to Brigham and Houston (2009:629) leasing takes three basic forms, i.e. operating lease, financial (capital) lease, and sale-and-leaseback arrangements. An operating lease, also called a service lease, is a lease under which the lessor maintains and finances the property. Costs of maintenance and other related services are built into the regular lease payments. The ownership of asset stays with the lessor while the right to use the asset is transferred to the lessee. At the end of the lease period, the lessee returns the property to the lessor. The value of the asset is not fully amortized because contracts are usually written for a period shorter that the expected economic life of the leased equipment. Additionally, the contract frequently has a cancellation clause giving an opportunity to the lessee to return the asset that is no longer needed or is outdated due to technological developments, thus getting more flexibility in a changing business environment. Industrial and business equipment as well as automobiles and commercial vehicles are the primary types of equipment involved in operating lease. A financial lease differs in three aspects from an operating lease. There is no possibility to cancel financial lease during its time span. Also, it does not cover maintenance costs by the lessor, leaving them to the lessee. The finance lease is primarily a method of raising finance to pay for assets, rather than a genuine rental. Therefore, it is fully amortized. The lessor receives rental payments that are equal to the full price of the leased equipment increased for an investment return. Generally, the user of the asset, the lessee, negotiates the terms of trade with the manufacturer or the seller of the needed asset as well as lease terms with a leasing company. The lessor pays the manufacturer/seller for a selected equipment and signs the lease contract with the lessee, which is obliged to make lease payments according to the contract. A sales and leaseback type of leasing can be thought of as a special type of financial lease. In this case, the company that owns and use specific asset sells that property to the lessor and simultaneously signs the leasing contract to lease back the same asset for a specified period of time, thus becoming the lessee. Basically, the sale-and-leaseback plan is an alternative to taking out a mortgage loan. This type of leasing secures the lessee with immediate cash inflow when the asset is sold while retaining the undisturbed use of equipment. Many lessors offer leases under a variety of terms, thus making new combination leases that have mixed features. For example, the usual cancellation clause in operating lease is also a part of finance lease today but supplemented with penalty payments to the lessor in order to compensate for the unamortized amount of the leased asset. Additionally, in the 1990s some companies started to use synthetic leases in order to keep debt off their balance sheets (Brigham & Ehrhardt; 2008:717). The company would create a so-called special purpose entity (SPE) that buys needed asset with borrowed funds. In a second step the company would lease the same asset from the SPE, thus keeping the asset off the balance sheet under the terms of operating lease and expensing lease payments in its income report. Other leasing types stated in the literature are direct and indirect leasing, short-term and long-term leasing, full service (rental) and net leasing, leasing per asset type, leveraged leasing, first hand and second hand leasing, etc. (Poljičak; 2010:173).

