

The importance of leasing for SME financing

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The ability of SMEs to access finance is important for funding business investment, ensuring businesses reach their growth potential, and for facilitating new business start-ups; a lack of finance can constrain cash flow and hamper businesses' survival prospects (BIS, 2012).

Typically, SMEs are not able to raise money directly in the capital markets and are therefore – with regard to external sources – mainly dependent on traditional bank financing, which is itself limited by constraints due to banks' refinancing capacity, their risk appetite and capital adequacy (see e.g. Kraemer-Eis, Lang, and Gvetadze, 2013).

An important element of SME finance is not directly provided by banks through traditional loans but rather by leasing or factoring companies. The intention of this article is to enhance the awareness of leasing and its importance as additional financing technique for SMEs that expands the access to short- and medium-term financing for capital equipment.

Leasing as integral part of the financing tool set. *To what extent do SMEs use leasing?* SMEs finance themselves to a great extent by internal sources, both from the business owner and through retained profit. Many SMEs also use external sources of finance, informal sources (such as family and friends, and some types of business angel investment) and formal sources, such as bank loans, leasing, trade credits, factoring and more “formal” venture capital. Nevertheless, as mentioned above, SMEs have usually more difficulties in accessing external financing than large enterprises. We could even simplify that: the smaller and younger a company is, the bigger its financing challenge (Pelly and Kraemer-Eis, 2012).

This general picture is confirmed by recent *empirical evidence*. According to the ECB's “survey on the access to finance of SMEs in the Euro area”, covering April to September 2013 (ECB, 2013), access to finance remained the second most pressing problem for Euro area SMEs, and it appears to be a more severe concern for SMEs than for large firms. However, the most pressing problem for SMEs was still “finding customers”.

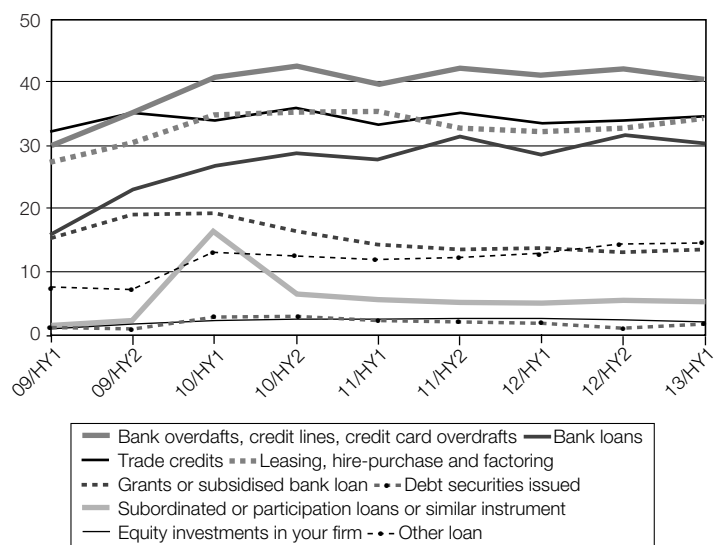
The composition of external sources of finance has changed somewhat during the past years (see Table 1). While the ECB data does not isolate leasing products specifically, “leasing, hire-purchase and factoring” taken together² has always ranked either second or third among the categories of mostly-used

external financing sources, preceded only by “bank overdrafts, credit lines and credit card overdrafts” and several times also by “bank loans”. Compared to 2009, the importance of “leasing, hire-purchase and factoring” even increased.

The relatively high importance of leasing for the external financing of SMEs is confirmed by the study “The Use of Leasing Amongst European SMEs” (prepared by Oxford Economics (2011) on behalf of Leaseurope).³ In 2010, according to the survey, leasing was the most popular source of external financing, which was used by 40% of the surveyed SMEs.⁴ The second most important external financing source was bank loans of more than three years.

However, even if a large number of SMEs use leasing, the share of invest-

Table 1: Sources of external financing of Euro area SMEs



Note: Over the preceding six months; percentage of respondents.
Source: ECB (2013), ECB Statistical Data Warehouse.

ment financed by leasing (16.7%) is actually smaller than the share of SMEs which used leasing as a financing tool, as depicted in Table 2. Bank loans (all maturities taken together plus other forms of bank loans) are used to finance a larger part of SMEs' investments (31.2%).

