



LEASING-COURIER



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SNEZHINKA BATHWORKS, KRASNODAR

The municipal enterprise Snezhinka (snow-flake) was founded in 1999, when the city of Krasnodar decided to revamp its public baths and laundries. The company took over the largest bath-house in the city, situated in a historic 19th-century building, and added seven more establishments that were scattered throughout the suburbs of Krasnodar. All of them were in a dilapidated state, and some had actually been closed for several years. The idea of reorganizing the city's bath-houses and laundries originated with the Department of Municipal Services. Their goal was not just to help the run-down establishments survive, but to make them profitable.

Snezhinka's director, Anna Vasilevna Olkhovaya, told us how her company managed to turn the local public bath and laundry giant around. «Our complex of bath-houses and laundries was operating at a loss, since our average client simply could not afford to pay the full cost of the public baths. The actual cost of serving each bather in the year 2000 was 32 rubles, yet our clients paid only 12 rubles (6 for pensioners and the disabled). The municipal government has been footing the difference, since it established prices for the public baths.

Continued on page 23



Leased automobiles allowed this commercial laundry to widen its drop-off network and create 27 new jobs

«Snezhinka» President A.V. Olkhovaya



COMPARING THE FINANCIAL TERMS OF LEASE AGREEMENTS

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Continued from Issue #3 (15) 2001



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In the last edition of the Leasing Courier, we discussed the leasing company's commission. We left off in the middle of a hypothetical example, where a certain company, Vidgets, Inc., asked three separate leasing companies for an estimate as to the total sum of their lease payments. All three companies quoted the same amount: 17,573,600 rubles.¹

Does this mean that the leases are financially equivalent? Not at all. Even if the total sum of the lease payments is identical in all three cases, there are several other factors that will affect the lessee's cash flow:

- 1) The distribution of the payments over time;
- 2) The payment due dates (at the beginning or end of each fiscal period);
- 3) The frequency of the payments.

We can see the effects of these three factors when we discount the projected flow of the lease payments. Before we continue with our example, we should say a few words about the discounting process.

The Discounting Process²: Time Value of Money

The time value of money is the «actual» value of the funds that you expect to receive or spend in the future. In other words, money has a different value at different times - and you can't compare apples and oranges. We need to convert the amounts so that they are comparable, which is done by discounting.

Financial analysts list the following reasons for discounting money, all of which imply that money now is worth more than money in the future:

- inflation
- the risk of not receiving future income
- opportunity costs (existing funds might have been better invested in some other profitable enterprise)

In order to compare different cash flows correctly, one has to reduce them all to one particular moment in time - that is, to discount them. This is done in the following way: the nominal sum of each lease payment is multiplied by

$$\frac{1}{(1+r)^n}$$

where r equals the discount rate and n equals the number of the payment period. By adding up the discounted values of the lease payments, we obtain the lease payments' total discounted value (see Diagram 1). In English this is called «present value,» but several different terms are used in Russian, such as «reduced value,» «current value» and «discounted value».

¹ We assumed that the lessee did not incur any additional expenses in connection with the lease, apart from the lease payments themselves.

² A great deal of research and a number of textbooks have been written on this subject. This article does not pretend to offer a complete analysis of the topic. If you are interested in learning more about discounting, we suggest using a textbook on financial management, such as V.V. Kovalyov's «Introduction to Financial Management,» Moscow, «Finance and Statistics,» 1999

Step 1.

Obtain the lease payment schedule from the leasing company.

In addition to inquiring about the total sum of the lease payments, the lessee must also find out about the lease payment schedule - i.e., how the total sum is broken down over the term of the lease.

Proposed Lease Payment Schedules

| Payment Number | Aurora | Babochkin & Co. | Monolizing |
|--------------------------|-------------------|-------------------|-------------------|
| 1 | 1,558,700 | 1,815,365 | 1,207,800 |
| 2 | 1,494,900 | 1,751,565 | 1,207,800 |
| 3 | 1,431,100 | 1,687,765 | 1,207,800 |
| 4 | 1,367,300 | 1,623,965 | 1,207,800 |
| First-Year Total | 5,852,000 | 6,878,660 | 4,831,200 |
| 5 | 1,303,500 | 1,560,165 | 1,207,800 |
| 6 | 1,239,700 | 1,496,365 | 1,207,800 |
| 7 | 1,175,900 | 1,432,565 | 1,207,800 |
| 8 | 1,112,100 | 1,368,765 | 1,207,800 |
| Second-Year Total | 4,831,200 | 5,857,860 | 4,831,200 |
| 9 | 1,048,300 | 1,304,970 | 1,207,800 |
| 10 | 984,500 | 1,241,170 | 1,207,800 |
| 11 | 920,700 | 1,177,370 | 1,207,800 |
| 12 | 856,900 | 1,113,570 | 1,207,800 |
| Third-Year Total | 3,810,400 | 4,837,080 | 4,831,200 |
| Redemption Payment | 3,080,000 | 0 | 3,080,000 |
| Contract Total | 17,573,600 | 17,573,600 | 17,573,600 |

As you can see from the table, all three companies have proposed the same periodicity (quarterly payments) and contract length (three years). In both the first and the third examples, the lessee redeems (purchases) the leased asset at its residual value (3,080,000) when the lease expires. In the second example, the lessee redeems the asset in full through his quarterly lease payments (and is assumed to acquire the asset at the end for a nominal sum of one kopeck, which we have left out of the calculations).

