Leasing company

Summary of the Operation Performance Evaluation Review

THE PROJECT

In September 2000, the EBRD approved a syndicated, parallel loan of €100 million for a leasing firm in one of the EBRD's countries of operations. The EBRD provided €35 million for five years, however the commercial banks that joined the syndicate only provided €20 million for three years, significantly short of the €65 million planned at approval.

The Company was the largest leasing firm by both number of transactions and portfolio size in the country. It was also the largest independent leasing company in an industry dominated by bank-owned leasing companies. (The Company was, however, subsequently acquired by a major Western bank in 2001.) The Company was founded in the 1990s with a focus on smaller firms and small ticket leases, especially for motor vehicles.

The Bank spent several years prior to the project performing due diligence and trying to negotiate an equity investment in the Company. In all, the Bank considered at least three equity investment opportunities, but finally dropped the effort in favour of arranging the project's syndicated loan. The story of the Company is one of great entrepreneurial success greatly rewarded. In 2000 the Company was taken public in an IPO that listed the firm on a stock exchange. New equity from the IPO endowed the Company with strong capitalisation (debt to equity of only 190 per cent versus a loan covenant of 600 per cent). This underpinned the project which began disbursing in May 2001, just over a year after the IPO.

PROJECT RATIONALE

The Project sought to:

- Support entrepreneurship by expanding leasing operations in the country. Leasing is a preferred form of financing for small and medium-sized enterprises (SMEs) that have a short track record and scarce collateral to offer beyond the leased good itself. Over 90 per cent of the Company's clients were small firms (less than 50 employees), making it an excellent partner for achieving such outreach.
- Support diversification of financial services in the country by extending Bank finance to non-bank financial institutions such as the Company in accordance with the strategy for the country of operation. This would help the low penetration rate for leasing in the country to converge more quickly with the EU penetration rate.
- Extend funding maturities for the Company from the maximum three years offered by the banks to the five years offered by the EBRD. The longer tenors would allow the Company to match the tenor of leases more closely to the economic life of the leased assets, and to finance assets with longer economic lives. The longer tenors would reduce refunding risk for the Company and foreign exchange risk as well by match-funding existing leases denominated in euros.

ACHIEVEMENT OF OBJECTIVES

The EBRD's syndicated loan for the Company had the following objectives:

Support entrepreneurship, reach 5,000 SMEs: *Achieved*

At the time of the Bank's investment, the Company was a rapidly growing, well-managed leasing firm with a leading market share. The Company was supplying scarce medium-term finance to purchasers of motor vehicles that were mostly SMEs in a rapidly expanding market. It had built strong relationships with leading vehicle vendors that benefited from cooperating with the Company. It was not involved in consumer leasing, a market that has still to develop in the country. Therefore, almost all of its leases were with SMEs at an average lease value of less than €15,000. The Company also provided leases of other equipment (about 10 per cent) besides motor vehicles for SMEs.

Support diversification of financial services in the country: *Achieved.*
The Project supported continuing growth of the leasing industry in the country. The timing of the Project unintentionally coincided with a crisis in the industry. A large bank had allowed its leasing company to fail, causing loan losses for many banks that had been lending to the leasing company. Also, the lack of a clear leasing law meant that secured lenders were able to recover the pledged assets from lessees without regard to their rights of use or their performance under the lease contracts. The resulting high publicity and political fall-out led to an improved leasing law. Since then the leasing industry has continued to grow and consolidate. The Company's rapid growth and industry leadership have had a decisive impact on the sector, especially in the motor vehicles sector.

Successful syndication to a broad number of banks, including banks new to the Company: *Partly Achieved*
The Company had required that the loan syndication enrol only those banks that were not already its lenders. Few banks met this criterion because the Company was an active borrower in the market. Also, the failure of the leasing company, described above, hurt the syndication market for the deal: some banks that had shown interest early backed away. Other factors delayed the syndication for several months, causing it to become stale and damaging its prospects. Consequently, the syndication fell well short of its goal of €65 million: it reached only three banks for a total of €20 million, of which two were from the same banking group, so that in substance only two banks were involved in the syndication.

Growth in investor confidence as indicated by the market capitalisation of the Company: *Fully Achieved*
The Company's progress from its foundation as a privately owned firm in the 1990s, through its IPO in 2000, to its acquisition by a financial services group in 2001, is one of storybook perfection. During its 500 days as a listed company, investors who bought shares in the IPO and sold them to the financial group enjoyed a 37 per cent IRR in local currency. During that short period the market capitalisation of the Company's equity increased by over €100,000,000.

Achieve progress in the Country's leasing regulatory framework: *Achieved*
The Bank, in its 2002 and 2003 Financial Intermediaries Report, identified the need for policy dialogue to seek improvements to legal, accounting and tax laws and regulations in the non-bank financial sector. As a leader in the sector, the Company took steps to address the need for such improvements. It seems, however, that the major shapers were the country's legislators, rather than industry or the Bank. There is a need for better dialogue and consultation between the government and the sector.

