# Leasing: Riding High on Technological Innovation

By Yuji Hasumi

In Japan, the leasing industry has been the acknowledged standard-bearer of new businesses. Yet it is already close to a quarter of a century since Japan Leasing Corp. was established in 1963 as the country's first leasing company.

Throughout the period of high economic growth and the subsequent era of "softonomics" in which tertiary industry claimed an ever-growing share of the Japanese economy, leasing grew spectacularly. Today it is nearly a ¥5 trillion industry. Its share of private-sector plant and equipment investment makes it Japan's biggest equipment investment industry.

## A ¥5 trillion industry

According to fiscal 1986 statistics compiled by the Japan Leasing Association, lease contracts concluded in fiscal 1986 (April 1986 to March 1987) totaled ¥4,758 billion (about $32 billion at the rate of ¥150/$), up 10.1% over the year before. As the deflationary impact of the strong yen plunged the Japanese economy into confusion, the leasing industry posted double-digit growth in the value of its lease contracts for the sixth consecutive year (Fig. 1).

To be sure, the 10% range is low by industry standards. In fiscal 1982, the year-to-year increase was 24% at ¥2,397 billion, followed by 24.9% at ¥2,993 billion in fiscal 1983 and 22.8% at ¥3,676 billion in fiscal 1984. In fiscal 1985, an increase of 17.6% pushed the total value of contracts over the ¥4 trillion mark for the first time, finishing at ¥4,322 billion.

Rapid growth has made leasing an even more important part of the economy. According to an Economic Planning Agency survey, of ¥53,716 billion in private-sector plant and equipment investment in fiscal 1986, 7% was purchases of equipment by the leasing industry. This outpaced equipment investment by the entire electric power industry, which only accounted for 6.7% of the total. It was, in fact, the second year in a row that the leasing industry had left electric power in the dust. Leasing is now Japan's biggest equipment investment industry (Fig. 2).

## Information equipment takes the lead

Computers and peripherals accounted for ¥1,579 billion, or 33.2% of the total value of lease contracts concluded in fiscal 1986. If the ¥522 billion worth of communications equipment is added to this figure, information-related equipment accounted for 44.2%, by far the largest single category (Fig. 3). Users of information-related equipment, wary of how quickly it can become obsolete, are using leasing to the full to avoid getting stuck with outmoded systems.

The second biggest share of lease contracts was claimed by industrial machinery, which accounted for 15.7%, or ¥746 billion of the fiscal 1986 total. It was followed by machines and equipment for commerical and service industry use at 10.1%, or ¥478 billion. Fourth were business machines, accounting for 9.5% at ¥453 billion, and fifth, machine tools, representing 6.2% of total contract value at ¥249 billion. The top five categories alone accounted for more than 80% of the total value of leased equipment.

## Technological innovation spurs growth

The rapid growth leasing has attained in Japan is ascribable, above all, to the fact that corporate management sees it as an ideal hedge against technological obsolescence.

Back in the early 1960s, leasing made little headway. In part this was because the Japanese were unfamiliar with the concept, and in part because corporate management was still strongly imbued with conventional ideas of ownership. With the start of high economic growth in the second half of the decade, however, it became imperative to expand plant and equipment investment, even as corporations were experiencing chronic shortages of funds. This combination of factors opened the doors to the leasing system.

Leasing has a number of intrinsic merits. For instance, there is the privilege of writing off lease charges as straight-forward expenses, thereby simplifying bookkeeping. However, it was the system's supplementary financing function that corporate managers most prized, at least in the beginning. Small and medium-sized enterprises with weak credit standings with banks could use leases to in effect finance the installation of new equipment. In fact, more than 60% of the

Strong demand for leased office automation equipment contributes to the industry's double-digit growth.

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companies using leases were small and medium-sized businesses.

Even during the period of moderate economic growth after the two oil crises of the 1970s, the leasing industry sustained its high growth. A major reason was rapid technical innovation as electronics and mechatronics found applications in machinery and equipment. Most important was the development and popularization of general purpose computers and automated equipment for streamlining office work, such as facsimile machines, word processors, small business computers and copying machines. Factory automation also played its part. What these products of high technology have in common is that they can be rendered obsolete overnight by the development of newer or more advanced models.