Step 2

Calculate all additional expenses that will arise in connection with the lease, apart from the lease payments themselves (insurance, property tax, transportation, installation, etc.).

After obtaining the lease payment schedule, the lessee must compare the payments to his expected income. That is, he must determine whether he will have enough cash at each stage of the agreement to meet his obligations.

Step 3

Calculate your future cash flow and determine how well the proposed payment schedule suits your company's needs.

Let's assume that the lessee in our example has enough financial resources to accept any one of the three proposed payment schedules. He must consider how great his actual expenses will be under each of the plans. Although the total sum of the lease payments is identical in all three cases, the distribution of these payments over time is different, which means that the lessee's actual expenses will also vary. The way for the lessee to determine his actual expenses is by comparing the discounted cash flows under each plan.

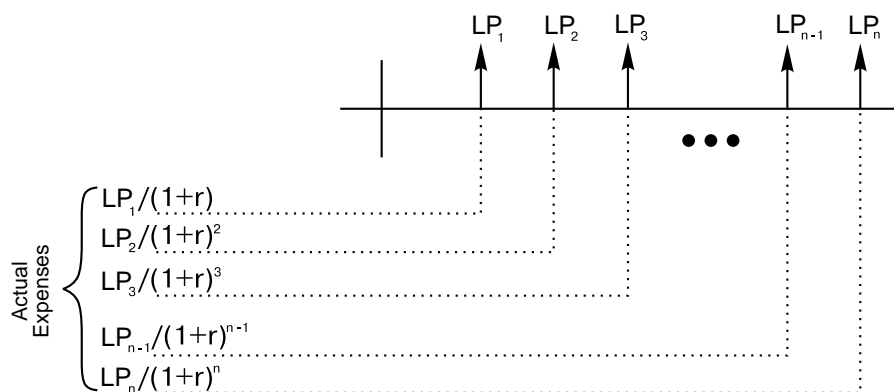
Step 4

If your expected cash flow allows you to choose between several leasing plans, you must compare the lease payment schedules in terms of:

- distribution of payments over time
- payment due dates
- periodicity

and choose the option that best suits your company's needs. You can determine that by discounting your cash flow and comparing the present values.

Diagram 1. Discounting Cash Flow under a Leasing Plan



Where: LP = Lease payment per period
r = discount rate

The following are the figures we obtain by discounting the lease payments for the beginning of each payment period at a discount rate of 28%.³

| Company | Present Value of Lease Payments |
|-----------------|---------------------------------|
| Aurora | 12,064,664 |
| Babochkin & Co. | 12, 878,430 |
| Monolizing | 11,632,256 |

Monolizing's offer is clearly the most attractive: the lease payments are uniform and equal, and the leased asset is redeemed at its residual value when the lease expires.

How Various Aspects of the Lease Payments Affect Present Value

Let's use Monolizing's lease payment schedule as an example to see how certain features of the lease payments can affect their present value. For the purposes of this example, we will focus exclusively on changes in the present value of the lease payments, ignoring all of the lessee's other expenses.

How the Payment Due Date Affects Present Value⁴

If the lease payments were made at the end of each payment period, rather than at the beginning, this would lower the lessee's actual expenditures. The present value of the lease payments for the entire three-year term of the lease would fall to 10,960,733 (671,523 less than if payments are made at the beginning of each period).

³ There are many different methods for determining the discount rate, but since this lies beyond the scope of our current discussion we will not focus on it here. We have simply chosen 28% based on a hypothetical interest rate for the lessee's bank loan.

⁴ We use a discount rate of 28% to calculate the present value in each example.

How Payment Frequency Affects the Present Value

If Monolizing wished to receive the lease payments at the beginning of each month, rather than on a quarterly basis (in which case the lease payments would be 402,600 each), this would lower the lessee's real expenditures. The present value of the lease payments would fall to 11,302,869 (329,387 less than with quarterly payments).

The Combined Effects of the Payment Due Dates and Payment Frequency on Present Value

Real expenditures would be lower still if the lease payments were made on a monthly basis and at the end of the payment period. The present value of the lease payments would fall to 11,075,061 (557,195 less than for quarterly payments made at the beginning of the period)

How Changing the Terms of the Lease Payments Affects the Lessee's Real Expenditures (Based on the Monolizing Example)

| Plan Number | Lease Payment Terms | | Present Value of Lease Payments | Savings Over Plan # 1 |
|-------------|---------------------|-------------------|---------------------------------|-----------------------|
| | Payment Frequency | Payment Due Date | | |
| 1 | Quarterly | Beginning of Term | 11,632,256 | |
| 2 | Quarterly | End of Term | 10,960,733 | 671,523 |
| 3 | Monthly | Beginning of Term | 11,302,869 | 329,287 |
| 4 | Monthly | End of Term | 11,075,061 | 557,195 |

Establishing a Hard-Currency Equivalent When Calculating the Lease Payments

Leasing companies often «peg» the lease payments to a hard-currency equivalent if they have taken out foreign-currency loans to finance the lease. However, they may also do so simply to protect themselves against sudden changes in the ruble exchange rate.