OVERALL ASSESSMENT

The project was rated *Highly Successful* because of *Excellent* transition impact, both realised and potential, for which risk to potential transition impact was *Low.* Achievement of objectives was *Good* despite a short-fall in the syndication volume. The project supported the rapid, well-managed growth of the country's largest and most transparent independent leasing firm. The Company created leasing in the country and maintains its leadership of the sector. It early adopted a transparent approach, including applying US GAAP, arranging to be listed on the LSE and the WSE, obtaining an international credit rating, and working with the EBRD. The Bank's investment signalled confidence in the Company and the sector at a delicate time of industry consolidation and during a challenging syndication exercise. Therefore, additionality is rated as *Verified in all Respects.* The Bank's investment helped attract a major

Western bank to the country to acquire the Company. Environmental performance was *Good* and the extent of environmental change was *Some* thanks to leasing of new motor vehicles to replace older models. The Company's financial performance was rated *Excellent*: The firm has been consistently profitable and rapidly growing with good capitalisation throughout the period of the Bank's investment, although margins have been narrowing thanks to economies of scale in the industry and fierce competition. The Bank's investment performance was *Good*; the loan facility was correctly priced and has performed well. Bank handling was rated *Good*: due diligence was thorough, and support teams made strong contributions. The Bank allowed its syndication efforts to be too narrowly constrained by the client, limiting achievement of the syndication objective.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

Overall transition impact was rated *Excellent*, with a rating of *Excellent* for realised and *Good* for remaining potential transition impact. The risk to the future realisation of potential transition impact is *Low* because the Company is a well-managed and successful firm that is now owned and actively managed by a strong financial services group. The project provided valuable long term funds at a crucial stage of the Company's growth, helping it to maintain competitive pressure in the industry and to draw competitive responses from other leasing firms. The EBRD's funding contributed 20 per cent of the Company's total funding needs in 2001, when the EBRD became its single largest lender. The EBRD's support to the leading player, based on a sound financial and franchise analysis, helped maintain market confidence at a time when one of the country's major leasing firms had collapsed. The Project favourably impacted several thousands of SMEs that leased new motor vehicles and other equipment from the Company on longer tenors than had ever been available in the market. It also spurred competition and market expansion in the motor vehicles supply and leasing sectors, especially the vendor franchises, with knock-on impacts forward and backwards in that supply chain. Finally, the EBRD's support for the Company helped attract the entry of a major new player to the market to acquire the Company.

The Company was, at the time of the Bank's entry, an active user of bi-lateral banking facilities secured by security collateral in its leases and leased equipment. The Bank's contribution was to provide a syndicated facility, with extended tenors, involving a locally based collateral agent. The package was valuable to the Company which was outgrowing the capacity of its banks to finance new leases; in fact, the Company had had to cease writing leases one winter because it had run out of available banking facilities. Also, the longer tenor of the EBRD commitment permitted the Company to better match its assets and liabilities, reducing the pressures on cash flow. The collapse of a major leasing competitor scared off some new lenders that the deal was meant to attract. Additionality is rated *Verified in All Respects*.

BANK HANDLING

Bank handling was rated *Good*, demonstrating strong teamwork among the EBRD's Banking Department and key support units. Both Risk Management and the Office of the General Counsel made important contributions to project execution in this case. The syndication effort fell short of its goal of €65 million because the Bank accepted the client's condition not to approach the Company's main partner banks. In hindsight, it was an error to accept the client's condition.

MAIN ISSUES AND LESSONS LEARNED

The Bank's skills permit equity investment in leasing firms. The Bank has built financial models and acquired understanding of lease accounting and taxation that should now permit it to make reliable and quicker decisions about becoming an equity investor in leasing firms. The shortage of equity in the sector, its rapid growth, and the attractiveness of well-run leasing firms to strategic investors offer important opportunities to the Bank for transition impact and investment performance.

Leasing can be used as a delivery mechanism for SME finance. Small ticket leasing can be a reliable way to provide long term finance to thousands of SMEs for acquisition of motor vehicles and other types of equipment. Successful outreach to SMEs via leasing firms depends on a strategic focus by the leasing firm on high volume, small value leasing contracts.

Vendor-linked leasing spurs backward linkages (transition impact). Teaming with vendors, such as motor vehicle and construction equipment dealers, is an important factor for success in the leasing industry. Firms that partner with leading vendors require more focused strategies and operations than those that do not, increasing chances for successful rapid growth and sustainability.

Clients must retain adequate legal counsel. It is important that the Bank require its clients to engage adequate legal counsel as one of its terms and conditions. This is especially important in the case of financial services firms that have many loan and collateral security agreements with many counterparts. Terms and conditions of Bank mandate letters should stipulate that the Bank may decline to proceed with negotiating the investment agreements if the client does not retain reputable counsel with adequate institutional capacity to advise it. In this case, the Office of the General Counsel should insist that the firm retain strong outside counsel.

The loan syndication strategy should not be constrained. First time borrowers in the syndication loan market should follow the EBRD's advice regarding market practice. The Bank should in principle decline to work with borrowers that, after an intense effort to educate them, do not heed its advice as to structure, pricing, and syndication strategy.

The logical alternative solution to equity is subordinated debt. Subordinated debt, convertible or with warrants, can offer a better risk profile for the Bank than equity while preserving some of the upside potential of equity. It can also provide the valuable long-term funding needed by a financial institution and strengthen its access to senior debt capital. When an equity deal looks unfeasible, it is important to consider the logical alternative.