However, when looking only at those SMEs that actually used leasing in 2010, the share of investment financed by leasing is higher (32.4%) and exceeds the shares of investment financed by bank loans (30.1%) or by any other financing source. Thus, for SMEs which decide to lease an asset, this instrument becomes on average the most important part of their financing tool set.

Scaling up the figures from the eight country sample, Oxford Economics (2011) estimates the SME leasing volume for the whole EU to be €100bn for 2010 which corresponds to 52% of total leasing to businesses.

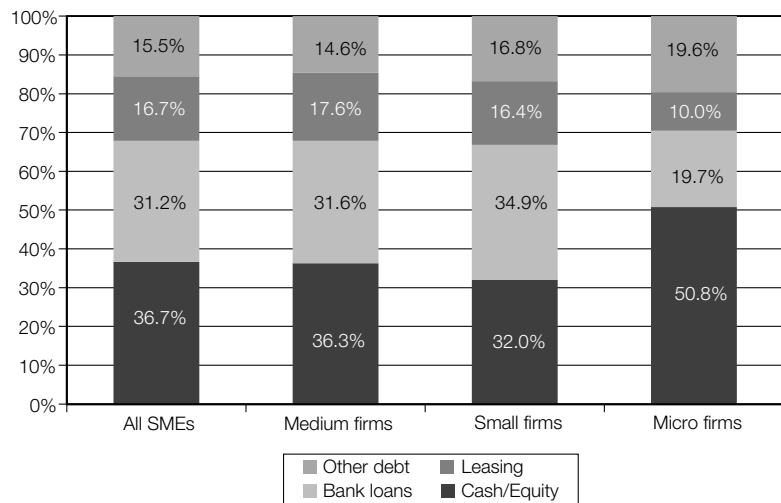
As depicted in Table 3, the estimated total new SME leasing volumes show remarkable differences across countries. France held the leading position in 2010 with an estimated new SME leasing volume of €19bn. In contrast, SME leasing plays a smaller role in the Netherlands.

What kind of SMEs use leasing? When looking at different enterprise size classes in the EU, the use of most external financing sources on average increases with company size (see Table 4); the same applies to leasing (including hire purchase and factoring).

According to the 2013 results of the European Commission's (2013a) SMEs' Access to Finance Survey, only 19% of SMEs with one to nine employees used leasing (including hire purchase and factoring) as a funding source, compared to 43% of business with 10 to 49 employees, 54% of businesses with 50 to 249 employees and 60% of large enterprises (with 250 or more employees).

According to the European Commission (2013a), there was also a difference by turnover: While approximately half of the companies with a turnover greater than €2m made use of leasing, hire purchase or factoring, only 24% of SMEs with a smaller turnover used this type of financing. SMEs in the industry sector were more likely than those in other sectors to have used this source – 42% had done so, while those in the trade sector were least likely (31%). These results are broadly in line with the findings of Oxford Economics (2011).

Table 2: SMEs' fixed asset investment financed by different sources in 2010, by size class



Source: Oxford Economics (2011).

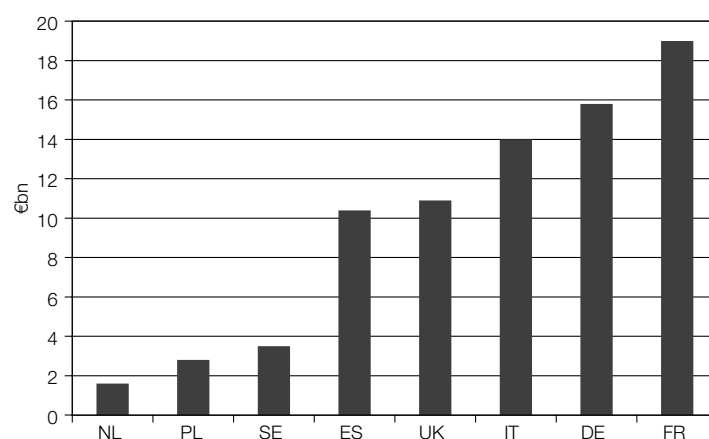
While it is generally difficult for young firms to access external financing sources, SMEs' access to leasing seems to develop quicker than the access to other sources of external financing as depicted in Table 5. According to the Oxford Economics (2011) survey, the relative importance of leasing was highest for relatively young enterprises aged between two and five years.