Whenever the lease payments are pegged to a foreign currency, the lessee should realize that he is bearing the full brunt of the currency risks (i.e., the risk of unfavorable changes in the ruble exchange rate). Let's consider what happens to the lessee's real expenditures in such cases.

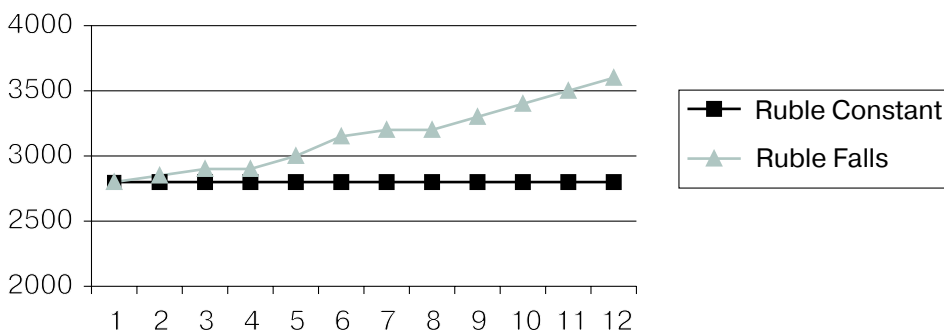
Example:

Let's imagine that the lessee has signed a three-year lease under which he is required to make twelve quarterly payments of \$100 in rubles at the prevailing exchange rate at time of payment. At the beginning of the lease, the exchange rate is 28 rubles to the dollar.

If the exchange rate does not change over the course of the lease, each payment will be 2,800 rubles.

If the ruble depreciates over the course of the lease, then the lessee ends up paying more in ruble terms, even if the dollar equivalent remains the same (in the following chart, the exchange rate has gone up to 36 rubles by period #12, thus increasing the payments by 800 rubles).

Changes in the Ruble Value of Lease Payments Pegged to a Foreign Currency Equivalent



If, on the contrary, the ruble exchange rate should appreciate (as happened in the year 2000, when the ruble rose from 28.87 to the dollar on February 2 to 28.16 on July 27), then the lessee will obviously benefit.

The parties must take into account the nature of the lessee's business before deciding to peg the lease payments to a foreign currency. Most Russian lessees sell their products for rubles on the Russian market, where prices have generally failed to keep up with exchange rates. This means that under extreme conditions, the parties may have to restructure the lease by altering the payment schedule, allowing the lessee to defer his payments or take other measures to ensure that the lease reaches its full term.

In this article we have shown how the profitability of a lease agreement can depend on the specific characteristics of the lease payments. We would like to emphasize once again that the lessor and the lessee have considerable freedom in determining the sum, structure and schedule of the lease payments. Therefore, the lessee may (and should) make clear demands regarding the nature of the lease payments and their distribution over time. For example, by making sure that the leasing company takes into account the cyclical nature of his business, the lessee will actually be helping the leasing company to structure the lease appropriately and avoid any unnecessary delays in the lease payments. ■

We hope that this article will help you conduct more effective negotiations with potential leasing companies. Good luck!

HOW LEASING COMPANIES CAN MINIMIZE THEIR RISKS BY CONDUCTING A COMPLETE ANALYSIS OF THEIR POTENTIAL LESSEES

Analyzing the Lessee's Current Finances and Projected Cash Flow

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In this article we continue our discussion of risk management for leasing companies, which we began in issues #14-15.

In our last article we discussed the various sources of information from which a leasing company can safely draw conclusions about a potential lessee's financial situation. We focused on one aspect of this analysis in particular: analyzing the lessee's balance sheet.

This time we shall consider the main principles of analyzing the lessee's liquidity and financial soundness. We should note that many of these measures use ratios that tend to be quite different between industries, and should not be considered absolute.



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Analyzing the Lessee's Liquidity

Liquidity is one of the most important elements of an enterprise's financial condition, as it determines the enterprise's ability to meet its current obligations on time.

There are many different methods for evaluating a company's liquidity, but the most common is the ratio method, which takes into account the following factors:

- Current Ratio
- Acid Test Ratio (Quick Ratio)
- Cash Ratio

Current Ratio

This ratio indicates whether a company has enough current assets to meet all of its short-term obligations. It is calculated as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets (total from balance sheet section II, line 290)}}{\text{Current Liabilities (total from balance sheet section V, line 690)}}$$

One should bear in mind that using this formula to calculate the current ratio does not necessarily give you a realistic view of a company's financial situation. The only way that this can serve as a reliable gauge of the lessee's solvency is if all of the assets listed under section II are fully liquid - i.e., if they can be readily converted into cash at their stated value. In addition, several of the liabilities recorded under «Short-term liabilities» are not really payable on-demand or in the next twelve months, and some are not even liabilities *per se* (such as future income).

