

## Leasing in Ukraine

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### Summary

The Ukrainian Leasing Market has expanded rapidly over the past two years, following the enactment of a new Law on Leasing. It has substantial potential for further growth as the market is still immature as compared to other similar countries. The barriers to entry into the leasing market are relatively easy and this situation has led to growing competition with strong foreign capital flows into the sector.

### Potential Size of the Ukrainian Leasing Market

The potential leasing market in Ukraine is quite large as the country will require significant investments to renovate its obsolete productive assets. Official government statistics indicate that \$90 billion is required to renew fixed capital stock (a figure close to almost 100% of GDP), though some experts believe that the real figure is close to \$170 billion. The average depreciation of fixed assets in the economy is 50%. In sectors such as agriculture, industry, construction, water and air transportation, the average depreciation of fixed assets is 60%. For transportation and industrial equipment alone the average depreciation is believed to be 80-90%. Many industries suffer from insufficient investment in capital assets due to high cost of capital and lack of long-term debt financing.

In the last few years, the Total Investment in Fixed Capital in Ukraine has grown at a fast pace, as shown below:

In billion Hrivnias

2003	2004	2005	2006
51.01	75.71	93.10	125.25 (\$24.8 billion)

Another indication of the potential leasing market is that the ratio of leased assets to GDP is very low at 0.63% (in 2006), up from 0.31% (in 2005). This indicator is far below other countries, such as Russia (1.1%) and Romania (3.2%).

In developing countries with high GDP growth rate, leasing accounts for 10–15% of investments in capital assets. This number is only 1.5% in Ukraine. The average economic growth in Ukraine was 7.5% during 2000–2006, with good prospects of sustained high growth in the future.

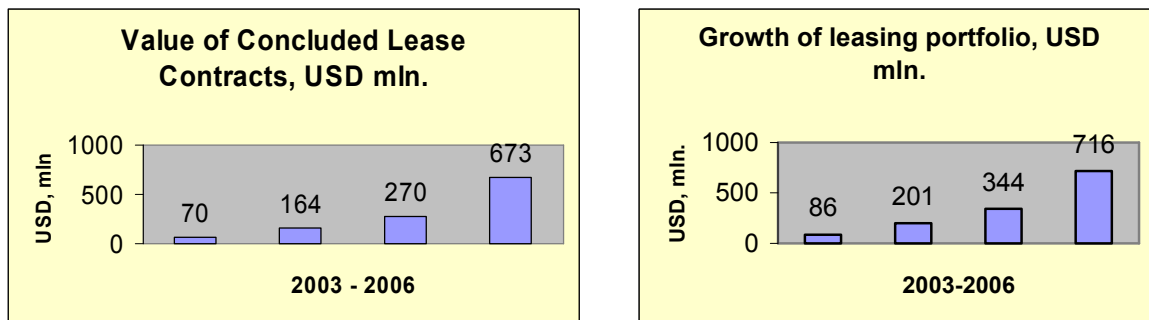
Therefore, the potential market for the leasing sector could expand to \$2.5 billion and higher per year contingent upon improvement of the business and legal environment.

The 2007 IFC survey of companies active in the Ukrainian leasing market showed that these companies expect their portfolio of leasing agreements to reach \$4.4 billion in coming years. As of January 2007, the portfolio of leasing agreements increased by 100% to \$650-\$716 million from \$353 million as of January 2006. However, it should be noted that since the sector is relatively small, large single contracts, such as the leasing agreement with Ukrainian railroads, contribute a great deal to this high growth rate.

## The Leasing Industry

As of June 2007, the Ukrainian Commission on Financial Services registered 136 companies, thus authorizing them to conduct leasing operations. According to the International Finance Corporation (IFC) only 65 of these companies carried out leasing operations (as of January 2007) as compared to 50 companies in 2006 and 34 companies in 2005.