If companies bought such equipment outright, they would be saddled with several years of depreciation in accordance with the legally set depreciation schedule. Their hands would be tied, preventing them from quickly switching to the latest equipment. They would fall off the bandwagon of technological innovation. This realization among corporate management was the primary factor boosting the scale of the leasing industry close to ¥5 trillion annually.

## A need for qualitative change

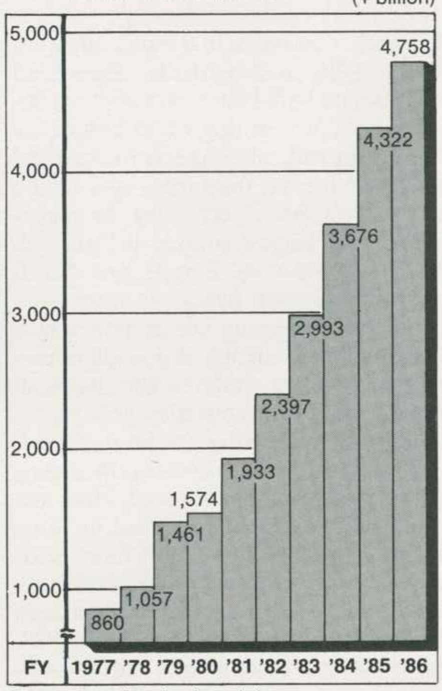
Quantitatively, the leasing industry may be Japan's largest equipment investor. Now, though, it must undergo qualitative change. The principal reason is the same old story so familiar to other Japanese industries: excessive competition.

Back in 1970, there were only 33 leasing companies in Japan. Now, lured by the industry's growth potential, banks, *sogo shosha* (general trading companies) and even manufacturers have flooded into the market. Today the number of leasing companies exceeds 280. The overcrowding has lowered leasing rates, in turn squeezing earnings. Whereas the ratio of current profit to sales for the top 23 leasing companies averaged 4.89% in 1978, a survey by the Ministry of International Trade and Industry found it creeping along at 1.8% in fiscal 1985 (Table 1).

Such being the situation, the top leasing companies have all begun to diversify. One field drawing their attention is long-term loans extending 10 years or beyond, loans which Japanese banks cannot make within the country's traditional financial framework. In fact, leasing contracts now account for less than half the business of most big leasing companies. In the business term ended March 1987, leasing contracts shrank to 37% of business in the case of Orient Leasing Corp., the industry leader, and to 26% in the case of pioneering Japan Leasing Corp.

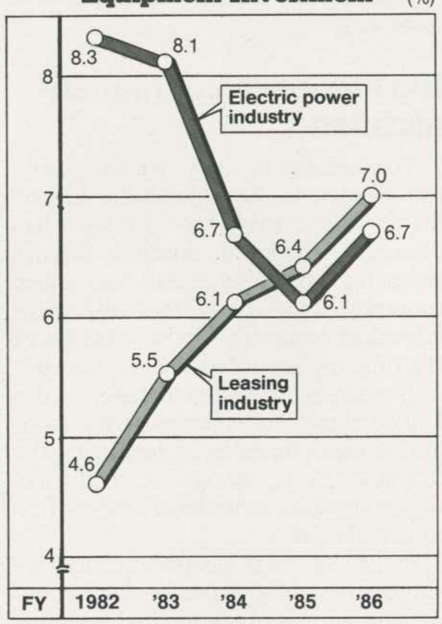
Because finance leasing accounts for most of the leasing contracts in Japan, it is difficult for companies in the indus-