Therefore, in order to obtain a realistic estimate of a company's liquidity, one has to adjust the data in the following manner:

- Exclude the following illiquid assets from the enterprise's total current assets (line 290 in the balance sheet):
 - accounts receivable that are not expected to be paid within the next 12 months (line 230)
 - unrecoverable accounts receivable (based on balance sheet supplement #5)
 - stock of raw materials, unfinished and «frozen» production, illiquid inventory (based on expert analysis)
- Exclude the following non-payable liabilities from the enterprise's total current liabilities (line 690):
 - income from future periods (line 640)
 - reserves for future expenditures (line 650)

Once we make these adjustments, our liquidity ratio looks like this:

$$\text{Current Ratio} = \frac{\text{Line 290} - \text{Line 244} - \text{Line 230} - \text{Line 221 of Form \#5}}{\text{Line 690} - \text{Line 640} - \text{Line 650}}$$

The prevailing view is that current assets should exceed current liabilities by at least two times. The Federal Insolvency Board suggested this norm back in 1994 within its Methodological Statutes for Evaluating the Financial Condition of Enterprises and Revealing Their Unstable Balance Structure. According to these statutes, a company may be declared insolvent if its current liquidity ratio at the end of a fiscal period is less than 2.

Although this document is no longer in effect,¹ the opinion still prevails among analysts that assets should exceed liabilities by at least two times. One should also bear in mind, however, that large amounts of current assets can strain working capital, and may not be an efficient use of financial resources. A more appropriate minimum current ratio would therefore be 1, in our view. This means that current assets should not be lower than short-term liabilities, and that the enterprise will be able to pay off its existing obligations with working capital.

Quick Ratio (or 'Acid Test')

This ratio indicates an enterprise's ability to meet its short-term obligations with highly liquid assets. The most highly liquid assets include cash (line 260), short-term investments (line 250), accounts receivable (line 240 minus line 244, «members' payable contributions to charter capital») and finished products (line 214). Thus, the formula for calculating the quick ratio is as follows:

¹ It has been replaced by the Methodological Instructions for Analyzing the Financial Condition of Organizations, confirmed by Order N 16 (January 23, 2001) of the Russian Federal Service for Financial Recovery and Bankruptcy. This document merely contains principles for calculating various indicators. It is not regulatory in nature.

$$\text{Quick Ratio} = \frac{\text{Line 260} + \text{Line 250} + \text{Line 240} - \text{Line 244} + \text{Line 214}}{\text{Line 690} - \text{Line 640} - \text{Line 650}}$$

Experts recommend a quick ratio of 0.7 - 0.8.

Cash Ratio

This ratio indicates the degree to which a company can meet its short-term obligations with cash and short-term investments - i.e., its most liquid assets.

$$\text{Cash Ratio} = \frac{\text{Line 260} + \text{Line 250}}{\text{Line 690} - \text{Line 640} - \text{Line 650}}$$

Both Russian and foreign analysts recommend a cash ratio of at least 0.2.

The higher a company's liquidity measures, the more solvent it is considered to be; i.e., the easier it will be for the company to meet its short-term obligations, such as lease payments. However, one should remember that a high level of liquidity also means that an enterprise's current assets outstrip its current liabilities, which usually increases its working capital needs. Furthermore, a high level of liquidity may indicate that the enterprise is doing a poor job of managing its working capital, i.e., accumulating excess stock of raw materials or finished products, overdue accounts receivable, etc.

A high level of liquidity indicates that a potential lessee should be able to meet his current obligations in full and on time. This means that there is a lower risk that he will default on his lease payments. However, one also has to remember that high levels of liquidity may indicate poor management of working capital and a potential contraction in cash flow if cash cannot be realized for the accumulated assets.

There is one rather interesting method for calculating the current liquidity ratio of an enterprise, according to which the necessary amount of current liabilities is based on the turnover rate for accounts payable and receivable, the size of the enterprise's least liquid assets and the value of its material resources. The actual value of the enterprise's current assets is then correlated to the calculated value of its current liabilities, which reveals the current liquidity ratio that is necessary for that particular enterprise.²

When analyzing an enterprise's liquidity, one should take a close look at how the enterprise's liquidity indicators have evolved over time. One should also try to determine what has caused these indicators to change: changes in the enterprise's current assets or current liabilities, changes in its long-term assets, etc.

Analyzing an Enterprise's Financial Soundness

The purpose of analyzing a potential lessee's financial soundness is to determine how much he depends on external sources of finance.

Several financial indicators can be used to characterize an enterprise's financial soundness, but two are particularly important: the correlation between the enterprise's equity capital and borrowed funds (equity/total assets ratio), and its level of working capital.

² You can learn more about methods of calculating standard liquidity factors in M.N. Kreinina's «The Financial Condition of Enterprises: Calculation Methods,» Moscow, 1997

Equity/Total Assets Ratio

The equity/total assets ratio is calculated as the correlation between equity capital (the total under section III, Capital and Reserves, line 490) and the total sum of equity + liabilities or, equivalently, assets (lines 490, 590 and 690, or lines 190 and 290).

$$\text{Equity/Total Assets Ratio} = \frac{\text{Line 490}}{\text{Line 490} + \text{Line 590} + \text{Line 690}}$$

The lower the ratio, the higher the sum of debt financing - and the higher the risk of insolvency. Moreover, companies with large amounts of debt financing generally have large interest payments to make, which means they will have fewer funds left over to make their lease payments. There are no strict rules about the minimum acceptable equity/total assets ratio (it's a hot topic in corporate finance), but the prevailing view is that it should not be less than 0.5. We derive this figure by a transformation of the formula for calculating the equity/total assets ratio: since the denominator is calculated as the sum of equity capital and debt financing, if equity capital exceeds debt financing, then the autonomy ratio will be greater than 0.5.