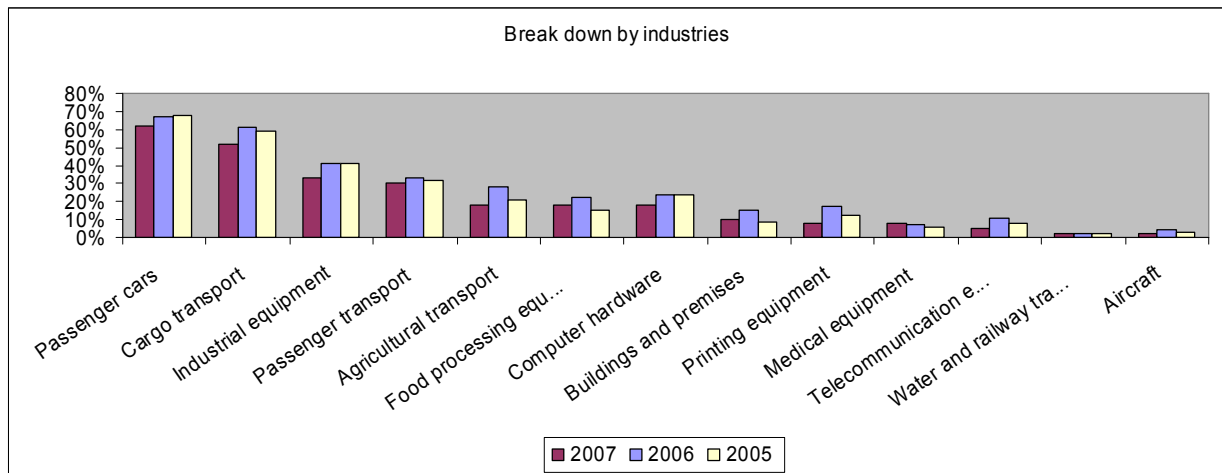
There are about 10 registered international leasing operators (such as TBI Leasing, Dutch held). Market operators believe that about a dozen companies “dominate” this sector. The share of foreign sourced capital in the authorized capital of the leasing companies is 46% (30% in the banking system). Official statistics shows that employment in the sector stands at 1395 people.



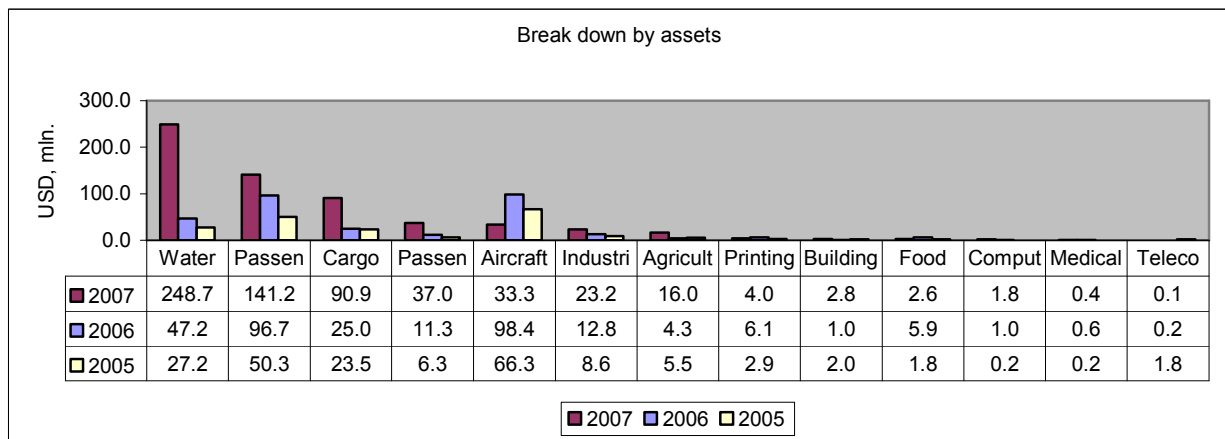
Source: IFC

In 2006, Ukrainian customs registered \$339.5 million worth of imports under leasing contracts. The share of financial leasing deals was \$75.7 million (23.4%). For the first 5 months of 2007, imports under leasing contracts reached \$140 million with a slight increase of financial leasing.