The advantage of leasing for young SMEs and other enterprises that are considered to bear comparably high credit risk is also shown by relatively low rejection rates. Despite an increase from 2007

to 2010, leasing remained the financing source with the lowest rate of unsuccessful applications.

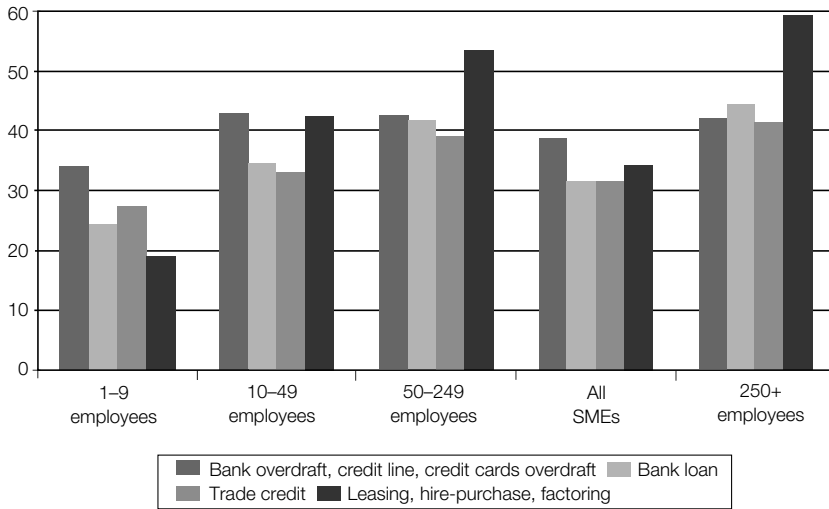
Moreover, the success rates in obtaining leasing finance are relatively similar between the so called gazelles, i.e. the young high-growth enterprises, and all SMEs. For other forms of finance (e.g. bank overdrafts or credit lines) gazelles show considerably lower approval rates than other enterprises in most countries (see also Table 6). Thus, the OECD (2012) concludes that "[l]easing is the form of finance that appears to be equally suitable for enterprises with dif-

Table 3: Estimated new SME leasing volumes by country in 2010



Source: Oxford Economics (2011).

Table 4: EU enterprises having used different financing sources (by enterprise size class)



Note: Over the preceding six months; percentage of respondents; survey conducted from August to October 2013.
Source: European Commission (2013a).

ferent growth characteristics, with approval rates relatively similar in most countries.”

A closer look at differences by country. When looking at country level, large differences in the use of leasing appear (see Table 7). In the latest period (August to October 2013) for which the European Commission (2013a,b) survey was conducted, 34.5% of SMEs used leasing, hire purchase or factoring in the whole EU. However, while approximately half of all SMEs made use of

these instruments in Germany and Estonia, their use was relatively small among SMEs in Cyprus, but also in Romania and Greece.

Why and how do SMEs use leasing? According to Oxford Economics (2011), SMEs on average have a variety of reasons for their decision to lease an asset (see Table 8) – the main reason seems to be price considerations (price of leasing relative to other financing forms).

The importance of different reasons for using leasing becomes clearer when

looking at different SME size classes. For example, medium-sized enterprises seem to lease due to price considerations, better cash flow management and the absence of the need to provide collateral. In contrast, micro-enterprises stated tax benefits next to price considerations as main reasons to use leasing. Interestingly, the absence of collateral requirements seems to be less important for micro-enterprises than for small or medium-sized firms.

Reasons for leasing vary more over countries than over sectors; this could be due to different tax and regulatory environments. For instance, collateral considerations were most important in France and Italy, while tax benefits were mainly stated in the UK.