The main principle behind a lessee's financial soundness is that his long-term assets, as well as his illiquid working capital, should be financed through long-term sources of credit. If an enterprise's illiquid assets are financed through short-term obligations, this increases the risk that the enterprise's current assets, and even its long-term assets, will lack essential financing if anything changes in its relationships with its main partners (e.g., if its suppliers curtail payment deferrals). This in turn will heighten the risk that the lessee will default on his lease payments.

The structure of an enterprise's assets and liabilities depends in part upon its particular industry. Manufacturing and construction firms, for example, tend to have a large share of non-working capital, which means that they require more long-term sources of finance to maintain their financial stability than, say, a retailer, whose assets consist primarily of working capital with high turnover. Enterprises that are highly profitable or that have a high turnover rate of current assets can afford to maintain relatively high levels of debt financing. Furthermore, a manufacturer's working capital consists primarily of inventory and accounts receivable, while a retailer's assets consist largely of cash and relatively liquid inventory; thus, current assets have varying degrees of liquidity.

Therefore, the 'standard' equity/total assets ratio of 0.5 should be considered a rough guide. Applying the same norm to different types of enterprises would be highly inappropriate.

Net Working Capital

As we mentioned above, the main principle behind an enterprise's financial soundness is that its long-term sources of finance must fully cover its non-liquid assets.

Therefore, net working capital, which is calculated as the difference between long-term sources of finance (long-term loans and equity capital) and long-term assets, must be greater than zero.

$$\begin{aligned} \text{Net working capital} &= \\ &= (\text{Equity capital} + \text{Long-term liabilities}) - \text{Long-term assets} = \\ &= (\text{Line 490} + \text{Line 590}) - (\text{Line 190} + \text{Line 230}). \end{aligned}$$

Negative net working capital means that some of the enterprise's long-term assets are financed through short-term liabilities. This in turn means a greater risk that the enterprise will fail to meet its current obligations in a timely fashion.

On the other hand, a very high level of net working capital, like high levels of liquidity, may indicate that the enterprise is not managing its resources efficiently. The optimum level of net working capital depends on the enterprise's specific nature, particularly its size, sales volume, and inventory and accounts receivable turnover periods.

The optimum level of a company's liquidity and financial soundness depend on its type of business, asset structure and current asset turnover rate. It is therefore impossible to apply the same standards to every company.

Analyzing a potential lessee's financial soundness, in conjunction with his liquidity, will give you some idea of his overall financial condition. If both indicators appear to be weak, the lessee may be headed towards bankruptcy, and there is a considerable risk that he will fail to meet his current obligations, including his lease payments. ■

We will continue our series on analyzing a potential lessee's finances in the next issue of the Leasing Courier. Our next article will explain how to analyze a potential lessee's profitability.

In the «Expert Opinion» section we publish materials sent to the editorial board by participants in the leasing sector. The purpose of this section is to show the diversity of existing opinions. The opinions of the authors published in this section do not necessarily represent the official opinions of the International Finance Corporation. IFC does not guarantee the accuracy or reliability of the information presented in these articles or bear any responsibility for the consequences of its use.

BEFORE YOU START NEGOTIATING A LEASE, TAKE A CLOSE LOOK AT RUSSIA'S ANTITRUST LAWS

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It would be fair to say that in the early days of Russian leasing (and perhaps even today) most Russian businesses were not even aware that lease agreements could be subject to approval by the antitrust authorities. This is largely because most of our attention has been focused on tax, customs and currency regulations — as well, of course, as leasing laws. Until now, researchers have largely neglected antitrust laws. This is actually a mistake, since lease agreements that fail to comply with these laws can be declared null and void. It is my hope that this article will help both leasing companies and lessees understand the implications of Russian antitrust laws.

There are two Russian laws that contain antitrust regulations pertinent to leasing: Law #948-1 on Competition and the Restriction of Monopolies in the Commodities Markets (03/22/91) and Law #117-F on Preserving Competition in the Financial Services Markets (09/23/99).

One of the most important antitrust regulations for the leasing industry is Article 18, Clause 1 of the Law on Competition, which states: «enterprises may not transfer assets worth more than 10% of the book value of their fixed business assets and non-material assets to another enterprise without the prior approval of the Federal Antitrust Authorities.»

Prior approval is only required if the enterprises combined assets are worth more than 100,000 times the minimum wage (MROT), if either of them appears in the Register of Businesses with Market Share of More than 35%, or if the recipient has managerial control over the sender's commercial activities.

If the enterprises' total assets are valued at more than 50,000 times the minimum wage, but less than 100,000 times, then they merely have to notify the Federal Antitrust Authorities of their lease agreement within 15 days.

Thus, the lessee must notify or get prior approval from the Federal Antitrust Authorities when the following two circumstances occur simultaneously: First, if the leased asset is worth more than 10% of the book value of the lessor's fixed business assets and non-material assets; and second, if either the lessee or the lessor has total assets worth more than 50,000 times the minimum wage or one of them is included in the Register of Businesses with Market Shares of More than 35%.

