

Please Release Me, Let (s)Me Grow ...

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Leasing - the quintessential SME financing sector has been unable to take advantage of current SME demand, and looks poorly placed for growth in the UK and Europe. New technology and emerging markets may be the answer.

Leasing accounts for 25% of the annual UK capital expenditure market and serves 700,000 SME customers. By combining asset usage and distribution expertise leasing offers a different form of credit to businesses - one which can sit beside balance sheet lending products such as overdrafts and commercial loans in their financing portfolio.

So, as a complimentary and even competitive product to loans for SMEs, leasing could potentially have grown its market share even further during the recession. Not only were customers looking for an alternative, but the government has at times seemed desperate for an alternative to stimulate the small business credit market. However, in 2009 at the height of the crisis, leasing volumes did not compensate for reduced SME lending, they also dropped 30%.

That a surge forward didn't happen is down to the structure of the industry. After two decades of efforts to maximise the total share of SME credit spend and consolidate distribution, 90% of leasing in the UK is done by banks. With leasing and lending in the same groups, and without a separate identity in the capital markets, when lending collapsed, leasing did too.

The picture is even more glum behind the headlines. Future profitability depends on keener pricing and lower costs. But after two decades of consolidation of back offices and distribution, leasing is looking to either retail banking technology or its own outdated leasing platforms to engage with a market that requires more, rather than less differentiation, with service-rich offerings and bespoke pricing.

Banks therefore face a dilemma. When regulatory capital requirements are increasing, should they invest to differentiate and grow their leasing businesses, or continue to seek overlap and cost reductions by forcing leasing and lending closer together, and chasing big vendor accounts? In a recent LeaseEurope survey of the CEOs of Europe's major lessors, six out of seven saw only further bank-led consolidation in the next five years – not a future that is likely to fill SME customers with optimism about either choice or price.

There are two trends that suggest an alternative strategy is possible. While consolidation and back office cost reduction may be the prescription for bank owned lessors, a more profitable cost and product model is available to others. First, SME growth in emerging markets is creating attractive conditions for large scale leasing outside traditional markets, making investment in large scale SME service businesses an attractive proposition there. Second, technology developments favour leasing both in underwriting and cost reduction.

Growth rates are bigger in emerging economies than in developed economies. So are populations. China, India, Mexico, Brazil, Indonesia all have increasing scale in their financial services sector. According to McKinsey and the IFC, SMEs in emerging markets have un-intermediated cash balances

of \$150-180 BN, and a credit gap of \$700-850BN . Financial services in these economies have the macro conditions to prompt investment and development in SME products such as leasing. In the next phase of SME leasing, incumbents will face emerging market competitors with strong domestic demand. Those with the lowest cost and risk profiles will prosper, which is where new technology comes in to play.

SME leasing has its secret ways that differentiate it from lending. Technological developments favour these differences. Where an asset increases the productivity and profitability of a company, it becomes at least partly self collateralising – paying for itself and allowing the lessor to go further than a balance sheet lender. Close relations with the vendors provides additional risk sharing mechanisms, as well as a knowledge of the secondary market for end of term.

Asset usage, remarketing and collaboration with vendors are all aspects that are facilitated by greater data monitoring and collection capabilities. ‘Big Data’ - McKinseys term for the huge streams and databases of information now available- can significantly enhance leasing’s ability to differentiate itself in the credit market, allowing it to underwrite better and to innovate.

While both lending and leasing will continue to use financial records, payment data and other historic information, data storage and data transmission offers leasing the ability to track assets and asset usage in real time. The enhanced databases can be exploited in revised pricing and risk models. Real time asset usage will be a clear indicator of current financial health, occurring earlier in the financial cycle than either payment, or reporting. Leasing potentially could have the best underwriting information of any SME financial product.

Technology enables the sector to develop new services for its clients in asset life cycle management. Knowing how individual customers use their assets will prompt more efficient purchasing maintenance, and replacement cycles. Lessors will be in a position to sell their increased asset expertise to maximisation the value of the asset to the end user.

Technology developments continue to facilitate further cost reductions if organisations are willing to change. Online customer and vendor interfaces enable redesign of sales and customer services, reducing low value, high cost manual interactions. Where credit decisions are driven more by data mining than qualitative analysis, expertise shifts from manual intervention to algorithms. Neither shift is absolute, but both are sufficient to enable a slimmer organisation with different roles. Teams of underwriters can be replaced with fewer, more expert analysts. Field based sales and large back office staff become more empowered better trained, office-based sales.

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The starting point for engaging with new technology is important. Consolidators who have been buying up competitors since the 70s are in a difficult position from which to change direction.

Acquisitions and consolidation create legacy issues. The more you buy the bigger the legacy issue, and the bigger the bill to shift to a new technology strategy. Systems developed in the 70s and 80s were not designed to collect gigabytes of data real time, just as they were not designed to facilitate real time enquiry and account management by customers, with rapid price changing and asset lifecycle services. Despite advances in core system replacement, the cost and disruption is still enormous. The argument can only be won by increasing market share domestically or globally.

Leasing company owners are in a market that is growing in scale and in technological sophistication. Incumbents have the market share, the relationships, the expert staff but the wrong technology. Newcomers could deploy the right technology, hire the staff and attempt to win the relationships and gain share in the open market. In the face of current regulatory capital changes it seems a long shot to bet on UK bank owners investing substantially in SME leasing, and accepting the risk of systems change. For some, a better option may be to maximise the value of leasing subsidiaries by disposal.

SMEs need a more competitive credit market if they are to prosper. Divestment of at least some of the current bank leasing subsidiaries would be a good first step.

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