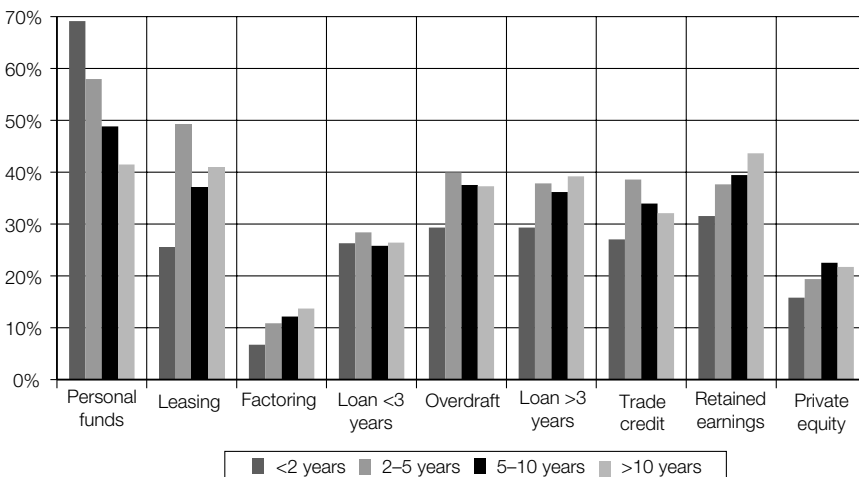
The choice of a particular financing source can also depend on the specific investment type, e.g. on the asset which is financed. SMEs typically lease a broad range of assets; however, vehicles of various types account by far for the biggest share.

Support measures in favour of leasing for SMEs. Leasing is an important financing tool for SMEs which provides financing close to the investment periods of the leased assets. However, in the current financial and regulatory environment, also the leasing companies themselves have distorted access to (re-)financing. Public support of this instrument can help to mitigate market weaknesses and to enhance the access to finance for SMEs.

The problems are different depending on the ownership model of the leasing companies. According to Leaseurope and KPMG (2012), 50% of European leasing companies were bank related, 18% captives, and 32% independent in 2010.⁵ However, in terms of shares of new volumes “90% of the European leasing market is in the hands of bank-owned leasing companies” (Mignerey, 2012). Moreover, “whether bank-owned, captive or independent, European leasing companies heavily rely on the banking sector to fund their operations” (Mignerey, 2012).

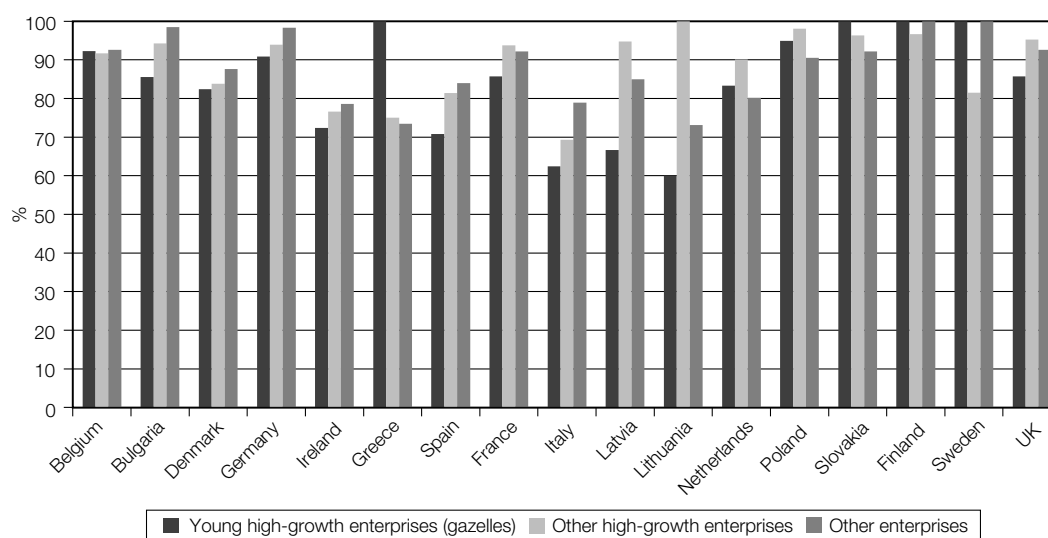
The financial crisis has not only affected banks and their leasing affiliates, but the leasing market in general has been particularly affected by the worsening of refinancing conditions. According to a survey among German leasing companies (Hartmann-Wendels and Pytlík, 2010), leasing companies which are independent from banks and manufacturers were hit the most. Several banks have reduced or fully abandoned the refinancing of leasing

Table 5: Use of financing source by SME age class in 2010



Source: Oxford Economics (2011).