**Fig. 1 Ten-Year Growth of Lease Contracts**



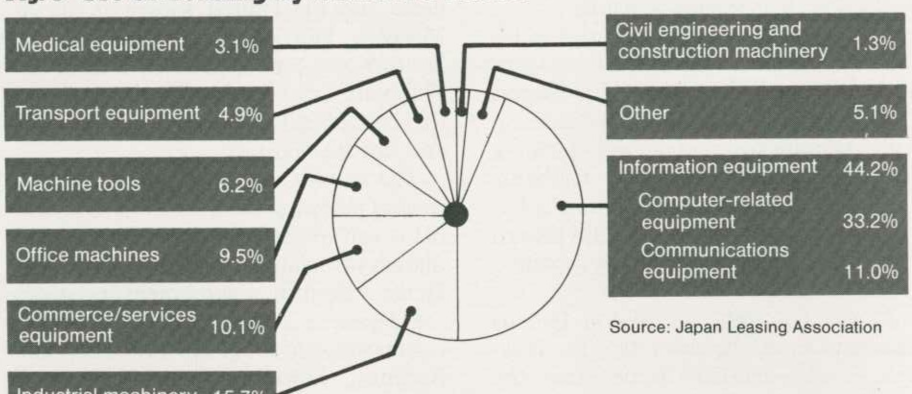

Source: Japan Leasing Association

**Fig. 2 Equipment Investments as Percentages of Total Private-Sector Equipment Investment**




Source: Ministry of International Trade and Industry; Japan Leasing Association

**Fig. 3 Use of Leasing by Item for FY1986**




Source: Japan Leasing Association

**Table 1 Leasing Company Earnings** (¥ billion)

| FY | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|---|---|
| **Sales** | 633.9 | 723.8 | 880.3 | 1,113.4 | 1,455.2 | 1,772.4 | 2,142.9 | 2,589.4 |
| **Lease fee income** | 489.6 | 535.7 | 670.0 | 812.8 | 1,001.2 | 1,183.1 | 1,405.6 | 1,654.3 |
| **Current profit** | 31.0 | 24.3 | 18.0 | 23.4 | 29.0 | 34.7 | 40.9 | 45.9 |
| **Current profit to sales** (%) | 4.89 | 3.36 | 2.04 | 2.10 | 1.99 | 1.96 | 1.91 | 1.80 |
| **Owned capital ratio** (%) | 2.47 | 2.26 | 2.14 | 1.80 | 1.43 | 1.48 | 1.42 | 1.32 |

Note: Average of 23 principal leasing companies
Source: Japan Leasing Association

try to differentiate themselves from their competitors. This has triggered a race to develop high value-added forms of leasing, such as maintenance and operating leases in the second-hand market of such commodities as cars, IBM computers and measuring instruments. The ability of the Japanese leasing industry to advance and grow in terms of earnings depends on the success of these new lease ventures.

## Big strides in internationalization

The leasing industry was originally transplanted to Japan from the United States. As the Tokyo money market has expanded, however, Japanese leasing companies have advanced into other countries. Indeed, internationalization has taken remarkable strides. Unlike in banking and securities, which have become sources of financial friction with the United States and other countries, there are no laws protecting or regulating the Japanese leasing market. Anybody, foreign companies included, is entirely free to hop aboard.

In the late 1960s, Japanese financial institutions established one leasing company after another. Lacking the know-how to go it alone, they frequently had to seek capital participation by American and European investment banks, merchant banks and their leasing affiliates.

The tie-ups arranged at the time included Orient Leasing with Chase Manhattan Bank, IBJ Leasing with Boston Overseas Financial Corp., Tokyo Leasing with Manufacturers Hanover Holding (Delaware) and Fuyo with Citibank. These cases of capital participation by foreign banks were the first few steps toward the internationalization of the Japanese leasing industry.

It was not until the all-too famous "Samurai lease," however, that the Japanese leasing industry leaped into the world limelight. The Samurai lease involved leasing aircraft to foreign airlines, using the emergency foreign currency loan system set up by the Japanese government in 1978 to help reduce Japan's trade surplus.

The Samurai leases worked in the following way. The Export-Import Bank of Japan provided low-interest loans to leasing companies, which used the money to purchase aircraft from the Western countries. The aircraft were then leased to foreign airlines. Although the system was discontinued after only one year, a total of 31 aircraft, valued at $930 million, were bought and leased. The know-how and experience gained through this aircraft leasing operation subsequently proved a great help to Japanese leasing companies as they expanded into the international leasing business.