Target customers/industries: Almost half of the leasing companies work with individuals (entrepreneurs) and large companies (sales above EUR 5 million). Two-thirds of the leasing companies work with small and medium enterprises. The current leasing portfolio reflects the structure of demand and risks in different industries. The two charts below show: (1) percent of leasing companies working in the indicated sub-sectors, and (2) break down of companies' portfolio by property types:



Source: IFC survey 2007



Source: IFC survey 2007

The representatives of the leasing companies tend to rank the attractiveness of properties for leasing according to the following order of priorities: transportation vehicles (all types), agricultural machines and equipment, oil refinery equipment, construction machinery and equipment, construction materials, manufacturing equipment, other manufacturing equipment, bank equipment, food processing equipment, printing equipment, entertainment equipment, and medical equipment. The IFC's own priorities are as follows: (1) transport, (2) agro-industrial, (3) manufacturers, (4) small businesses and start ups.

The statistics on industrial growth by sector may also give some guidance on the potential demand for leasing, though the conclusions will need to be validated by other means. The table below shows growth in different industrial sectors for the past four years:

Industrial Production by Sectors, yoy % change	2003	2004	2005	2006
<b>TOTAL</b>	<b>115.8</b>	<b>112.5</b>	<b>103.1</b>	<b>106.2</b>
<b>Extractive</b>	105.5	104.1	104.4	105.8
energy materials	103.6	101.9	103.1	103.3

non-energy materials	109.1	107.6	105.7	109.5
<b>Processing</b>	<b>118.2</b>	<b>114.6</b>	<b>103.0</b>	<b>106.3</b>
Food	120	112.4	113.7	110
textile and clothes	102.9	114	102.6	95.2
Leather	107.5	112.5	91.9	110.3
Wood/wood processing	123.6	125.5	119.5	113.9
Pulp/paper	125.7	125.9	112.7	110.3
Coke- and oil-refining	108.7	103.4	86.6	87.9
chemical production	116	111	107.8	100.9
rubber and plastic	120.7	128.8	117.6	111.1
Other non-metal mineral products	117.9	119.3	114.3	112.8
Metals and metal processing	114.3	112	98.5	108.9
machinery and equipment	121.4	118.9	112.2	102.9
electric equipment	119.2	149.3	90.8	110.7
transportation equipment	162.1	124.6	112.4	119.1
<b>Electricity, gas and water</b>	<b>104.7</b>	<b>98.9</b>	<b>102.9</b>	<b>106.7</b>

Ukraine's economic growth is expected to be around 6-7% during the next two years and slightly decelerate to 5-6% in subsequent years. These rates of growth are quite high and should be reflected in growth of demand for leasing, depending on the leased property "cost to the lessee" factor and available alternatives for financing.

Most leasing operators believe that demand for leasing will continue to be high and that the major problem in the sector is obtaining adequate data to check the solvency (cash flows) of the potential lessees and manage their portfolio.

## **Growth Expectations and Trends**

It is widely expected that transportation vehicles - including passenger, cargo, aviation and water transport - will be the largest and fastest growing segment due to high current demand, lower risk and fast pay off factors (now 78% of agreements are transportation vehicles). But other sectors will also show accelerating growth, not only due to lowering costs to lessees, but also because of increasing awareness of the leasing alternative and some improvement in taxation.

Agriculture is a lucrative target market, but it requires good management as it may involve considerable risks. The default rates in agriculture range from 17% to 45%, compared to average default rates of 12% for the leasing sector as a whole.

The potential for growth of leasing in agriculture is quite large, particularly because the availability of agricultural machinery is low. For example, one harvester currently cultivates 320 hectares of land (compared to 60 hectares in the USA) and one tractor cultivates 90 hectares (compared to 28 hectares in the US). The number of harvesters decreased 11% during the past 6 years. The IFC estimates that approximately 40% of all tractors in Ukraine were manufactured 15 to 25 years ago. Agricultural experts and the IFC believe that demand for tractors and harvesters should be at least \$460 million annually during the next few years. The agricultural sector is quite important in Ukraine, representing 8% of GDP in 2006.