Table 6: Success rates in obtaining leasing in 2010



Source: OECD (2012) and Eurostat.

companies, due to scarcity of banks’ own resources, regulatory requirements, or management decisions to stronger concentrate on core business activities.

Hartmann-Wendels and Pytlik (2010) state that a significant reduction of active refinancing partners was reported by leasing companies, in particular by smaller ones. Moreover, collateral requirements have considerably increased.

According to Mignerey (2012), the decision of some parent banks to downgrade leasing to the status of a “non-core” business was “simple to understand: leasing did not bring what banks needed, i.e. deposits; leasing required what banks were lacking, i.e. capital and liquidity”.

These developments are different from past recessions, when leasing companies were “only” hit by reduced overall investment activities which could often be compensated by an increase in leasing penetration rates (Hartmann-Wendels and Pytlik, 2010). This time, the deterioration in the access to refinancing came on top. Moreover, many independent leasing companies are also hit by structural problems such as a low equity base or a lack of specialisation which often leads to relatively low residual values of the leased assets in their balance sheets.

Support by the European Investment Fund (EIF) can mitigate such market distortions, thereby enabling the financing of new leases to SMEs and contributing to enhance their access to long-term financing.⁶

The following section describes a range of EIF guarantee products that are available to help the leasing industry support European SMEs. The focus is on those products where the EIF uses its own resources (in full or in part) to fulfil its central mission to support Europe’s SMEs (see Tables 9 and 10).

In addition to these products, the EIF also operates mandates (including from the European Commission) to channel EU and governmental funding to SMEs through financial instrument programmes such as CIP, JEREMIE and Progress Microfinance.

Further options for leasing companies under new mandates at European, national and regional levels can be expected in the future.

Concluding remarks. The intention of this paper was to enhance the awareness of leasing (and its importance) as *additional* financing technique for SMEs that expands the access to short- and medium-term financing for capital equipment.

Leasing is an alternative instrument to facilitate access to finance; it enables in particular new/young enterprises (including the so called “gazelles” (OECD, 2012 and 2014)) without credit track record and limited possibilities to provide collateral the use of capital equipment. As such, it also mitigates market weaknesses of SME lending.

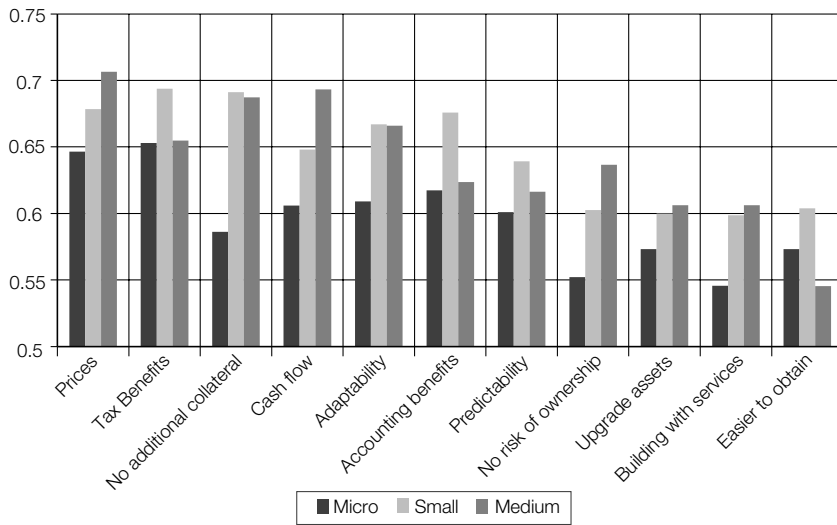
SMEs expect leasing to stay of high relevance as integral part of their financing tool set. However, the supply side has come under extraordinary pressure in the

Table 7: SMEs having used leasing, hire-purchase or factoring in different countries