Although it is the lessee's responsibility to contact the antitrust authorities, the lessor also plays an important role, since he must inform the lessee when the leased asset is worth more than 10% of his fixed business assets and non-material assets. The lessee should require some kind of written statement on this matter from the lessor, and should make sure that the statement has been signed by the lessor's chief executive officer, since the lessee may be held legally responsible for any violation of antitrust laws.

Leasing companies might ask the following question: should we include the value of the leased asset in the total value of our assets? Since this total is based on the results from the previous quarter, the leased asset is not usually included in the total - although it may be to both parties' advantage to do so.

Imagine, for example, that the lessor's fixed assets are worth 54.2 million rubles, while the leased asset is valued at 6 million rubles. If the leased asset is not included in the lessor's total balance, the value of the leased asset will exceed 10% of the lessor's fixed business assets and non-material assets, and the lessee will have to notify or seek prior approval from the antitrust authorities if the second condition is also met. If, on the other hand, the lessor includes the value of the leased asset in his total balance, then the lessee will not have to apply to the antitrust authorities, since the leased asset will constitute less than 10% of the lessor's assets and the second condition will no longer matter.

One can easily imagine the opposite scenario, where including the leased asset in the lessor's total

balance fails to bring it below the 10% barrier, while driving the parties' combined assets over 50,000 times the minimum wage, thereby forcing the lessee to turn to the antitrust authorities.

Let's suppose, for example, that the leased asset is worth 200,000 rubles, the lessor's fixed business assets and non-material assets are valued at 1.7 million rubles and the book value of the lessor's assets (not including the leased asset) is 2.8 million rubles, while the lessee's assets are worth 2.1 million rubles.¹ If the leased asset is not included in the balance, there will be no need to turn to the antitrust authorities, even though the leased asset accounts for more than 10% of the lessor's assets, since the parties' combined assets are valued at less than 50,000 times the minimum wage (5 million rubles²). If, on the other hand, the leased asset is included in the lessor's balance, it will still account for more than 10% of the lessor's assets and will also drive the parties' combined assets over the 5 million ruble mark, obliging the lessee to notify the antitrust authorities about the lease.

Let's consider a few more examples:

1. A leased asset is valued at 10 million rubles. The lessor's fixed business assets and non-material assets were worth 40 million rubles during the last fiscal period, while his active balance is 50 million rubles. The lessee's active balance is 70 million rubles. The leased asset is worth more than 10% of the lessor's fixed and non-material assets, so we have to look at the second indicator: the combined active balance of the lessor and the lessee, which totals 120 million rubles in this case. This is more than 100,000 times the minimum wage (10 million rubles), so the lessee must obtain prior approval from the Federal Antitrust Authorities before taking out the lease.

2. A leased asset is valued at 1 million rubles. The lessor's fixed business assets and non-material assets were worth 3 million rubles during the last fiscal period, while his active balance is 5 million rubles. The lessee's active balance is 4 million rubles. The leased asset is worth more than 10% of the lessor's fixed and non-material assets, so we have to look at the second indicator: the combined active balance of the lessor and the lessee, which totals 9 million rubles in this case. This is more than 50,000 times the minimum wage, but less than 100,000 times, so the lessee must notify the Federal Antitrust Authorities within 15 days after signing the lease.

¹ The book value of a company's assets is defined as the sum of lines 190+290 in the balance sheet, minus losses.

² Based on the current minimum wage of 100 rubles per month.

3. A leased asset is valued at 1 million rubles. The lessor's fixed business assets and non-material assets were worth 3 million rubles during the last fiscal period, while his active balance is 5 million rubles. The lessee's active balance is 4 million rubles. The lessee is listed in the Register of Businesses with Market Shares of More than 35%. The leased asset is worth more than 10% of the lessor's fixed and non-material assets, so we have to look at the second indicator: the combined active balance of the lessor and the lessee, which totals 9 million rubles in this case. This is more than 50,000 times the minimum wage, but less than 100,000 times. Nevertheless, because the lessee is included in the Register of Businesses, it is not enough for him to merely notify the Federal Antitrust Authorities; he must obtain their approval before signing the lease.

Organizations that violate Article 18 of the Law on Competition may be fined up to 5,000 times the minimum wage, while their directors may be fined up to 80 times the minimum wage.

According to the Russian State Antitrust Committee's Letter N NF/187 of 01/18/99, the Law on Competition also applies to subleases, guarantee agreements for leasing transactions, and the transfer of any rights or obligations under a lease agreement to a third party.

The Law on Preserving Competition in the Financial Services Markets has somewhat less importance for the leasing industry, since, first of all, it is up to the antitrust authorities to define what constitutes a dominant position in the leasing industry. Second, even if a leasing company is found to have a dominant position, this in itself does not constitute a violation of antitrust laws; it only means that the antitrust authorities may place the

company under systematic observation to ensure that it does not abuse its dominant position.

According to the Antitrust Ministry's Order # 342 of 05/06/00, a company may be found to have a dominant position in the leasing industry based on information obtained from the Russian State Committee for Statistics, leasing organizations, consumers groups and state, social, scientific, commercial or non-profit organizations and experts.