The demand for leasing may also be boosted by the fact that obtaining financing in general is becoming more attractive for businesses. The cost of borrowing is expected to decrease further. If in December 2006 the weighted average cost of borrowing was 15.1% in Hrivnias and 11.5% in hard currencies, in May 2007 it was 13.4% in Hrivnias and 11.4% in hard currencies (Source: National Bank of Ukraine).

Other expected trends in the leasing market are as follows:

- Competition will force leasing companies to further reduce the down payment on lease agreements and financial institutions will finance longer term leasing agreements.
- The share of small and medium business should continue to increase with an improved business environment and lower risks.
- Cross-border leasing operations should substantially grow after the importation regime of leasing operations change.
- The legal environment should steadily improve to support growth in the sector.

## **Government Regulations and Taxation**

The Commission on Financial Services is the government agency responsible for registration and oversight of leasing companies. The banking license includes leasing as one of the services of the bank. As compared to the banking license, it is fairly easy to register a leasing operations/company. Nevertheless, several leasing companies reported long delays and a number of problems with their registration.

Leasing operations are governed by the Civil and Commercial Codes, by the recent Law on “Financial Leasing” and Legal Acts on Taxation (Law on VAT, Law on Corporate Profit Tax), and by the Unidroit Convention on International Financial Leasing (which came into effect on July 1, 2007).

The Law on “Financial Leasing” does not clearly define operational and financial leasing. Nevertheless, the tax authorities treat leasing operations according to criteria provided in the Law on Corporate Profit Tax (which is in line with international practices for operational, financial, and lease-back leases).

For the accounting treatment of leasing operations, three National Accounting Standards apply: NAS #14 on “Rent”, NAS #7 on “Fixed Assets” and NAS #16 on “Costs”. These standards are close but not fully in compliance with international accounting standards (IAS #17 "Leases", IAS #16 “Property, Plant and Equipment”), including depreciation methods.

Furthermore, for business planning purposes it is necessary to consider “tax” accounting rules, which are quite different and governed by different legislation. There are several problems in regards to tax treatment of leasing operations that increase the cost of an asset to a lessee.

In financial leasing, the leased property is accounted for on the asset and liability sides of the balance sheet of the lessee. The asset is depreciated by the lessor in tax accounting. The transfer of property is treated as a “sale” from the lessor to the lessee and the payments for the leasing operation are “service” revenues. The difference between purchase price and leasing contract price is subject to profit taxes with deduction of most expenses. The depreciation expense rates are shown below:

**Maximum depreciation expense allowed per quarter**  
(contract price is the initial base value)

Classified into groups of assets:		% to base value	Annual (first year)
Group 1	buildings, structures, their structural components and transmission devises	2%	
Group 2	transportation vehicles, household electric, optical and mechanical devices and tools, other office equipment etc.	10%	34%
Group 3	any other fixed assets not included in groups 1, 2 and 4	6%	22%
Group 4	computers, automated data processing equipment, computer software etc.	15%	

*Important: The depreciation is applied to a group of assets on the balance sheet, not to a separate item under financial lease.*

Leasing operators believe that one of the issues with taxation is that accelerated depreciation methods should be applied to Group 3 to make financial leasing a more attractive investment instrument. This mostly relates to the residual value in tax accounting and market value at the time of closing of the financial leasing transaction.

The leasing payments to the lessor are recognized as gross revenues. But the main problem is that the allowed depreciation expense for the lessor sometimes is less than the amount (part) in the lease payments for the cost of equipment (principal). This difference and lessor commissions are taxed as profits. In effect, the lessor’s working capital or principal on the loan (to purchase equipment) is taxed. Therefore, the lessor has to increase his commission to avoid such a “loss”. Insurance and debt costs and operational expenses are recognized as gross cost. There is also a restriction on insurance payments (how much of the insurance payment can be classified as cost).