EU 28							
34.5							
Germany	50.7	Austria	41.3	Slovakia	33.4	Belgium	24.4
Estonia	48.9	UK	39.5	Lavia	32.6	Hungary	24.2
Sweden	46.5	Poland	38.2	Slovenia	30.3	Italy	19.8
Finland	45.2	France	37.8	Bulgaria	29.8	Portugal	19.7
Luxembourg	45.2	Netherlands	36.6	Malta	27.3	Greece	17.7
Denmark	43.5	Czech Republic	35.8	Ireland	25.6	Romania	17.3
Lithuania	42.1	Croatia	35.5	Spain	25.3	Cyprus	7.0
Non-EU countries							
Norway	41.3	Iceland	21.3	Montenegro	10.9		
Liechtenstein	34.4	Turkey	18.0	Albania	9.1		
Serbia	26.0	FYROM	17.6	Israel	4.0		

Note: Over the preceding six months; percentage of respondents, survey conducted from August to October 2013.
Source: European Commission (2013b).

Table 8: SMEs' reasons to use leasing



Note: 0=not at all important, 1=very important.
Source: Oxford Economics (2011)

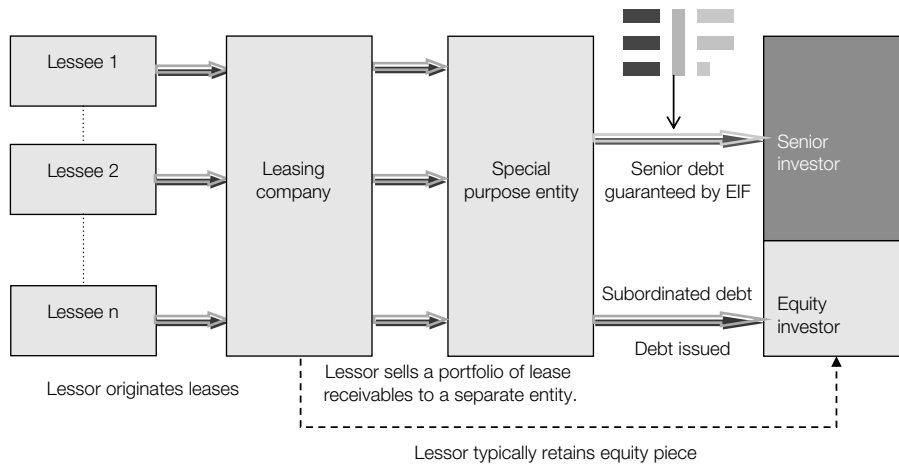
current economic and financial crisis. Thus, support via the European Investment Fund not only helps to enhance the access to finance for SMEs – including leasing – in general, but also to counteract the severe impact of the financial crisis on the refinancing conditions of leasing providers.

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Table 9: Structured finance

EIF, via the securitisation instrument, can help leasing companies find an alternative source of funding. An originated portfolio of leases can be sold to a separate bankruptcy-remote entity and funds can be raised in the capital market via the issuance of debt. EIF can facilitate the placement of debt with third-party investors by guaranteeing the timely payment of debt's interest and principal. The diagram below illustrates a plain vanilla structure; however EIF can offer more complex and bespoke solutions.



Target originators	How can EIF help?
EIF targets financial institutions committed to SME financing. This includes leasing originators of all types and sizes, such as: <ul style="list-style-type: none"> • Banks' leasing subsidiaries; • Banks; • Independent leasing companies, including smaller, unrated companies typically funded through bank lending. EIF typically guarantees senior debt sized between €50m and €100m.	EIF can help leasing companies find financing in challenging times. EIF has a pool of investors keen to invest in products guaranteed by EIF with an attractive all-in cost for the originators. The confidence given by EIF's participation in a transaction as a guarantor could also make it easier to find third party investors. EIF will be involved in the early stages of any transaction and will help guide first-time issuers through the process.

Requirements

EIF has a flexible approach aimed at facilitating deal execution. The EIF Guarantee is charged at a market rate, dependent on the risk taken by EIF. EIF will also request a letter from the leasing company committing to lend a certain amount to SMEs as a function of the Guarantee. EIF will always perform its own due diligence and require certain data from leasing companies in order to assess the risk of the transaction.