3. The leasing as an alternative financing source

Prior to 1950s leasing was generally used in real estate to finance the use of lands and buildings without paying the full price up-front and owning the property. In today's corporate world virtually any fixed asset can be leased while over 30% of all new capital equipment in the USA is financed through lease arrangements (Brigham & Ehrhardt; 2008:715). According to data of Leaseurope (2011), that represents 44 member associations in 32 European countries and covers around 92% of the European leasing market, total new leasing volumes reached 256.6 bill. EUR in 2011, an increase of 7.4% compared to 2010. The outstanding leases grew by 1.1% to 712.3 bill. EUR at the end of 2011. The largest European leasing markets in terms of new volumes are Germany (47.6 bill. EUR), France (39.6 bill.) and the UK (38.1 bill.). The structure of new leasing volumes per asset types indicates that the largest market segment is passenger cars with a 40% market share in 2011, followed by equipment (34%), commercial vehicles (17%) and real estate (9%). There are many advantages in relation to leasing, such as tax-related benefits, flexibility of contracts towards customer needs, lease payments tailored to cash flow generating patterns of the lessee, minimal initial expenditures, the preservation of working capital and credit lines, risk mitigation of assets obsolescence, improved liquidity, better cost control, increased access to financial funds and others (Kraemer-Eis & Lang, 2012:7-10; Boobyer, 2003:2-3; Groppelli & Nikbakht, 2006:338-339). Leasing is especially important for SMEs that typically cannot raise money directly in the capital markets and are mainly dependant on traditional bank financing. Furthermore, leasing finance provides SMEs with additional funds that expands their access to short and medium-term financing for fixed assets. A survey of 3,000 SMEs across 8 European countries that accounts for 78% of the European leasing market, shows that 40% of the SMEs surveyed used leasing in 2010, i.e. 28% of micro firms, 42% of small firms and 53% of medium firms, and 16.7% of their total investment was financed via leasing (Oxford Economics & Linedata; 2011). Also, the survey indicates that SMEs that use leasing invest 57% more on average than non-users of leasing. The report on UK SMEs financing (Fraser; 2004:18-19) indicates that 27% of UK SMEs in 2004 used leasing and/or hire purchase as a way to finance primarily vehicles (72% of SMEs), computer equipment (11%) and machinery (9%), putting leasing on the same level with bank loans. Lasfer and Levis (1998) analysed more than 3000 UK companies in the period 1982-1996 and showed that companies that use leasing were more likely to have tax losses, high fixed capital investment, high debt-to-equity ratio and to be larger than companies that do not use leasing. Small companies in the sample tend to use leasing for survival and growth opportunities rather than for profitability and tax reasons. They indicate that leasing is a substitute for debt financing in SMEs, while large firms use them as complements. Haiss and Kichler (2009:5) found that leasing and credit positively contributed to the economic growth of Eastern European transition countries and established complementary relations between leasing and the credit. Due to widespread use and variability in contractual terms, the accounting treatment of leases is of great importance. International Accounting Standard (IAS) 17 prescribes the appropriate accounting policies and differentiates operating and finance leases based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. In other cases, the lease should be classified as the operating lease. Financial leases must be capitalized in the books and disclosed in the balance sheet while operating leases must be stated in the footnotes. Accounting standards recognize leases essentially as a debt, thus preventing a company to use more leverage than otherwise possible.

4. The structure of the leasing market in Croatia

Business of leasing companies in Croatia is regulated by the Leasing Act enacted in 2006 (Official Gazette, 135/06). Also, a number of subsidiary laws and regulations further dictate dealings in the leasing market. There are 25 specialized leasing companies that are active and registered at the present moment (table 1). One leasing enterprise has authority to perform only operating leases, while another 24 provide both operating and finance lease services. The number of leasing companies has been stabilized after the Leasing Act came into force in 2007. Due to regulatory conditions only 25 leasing companies survived in 2007 out of 57 that provided services in 2006. The new regulation has put an end to the widespread practice of approving and distributing ordinary loans and similar financial services disguised as leasing business dealings. If capital ownership is observed indirectly, residents own only three leasing companies, while others are owned by non-residents, primarily by big foreign banks and financial institutions.

Table 1 General data on leasing companies in Croatia (01.01.2007-30.09.2012.)

Description	2007	2008	2009	2010	2011	30.09.2012
Number of leasing companies	25	26	26	26	25	25
Number of employees	997	1,007	992	989	958	n/a
Total assets (in bill. HRK)	30.30	35.07	33.67	28.07	25.60	23.08

Source: adapted from HANFA Yearly and Quaterly Reports (2007-2012)

Overall difficult market conditions and slowing down of economic activities in Croatia due to global economic crises, negatively influenced developments in the leasing market. Total assets of leasing companies have decreased 15.51% in the period 2007 to 2011, from 30.30 to 25.60 bill. HRK. The decrease is even bigger in the period 2008 to 2011 with total assets reduced 27% in 2011 compared to 2008. Generally, the leasing market downsizes in terms of total assets while retaining the number of companies and employees. The shrinking leasing market is also apparent when numbers of new leasing contracts and their structure are analysed (table 2). There were over 45% less new leasing contracts in 2011 compared to 2007. The value of new contracts decreased even more, almost 60%, from 13.82 bill. in 2007 to just 5.56 bill. HRK in 2011. The average value of new contracts was down 26.72%. Correspondingly, the value of operating lease contracts decreased 66.77%, and the value of finance lease contracts has been reduced by almost 54%. Negative trends in the market continued in first three quarters of 2012.