There are also the following problems regarding the VAT (value added tax):

- In a financial leasing operation, the lessor has to pay:
  - VAT on all extra value added to the purchased property.
  - VAT on the portion of the lease payment that exceeds two times the discount rate of the NBU (National Bank of Ukraine). The primary NBU rate is 8% as of May,

2007. So the lease payment as a percentage of the contract value should not exceed 16% to avoid VAT liability. In effect, this is a special taxation of the leasing operation.

- In an operational lease, each payment is subject to VAT, although VAT on purchases is treated as a tax credit.
- The operational lease of automobiles has a special tax treatment. Only 50% of the lease payment may be related to gross costs by a lessee.
- The withholding tax on a lease payment under a cross-border lease applies to the entire amount of payment, including principal (payment against cost of the equipment).
- The property under a leasing agreement, including a “temporary import regime,” is subject to VAT and import duties upon entry of the border with few exceptions.

### **Expected Changes in the Leasing Sector**

The Cabinet of Ministers has completed the elaboration of the *Draft Tax Code*, which includes improvement of the tax situation of leasing operations. It will be submitted to the Parliament for voting in the second half of 2007. The main changes are as follows:

- Principal amounts will not be subject to a withholding tax when transferring money, only interest and commission will be taxed.
- The differences between tax accounting and bookkeeping will be substantially reduced, specifically in regard to amortization and depreciation.
- The rule when the amount of a lease payment in excess of double the National Bank rate is subject to VAT will be changed. The triple National Bank rate will apply.

*The Civil Code and Law on Financial leasing* will be amended to include provisions on (i) the lessee right to buy an asset at residual value or pay its full value under lease agreement, (ii) forms of leasing to be clarified, (iii) procedures on repairs and (iv) identifications of equipment flaws (not clearly defined now).

The *import regime under leasing contracts* will also change. The draft law was voted on in the first reading. Imports under leases (cross-border lease) will be taxed at 3% from the amount of VAT and import duty (liability) under the leasing contract.

### **Factors that Hinder the Development of the Leasing Sector**

- The legal environment hampers sector development due to legal issues and ineffective taxation, including (i) VAT taxation of financial leasing operations (twice the NBU rate rule), (ii) the discrepancy between the useful life of a leased property as compared to depreciation allowances, (iii) restrictions on allocating insurance costs to “gross costs” (tax deductions);

- Insufficient human resources with experience in the leasing sector becomes a substantial constraint (USAID runs a project on training qualified personnel for leasing companies);
- Limited opportunities to obtain debt financing for leasing operations;
- Low awareness of businesses about leasing opportunities, especially among small and medium businesses.

## **Leasing Companies Operating in the Market**

The following companies operate in the leasing sector:

1. State leasing companies: “Ukragroleasing,” “Leasingtechtrans” and “Ukrtransleasing.” These companies were created and are funded by the government. “Ukragroleasing” operates in agriculture and purchases the produce of Ukrainian companies. In 2006, this company leased 600 pieces of equipment (\$31 million.) In 2007 it has already purchased 837 pieces of equipment for \$25 million and has an annual plan to lease equipment for \$65 million. Recently, it created a joint program with Prominvestbank (one of the largest banks by assets) to lease Western harvesters and tractors. Ukrtransleasing operates in aviation, transportation and agriculture. This company plans to lease 70 Ukrainian Antonov aircrafts. Also, it recently won the tender to lease 2050 railway cars to Ukrainian regional railroads. Leasingtechtrans was recently created with the aim to lease the newest product of Antonov aircrafts AN-148. The data in the IFC surveys does not cover these government leasing companies.
2. Ukrainian equipment producers carry out leasing operations on a limited scale. For example, Ukragromashinvest was created as a state owned company in the machine-building industry. Now it is privately run company that operates as a holding company (has equity in machine-building companies) with leasing operations. Other examples are AIS, Bohdan Leasing, etc.
3. Few foreign producers are running leasing operations in Ukraine (Scania Credit Ukraine).
4. Car rental companies: AVIS, SIXT, Hertz (ALD Automotive).
5. Many Ukrainian and foreign financial institutions opened subsidiary companies to run leasing operations. Practically all foreign banks that acquired Ukrainian banks operate in the leasing sector (BNP Paribas, Raiffeisen, SEB Bank (Sweden), UniCredit, Banca Intesa, Societe Generale Equipment Leasing). Ukrainian Banks include Arma Bank, Ukroprombank and Ukreximbank, but many other Ukrainian banks do not operate in this segment.
6. There are leasing companies established by international operators, such as Glav Leasing (Russian), TBI Leasing (Dutch), and First Lease Finance (Dutch held).
7. Some leasing companies are independent from producers and financial institutions, such as Leasing House, Leasing Business Solutions and Kapital Leasing. Banks may hold equity in these companies, but they are not subsidiaries.