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- The report is based on a survey about the use of leasing conducted amongst almost 3,000 SMEs across eight EU Member States and nine industrial sectors in July 2011. The eight countries (France, Germany, Italy, Netherlands, Poland, Sweden, Spain and the UK) represent 78% of new leasing volumes in 2010.
- Differences in the Oxford Economics (2011) and the ECB (2013) survey results could be attributed to different survey samples/country base and definitions of the financing categories included. However, the main findings concerning the relative importance of leasing are similar.
- Percentage of European leasing companies according to shareholder type.
- The EIF, part of the EIB Group, is the European body specialised in SME risk financing; its central mission is to support Europe's SMEs by helping them to access finance. For more information see: www.eif.org and EIF and Leaseurope (2013).

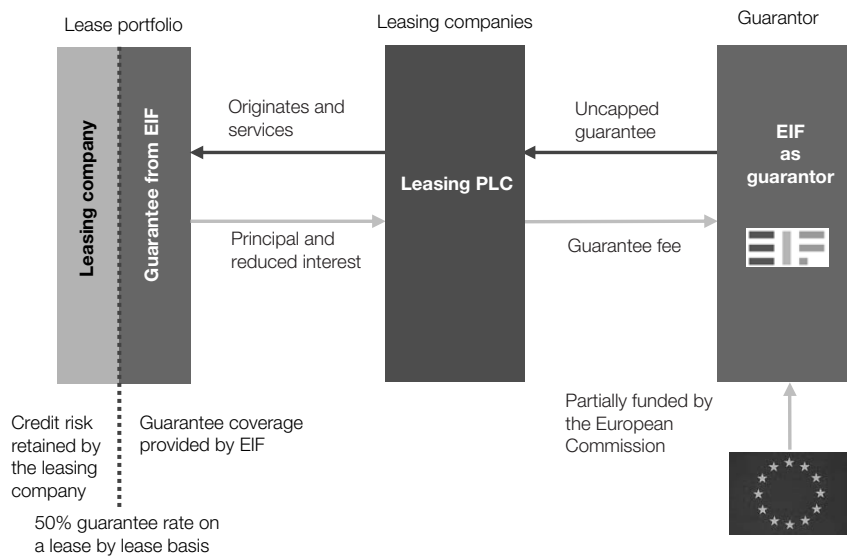
Notes:

- Helmut Kraemer-Eis heads the European Investment Fund (EIF)'s Research & Market Analysis (RMA). Frank Lang is Senior Manager in RMA. The opinions expressed in this paper reflect the views of the authors, which do not necessarily correspond to the opinions of the European Investment Fund or the European Investment Bank Group. This article is based on Kraemer-Eis and Lang (2012).
- For the ECB survey, leasing is grouped together with factoring, which is also a form of asset-based lending. Leasing is based on physical assets while factoring is based on receivables.

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Table 10: The Risk Sharing Instrument (RSI)

RSI is a pilot guarantee scheme sponsored by the European Commission to support innovative SMEs and small mid-caps. It enables leasing companies to share their risk with EIF on their new leasing activity, in exchange for an attractive fixed fee. Under RSI, EIF provides uncapped guarantees to leasing companies (including those mentioned under Structured Finance) on 50% of each eligible lease. The diagram below illustrates how the scheme operates.



What is an innovative SME or small mid-cap?

RSI supports SMEs and small mid-caps (companies with fewer than 500 employees) that have innovation potential or a focus on R&D. These are defined as companies that meet one of the following criteria:

- They invest in producing or developing innovative products, processes and/or services that present a risk of technological or industrial failure; or
- They are innovation-driven “fast growing enterprises”, i.e. their workforce or turnover has increased by at least 20% p.a. over the last three years; or
- They are “innovative” enterprises, i.e. satisfying at least one “innovation criterion” out of a set of pre-defined eligibility criteria.

Mechanics of the guarantee

The origination, credit analysis, decision process and servicing, are fully delegated to the leasing company based eligibility criteria set ex ante. The Guarantee is fully automated and as such, automatically covers leases for 50% of any principal and interest loss. Payments under the Guarantee will be made upon default, with a pro-rata sharing of recoveries. EIF has developed a lean and pragmatic quarterly reporting system.

Benefits to leasing companies

By reducing their risk, leasing companies can reduce their risk margins and increase both competitiveness and market share. Leasing companies not active or less active in the innovative SMEs and small mid-cap space can venture into this area, with the knowledge that losses can be minimised with the help of RSI.