Table 2 Number and value (in bill. HRK) of new contracts of leasing companies

Year	No. of new contracts	Value of new contracts	Avg. val. of new contracts*	Operating Lease	Finance Lease
2007	55,835	13.82	247.51	6.29	7.53
2008	59,410	15.46	260.23	6.67	8.80
2009	31,632	8.27	261.44	3.16	5.11
2010	28,446	5.70	200.38	2.12	3.58
2011	30,656	5.56	181.37	2.09	3.47
2012**	21,053	3.80	180.50	1.54	2.26
Chg. in % (2011/07)	-45.10	-59.77	-26.72	-66.77	-53.92

* in thousand HRK; ** Figures for January 1st to September 30th 2012
Source: adapted from HANFA Yearly and Quaterly Reports (2007-2012)

Similar negative developments could be observed when the number and value of active contracts are analysed in the same time period (table 3). Active contracts are contracts for operating and finance lease and loans that are still outstanding and that are going to be settled in the next periods. Thus, the number of active contracts dropped by 12.32% in 2011, while their value was cut in half to 19.34 bill. HRK. Operating lease contracts lost 2/3 of their value stated in 2007, finance lease contracts dropped 22.51%, and loans were down 12.32% in 2011. Similarly as with other data describing leasing operations, the market showed upward tendencies in 2007 and 2008, growing 10% to 15% annually. The reverse of positive developments has started in 2009 and it has not finished yet.

Table 3 Number and value (in bill. HRK) of active contracts of leasing companies

Year	No. of active contracts	Value of active contracts	Avg. val. of active contracts*	Operating Lease	Finance Lease	Loans
2007	158,407	39.22	247.59	14.76	16.66	7.80
2008	177,572	46.77	263.39	18.12	21.42	7.23
2009	158,939	26.74	168.24	9.02	15.42	2.30
2010	154,612	21.74	140.61	6.50	14.09	1.16
2011	138,893	19.34	139.24	5.61	12.91	0.82
2012**	130,009	16.94	130.30	4.81	11.49	0.64
Chg. in % (2011/07)	-12.32	-50.69	-43.76	-61.99	-22.51	-12.32

* in thousand HRK; ** Figures for January 1st to September 30th 2012
Source: adapted from HANFA Yearly and Quaterly Reports (2007-2012)

Closer look into the portfolio structure of new leasing contracts classified per asset type in the period 2008 to 2012 (table 4) reveals that most of the contracts are for passenger cars and commercial vehicles with contracts for industrial and business equipments (plant, machinery, transport machines and equipment) following. Leasing contracts for passenger cars are 35% to 45% of the total value of new contracts for every year in the period 2008 to 2011, while share of contracts for commercial vehicles varies between 16% to 22%. All main asset types reduced its value significantly over the period, thus reflecting a negative shift from the leasing as a financing source as well as showing deteriorated economic conditions.

Table 4 Portfolio structure per asset type – new lease contracts (in mil. HRK)

Asset type	2008	2009	2010	2011	2012*	Chg. in % (2011/08)
Real estate	,340.57	1,592.10	1,039.33	831.24	619.74	-64.49
Passenger cars	5,720.16	2,985.21	2,349.91	2,602.93	1,564.42	-54.50
Commercial vehicles	3,442.80	1,803.07	947.85	970.40	799.71	-71.81
Vessels	1,421.73	585.49	263.07	189.42	227.20	-86.68
Aircrafts	n/a	30.02	0.00	0.00	2.93	n/a
Plants, machinery, transport machines and equipment	2,396.61	1,118.23	984.27	864.40	559.54	-63.93
Other	142.16	156.83	116.88	106.52	28.75	-25.07
Total	15,464.02	8,270.95	5,701.30	5,564.91	3,802.30	-64.01

* Figures for January 1st to September 30th 2012

Source: adapted from HANFA Yearly and Quaterly Reports (2008-2012)

Portfolio structure of active leasing contracts classified per asset type indicates similarity with structure of new contracts (table 5). Again, total value of outstanding contracts decreased 58.65% in the period 2008 to 2011. The smallest drop in value was for real estate leasing contracts, almost 30%, while values of other asset types were cut significantly down to between half and three quarters of their level in 2008.