8. There are also registered companies that do not currently have operations in the market.

It is not clear who the leaders are in the sector, since companies tend to specialize in certain industries. ALD Automotive's portfolio grew from \$45 million to \$90 million in 2006. This company provides 2,500 vehicles for leasing and plans to increase its portfolio to 4,500 by the end of 2007 (Societe Generale group). /Source: mass media/

Very few companies on the market perform only operational leasing operations (10%); the share of financial leasing is steadily increasing. According to an IFC survey, 57% of companies perform financial leasing operations (47% in 2005). Only a quarter of the operators on the market offer lease-back transactions. Leasing companies offer a number of additional services, including registration of property, consultations, securing guarantees, customs clearance, etc.

Foreign owned leasing companies have comparative advantages over Ukrainian businesses due to lower financing costs and faster decision-making processes.

## **Risks and Profitability**

One of the challenges in the leasing industry is to carry out a sound credit history check of a potential lessee. In Ukraine, there are four credit history companies, although they have relatively small databases that are not adequate to the needs of the sector (the International Bureau of Credit Histories, the Ukrainian Bureau of Credit Histories and the First Ukrainian Bureau of Credit Histories). As a result only 8 leasing companies requested information from the credit history companies. Each bank maintains its own credit history database, which is not shared among the banks. The other sources of information on the solvency of the potential lessee are the public administration structures, references from other companies and State Registries on indebted properties. If large businesses generally do not pose problems, small and medium business (especially registered as LTD, the owners of which are not liable for companies' liabilities) used to be much less transparent. The IFC survey shows that, on average, every leasing company has had to initiate the return of property in 1-4 cases (contracts), which is a fairly low rate given the companies' portfolios. The IFC survey shows a default rate of 12% on average. This was achieved due to careful due diligence and selection of potential lessees in a market with strong demand.

### *Legal Remedies for Companies in Default*

The Law on Financial Leasing allows a lessor to use a Notary Public to repossess the property and collect lease payment from a lessee account. This mechanism is fairly easy and fast. It is enough to submit documents to the Notary Public who reviews the documents and authorizes the bank and State Executors Service (or according to the contract) to withdraw the leased property from a defaulting party. Although, the lessee may cause various obstacles for the State Executor. The 2007 IFC survey on leasing shows the use of the following mechanisms of repossession:

<b>Repossession mechanisms</b>	<b>% of companies using each type of repossession</b>
<i>According to the contract between the parties</i>	30%
<i>Court Suit</i>	26%

<i>By mutual agreement between the parties</i>	22%
<i>Court Order</i>	13%
<i>Notary Public writ</i>	9%

The Court Suit and Court Order are similar mechanisms (summing 39%). The cost of repossession of property might add up extra cost to its value, including courts, notary public and executive service fees. Therefore, the companies have to rely on their due diligence capabilities, comparatively large down payments and even seek additional collateral or guarantees of payment.