In spite of this long list, the antitrust authorities are unlikely to base their rulings on any sources other than the government statistics agencies' assessment of leasing volumes in Russia. Unfortunately, this is a rather depressing situation.

The State Committee for Statistics calculated the total volume of Russian leasing transactions in the year 2000 as 5.8 billion rubles.³ According to the Russian Association of Leasing Companies (Roslizing), the figure had already reached 13,321 billion rubles in 1999.

Since Russian leasing companies are so reluctant to disclose their real financial results, the State Committee for Statistics, which is responsible for gathering this information, must join forces with Roslizing, the Ministry of Justice's State Registration Chamber, and the Ministry of Economic Development, all of which have data on the Russian companies holding leasing licenses. This would make the official statistics on the Russian leasing industry far more accurate, which would benefit the entire industry.

³ *Principle Indicators of Investment and Construction Activity in the Russian Federation in the Year 2000. State Committee for Statistics N 12 (52, 2001, pp. 9)*

OUR COMMENTARY

*Olga Shishlyannikova, Attorney
IFC Leasing Development Group*

This article certainly raises some very important issues. However, there are several points that require further comment:

- This article only deals with antitrust regulation in the context of lease agreements. In some cases, the same regulations may also apply to the sales agreement for a leased asset.
- Most importantly, the antitrust authorities do not have the power to annul agreements. Only the

courts may do so. The only thing that the antitrust authorities can do is initiate an inquiry into a deal if it violates antitrust regulations in such a way as to create or strengthen a dominant market position and/or hinder competition - and only if the parties have refused or neglected to meet the authorities' demands in terms of restoring competitive conditions. As far as we know, the courts have not established any procedures for annulling agreements

that fail to comply with the antitrust regulations mentioned in Mr. Prilutsky's article.

- It may be true that the Statute on the Procedures for Petitioning or Notifying the Antitrust Authorities requires an entity to calculate the value of its business assets and non-material assets on the basis of the preceding fiscal quarter, in accordance with Articles 17 and 18 of the Russian Soviet Socialist Republic's Law on Competition and the Restriction of Monopolistic Activity in the Commodities Markets (confirmed by the Russian Antitrust Ministry's Order #276 of 08/13/99). However, the Statute over-generalizes the provisions of the Law on Competition: the law itself does not indicate that asset value should be calculated on the basis of the preceding fiscal quarter. Therefore, lessors and lessees may also use current data to define their asset values.

- The legality of the State Antitrust Committee's Letter #NF/187 of 01/18/99, which Mr. Prilutsky refers to in his article, is also rather dubious. There are no grounds for thinking that the Law on Competition and the Restriction of Monopolistic Activity in the Commodities Markets applies to either mortgage agreements or cession agreements (where one of the parties to an agreement transfers his rights and oblig-

ations to a third party). According to Article 18, Clause 1 of this law, antitrust regulation only applies to transactions involving the transfer of ownership or usage rights to fixed business assets or non-material assets from one party to another. A mortgage agreement does not entail the actual transfer of ownership or usage rights. The ownership rights to a mortgaged asset do not actually change hands unless the mortgagee seizes the asset. Even when a mortgaged asset is seized, the ownership rights are often transferred to parties other than the mortgagee, so it clearly does not make sense to require the mortgagor to obtain prior approval from the antitrust authorities before signing a mortgage agreement.

- Finally, we cannot agree with Mr. Prilutsky's opinion that the Federal Law on Preserving Competition in the Financial Services Market applies only to leasing companies that have a dominant position in the leasing industry. According to Article 16 of this law, antitrust regulations also apply to transactions where entities cede their rights to claim a share of a financial institution's assets (leasing companies are also considered financial institutions). At the same time, the law does not limit these statutes to financial institutions with a dominant position in the financial services market.

ADDITIONAL GUARANTEES FOR LEASING TRANSACTIONS: EXPERT OPINIONS

The Leasing Development Group's team of experts have often dealt with the subject of additional guarantees for leasing transactions in the course of their consulting work.

In developed leasing markets, the leased asset itself usually serves as a sufficient guarantee for the lease. Therefore, leasing companies do not generally require any additional guarantees against the lessee's financial obligations. In Russia, the situation is completely different. Leasing companies often feel that their property rights to the leased asset are not a sufficient guarantee, and they may therefore require additional guarantees, such as additional collateral, third-party sureties, guarantees that the supplier will buy back the leased asset, and so forth. This is perfectly legal, but for lessees it makes the process of taking out a lease far more complicated, while for start-ups it can make leasing virtually impossible.

We decided to find out what Russian leasing practitioners thought about guarantees: are they really necessary, and if so, why? In this issue we have published several letters that we received from lessees and leasing companies. We invite all of our readers to take part in this discussion.

Konstantin Merkulov,

Financial Director, Pro-Invest-IT (Lessee):

Leasing has been advertised as an excellent solution for small and medium-sized businesses. Unfortunately, these firms are rarely able to offer the kind of collateral that is required for a lease. The result is a Catch-22: in order to obtain new assets, I want to take out a lease; but in order to take out a

lease, I need to have assets — so that I can offer them as collateral. At least this is the problem that my own company faces.