Table 5 Portfolio structure per asset type (operating and finance lease, loans) – active lease contracts (in mil. HRK)

Asset type	2008	2009	2010	2011	2012*	Chg. in % (2011/08)
Real estate	8,851.16	7,348.09	6,196.35	6,245.46	5,823.81	-29.44
Passenger cars	16,644.57	7,830.54	6,184.40	5,436.14	4,561.21	-67.34
Commercial vehicles	9,105.60	4,689.66	3,779.89	3,174.03	2,857.78	-65.14
Vessels	2,993.43	1,662.42	1,204.24	796.85	695.41	-73.38
Aircrafts	n/a	34.46	30.73	37.32	4.44	n/a
Plants, machinery, trans. machines and equipment	8,483.44	4,729.09	3,942.96	3,325.45	2,881.81	-60.80
Other	692.37	443.29	401.41	322.51	113.37	-53.42
Total	46,770.57	26,737.55	21,739.98	19,337.77	16,937.83	-58.65

* Figures for January 1st to September 30th 2012

Source: adapted from HANFA Yearly and Quaterly Reports (2008-2012)

The unfavourable situation in the leasing market is additionally reflected in income reports of leasing companies. Although selected items in table 6, such as profit from interest, commissions and fees, and other revenues and expenditures, are mostly positive, leasing companies realized huge losses after income tax in the period 2008 to 2011. The largest loss of almost 602 mil. HRK was achieved in 2009. However, a profit after income tax of 285.76 mil. HRK was realized in the first three quarters of 2012. The main reason for reporting aggregate loss after income tax was the high cost of value adjustment of outstanding contracts due to impairment losses and write-offs. A number of lessees have become unable to pay their dues under the existing leasing arrangements, so leasing companies were compelled to book impairment losses. For example, according to data of HANFA the impairment loss in 2011 was 636.3 mil., thus being higher than profit from interest of 382.91 mil. realized in the same year.

Table 6 Aggregate income report of leasing comp. – selected items (in mil. HRK)

Profit/loss from	2008	2009	2010	2011	2012*	Chg. in % (2011/08)
Interest	-112.60	515.54	602.79	382.91	263.15	440.06
Commissions and fees	28.13	70.27	73.65	52.76	22.75	87.56
Other revenues and expenditures	15.05	176.00	-228.28	86.30	173.70	473.42
After income tax	-455.15	-601.90	-1,038.96	-132.20	285.76	70.95

* Figures for January 1st to September 30th 2012
Source: adapted from HANFA Yearly and Quaterly Reports (2008-2012)

5. Conclusion

Availability of needed funding strongly influences the competitive position and growth opportunities of companies. Leasing is an alternative mechanism to facilitate access to finance. There are many different types of leasing, such as operating and finance lease and others, that vary in specific terms and conditions and that can be tailored to customer needs. In general, a lease is a contract between the company (the lessee) that uses the leased asset and the lessor who owns the leased asset and get lease payments in return from the lessee. The importance of the leasing is reflected in the size of its market; there are 256.6 bills. EUR in the new leasing volume in 2011 in Europe. Also, about 30% of all capital equipment is leased in the USA. Leasing is especially significant for small and medium enterprises, because it enables them to finance growth and substitute traditional debt, thus increasing their liquidity and investments. Croatian companies are also using different forms of leasing provided by 25 leasing companies with 23.8 bill. HRK of total assets in 2012. Although the leasing volumes have decreased since 2008, the worth of 3.8 bill. HRK of new and 16.9 bill. HRK of active contracts is still very important as a financing source. Improvement of the current economic situation in the near future would definitely also lead to the recovery of the leasing market in Croatia.

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