In 1980, with the overhaul of Japan's Foreign Exchange Control Law, it became possible for leasing companies to undertake cross-border leasing on a purely commerical basis. In the six years from 1981 to 1986, cross-border leasing totaled an estimated $18 billion on a contract basis. About 50% of this, or $9 billion, involved aircraft, although petrochemical plants, industrial machinery and rolling stock have been increasing in recent years. The biggest market is Asia, followed in order by Europe and North America. Growth has been impressive, even though leasing contracts are now trending down slightly as a result of narrowing interest differentials between Japan and other countries and higher country risk involving certain nations.

The actual advance overseas by leasing companies has also quickened. More and more offices are being opened in Hong Kong, Singapore and even China. Japanese leasing firms are moving also into the world's two biggest financial markets, London and New York. As of early 1987, Japanese leasing companies had 104 overseas bases in 17 countries. The United States led with 25, followed by 19 in Hong Kong, 11 in Singapore, nine each in Indonesia and the United Kingdom, six in Malaysia, four in China, three each in South Korea and Brazil, two each in the Philippines, Sri Lanka, Thailand, Chile, the Netherlands, Greece and Australia, and one in Pakistan.

The expansion of the Tokyo financial market following the internationalization of the yen and progress in financial deregulation stimulated by the Japan-U.S. Yen-Dollar Committee agreement has given the Japanese leasing industry a prominent position in the global leasing market. Recently, however, there have been moves by some foreign banks to withdraw from the Japanese market.

A case in point is the withdrawal of Citicorp. In June last year, Citicorp sold the domestic claims held by its wholly owned Japanese subsidiary Citilease to Sumitomo Trust & Banking. Behind Citicorp's withdrawal was the realization that differences in the tax system between Japan and the United States (in Japan, unlike in the United States and Europe, virtually no tax privileges pertain to leasing) prevented it from putting its know-how to good use. Citicorp may also have concluded that today's fierce competition made the market unprofitable.

Other foreign banks have withdrawn from leasing joint ventures, for much the same reasons. Citilease's international division, however, is still operating. It appears that the company still prizes the Japanese financial market as a place to gather information and procure funds.

## A ¥9 trillion market in 1990

The rapid appreciation of the yen may have slowed leasing industry growth to 10.1% in fiscal 1986, a sharp drop compared with the high 20% plus growth of the preceding five years. But if the strong yen and the fact that the ratio of leases to total private-sector equipment investment in Japan is a mere 7% as compared to 24% in the United States are taken into account, Japan's leasing industry can be expected to continue to expand in the medium and long terms.

The Japan Leasing Association recently joined with the Nomura Research Institute, the Japan External Trade Organization (JETRO) and a wide range of experts to form a committee charged with compiling a report entitled "A Vision of the Japanese Leasing Industry." Their report forecast that leasing contracts in 1990 will be worth at least ¥7.5 trillion and might at the maximum reach some ¥9 trillion. Thus, in quantitative terms at least, there is no doubt that the leasing industry will expand. Nonetheless, it also faces problems that must be solved to pave the way to qualitative growth.

One problem is the financial constitution of the leasing companies themselves. The owned capital ratio of Japan's leasing companies is in the 1% range. Totally dependent on borrowings, they are fragile in the face of interest rate fluctuations. In order to solidify their financial footings, they must increase their owned capital.

A second challenge is the cultivation of new markets. Because the leasing business in Japan grew mainly through finance leases, it was vulnerable to fee competition. The result has been declining profit ratios for all in the market. In order to free themselves of excessive competition, leasing companies will have to develop maintenance and operating leases that boast higher value-added. This, in turn, requires that the leasing companies themselves acquire more know-how about the equipment they are leasing. In the process, they might well consider restructuring themselves from general leasing companies to specialized leasing companies better able to compete in a more challenging marketplace. ●