<b>Additional collateral and guarantees</b>	<b>% of companies resorting to these forms</b>
<i>Advance payment</i>	100%
<i>Insurance</i>	100%
<i>Contract penalties</i>	62%
<i>Bail surety</i>	43%
<i>Pledge on other property</i>	22%
<i>Guarantee</i>	17%
<i>Other types of advances</i>	7%
<i>Other</i>	13%

*IFC Survey 2007*

The leasing property that is subject to state registration possesses lower risks because such registration makes it easier to repossess it. The leasing company usually requests the government agency to suspend the lessee right to use the property.

All extra expenses of the lease are usually included in the contract price. The down payment serves as an additional guarantee against losses in case of repossession and resale of the leased property for the reasons mentioned above. Currently, the average down payment is 20%, down from 21% in the prior year and about 30% five years ago.

### *Profit Margins*

It is rather difficult to estimate the profit margins of the companies in this sector. As a rule, the lease payments might include insurance costs, lessor commission, interest on the loan, taxes, extra costs and amortization of the principal. The lease contract usually provides a lump sum to cover these costs.

The variables that affect the lessor margins are the following:

- The insurance fee is subject to negotiations between the parties, although lessors prefers to insure the leased property, lease rates vary from a fraction of one percent for equipment to 4–5 % for transportation vehicles.
- The cost of capital is higher for domestic companies compared to companies established by foreign owned banks (financial institutions) in Ukraine or parent manufacturing companies that receive financing from the parent companies.

For business planning purposes, it is feasible to investigate what margins the market can bear, particularly by industry since the cost of a lease to a lessee varies across industries and products. The weighted average cost of borrowing in Hrivnas is 13.4% as of May 2007 (NBU), although the cost of debt capital for Ukrainian leasing companies might be higher. According to the 2007 IFC survey, Ukrainian resident banks financed 60% of all leasing contracts (74.4% in 2005). The non-resident banks financing of the leasing sector increased to 23.8% (up 225% a year earlier). The share of suppliers remains very low at 0.8%. This survey result is not entirely consistent with official statistics. According to the NBU, resident-banks financing of leasing operations (financial leasing) amounted to \$49.1 million out of \$9.9 billion provided to investment activities (20% of all outstanding loans).

Operational leasing bears the additional cost of creating an infrastructure for storage and sometimes maintenance facilities of the equipment.

### **Prudential Policies of Leasing Companies**

Only one third of the leasing companies in the sector set up restrictions regarding the value of a leasing contract(s) for one single lessee, and 17% of companies do not have any restrictions policies. Most of the contracts allow purchase of the leased property before the leasing agreement expires. Only a quarter of the companies have experience with subleasing.

In 2006, the leasing portfolio of Ukrainian companies had the following terms:

***Contracts:***

1 year or less	From 1 – 2 years	From 2 to 3 years	From 3 to 5 years	Longer than 5 years
5%	13%	60%	20%	1.7%

*Source: IFC*

**Annex: Leasing Companies in Ukraine**

VAB Leasing	A – Leasing	ALD Automotive	Arma Leasing
Atompromkomplekt	ATON XXI	Bohdan Leasing	BUK Leasing House
Car Leasing Company	Diamant Bank	DrivePort LLC	Energoleasing
Energy Alliance	Euro Leasing	Finlex-Consulting	First Lease Finance
First West-Ukrainian Leasing Company	Galeon	Garant Leasing	Glavleasing
Ilta	Index-Bank	International Financial Agency	International Leasing Company
Intrans-Holdings	Krokus Leasing	LandLease	Lasca Leasing
LD Leasing	Lease IT	Leasing Business Solutions	KONFIL
Leasing House	Leasing Market	Nadra-Service	Onis
Optima Leasing/Sixt	OVTZ Max Auto	Panta Rei System	Promleasing
R.A.I.V. Service	Renta	Scania Credit Ukraine	SETCOM
Ukragleasing	Ukrainian Financial Leasing Company	Ukreximleasing	Ukrincomlease
Ukrmetexport	Ukrtransleasing	Ukrtransenergo	UniCredit Leasing
Universal Leasing Company	VAB Leasing	VIP Rent	