As difficult as it is to repossess a leased asset from an insolvent lessee, seizing a pledged asset is not any easier. Let's suppose, for example, that I want to lease some new computers. The only thing that I can offer as collateral is a set of similar com-

puters — and only on the condition that I can keep using them in the meantime, even after I have mortgaged them, since I cannot operate my business without them. From the lessor's perspective, how are the mortgaged computers any more secure than the leased ones? Confiscating collateral is actually even more difficult than repossessing a leased asset, since the lessor does not have any ownership rights.

I have done a bit of Internet research into the kinds of terms offered by different leasing companies. It turns out that the nature and size of the guarantee hardly depends on the nature of the leased asset. For example, the Moscow Leasing Company requires a 100% guarantee on all real estate leases, even though they are unlikely to have any difficulties repossessing a piece of real estate if the lessee defaults (unless, of course, the property burns down or caves in - but for that we have insurance).

I believe that the problem of guarantees needs to be discussed more widely as a serious obstacle to the development of leasing in Russia.

Maksim Yurevich Kalinkin,

Acting Legal Director, Moscow Leasing Company:

When the Moscow Leasing Company negotiates a new lease agreement, we ask the lessee to provide us with a guarantee on our investment, such as a surety, a bank guarantee or some form of collateral, depending on the size of the contract and the lessee's financial situation.

Acceptable forms of collateral include commodities, any kind of highly liquid equipment or vehicle, and real estate. The value of the collateral does not usually exceed the value of the lease agreement.

The Moscow Leasing Company does everything it can to bring their lease agreements - even the most problematic ones — to their logical conclusion, without confiscating the lessee's collateral. The only time we would resort to seizing a lessee's assets is if he committed grave violations of the agreement.

Although we can recover our investment by confiscating and selling off the lessee's collateral, this would obviously terminate our relationship with the lessee, and we have a vested interest in seeing that our clients succeed with their leases. We therefore try to resolve our disputes by negotiation, rather

than by taking matters to court or trying to confiscate the lessee's assets.

We generally need to have some additional form of guarantee from the lessee in order to ensure that we will be able to recover our investment, but guarantees are not an obligatory condition for every lease agreement.

If the contract value is relatively small, and the lessee appears to be financially sound, then we may decide not to require any additional forms of guarantee. If the contract is large, then we have to require additional guarantees. This is standard practice.

Valeriy Aleksandrovich Pryadko,

Leasing Director, Municipal Investment Company (Krasnodar):

Our company takes the following approach to guarantees. First of all, we have to require additional guarantees on our leases in order to protect ourselves against the risk of lessee default. It is sometimes difficult to determine the financial condition of our potential lessees, since some of our applicants are private entrepreneurs who tend to conduct most of their transactions in cash and do not have any documentation to prove their solvency. In such cases, it makes sense to sign a guarantee agreement with a legal entity that can provide the necessary documents and demonstrate its own solvency.

The second kind of guarantee is collateral. We require some form of collateral from every legal entity that wants to take out a lease, since we have already had cases where repossessing and selling the leased asset was not enough to help us recover our investment expenses, not to mention our lost profits. By requiring the lessee to give us property or commodities as collateral, we can be relatively sure that we will recover our investment expenses, including lost profits, if the lease agreement goes wrong.

Lessees are often put off by bank loans, with their rigid application procedures and strict requirements in terms of guarantees and insurance for mortgaged assets. Lease agreements, by contrast, are much more lenient and flexible where collateral is concerned, which makes the whole process that much easier and attractive to the

lessee. Lessees occasionally propose their own forms of guarantees, which sometimes include bank guarantees — but this is a rather expensive luxury. Nevertheless, thanks to the leasing company's relatively flexible approach, 90% of our potential lessees do not see additional guarantees as an obstacle to taking out a lease.

Irina Mikhailovna Chuvilyova,

Director of Credit Analysis, RG Lizing:

Unfortunately, there are a number of factors that prevent us from accepting the leased asset as the sole form of guarantee under a lease agreement. Repossessing a leased asset can be difficult not only because of bad faith on the part of the lessee, but also because of the technical features of the leased asset itself. Some of our leased assets are highly specialized to suit the needs of a particular lessee; others are actually «built in» to the lessee's production facilities and cannot function on their own. Economic instability and a weak second-hand equipment market increase the risk that we will not be able to sell a repossessed asset to recover our expenses. In addition, we are constrained by the requirements of the lenders that finance our leases.

The Russo-German Leasing Company (RG Lizing) currently uses almost every acceptable form of guarantee, including collateral (equipment, real estate, etc.), insurance against financial risks, third-party guarantees and so on. We take an individual approach to each guarantee plan, based on the liquidity of the leased asset and the particular features of each lessee, as well as the specific characteristics of each investment project.

We understand that requiring additional guarantees puts leasing out of reach for many Russian companies. RG Leasing has always striven to create new financial products, including those that would allow companies to take out leases without providing additional guarantees as long as they could fulfill certain criteria. A perfect example is our successful partnership with KhGS Center, one of Russia's leading suppliers of printing equipment. Our risk-sharing agreement makes it possible for us to work together without requiring any additional guarantees, which means that we can also work out new projects much more quickly. This kind of arrangement is especially attractive to small and medium-sized businesses.

Grigory Yurevich Vorobeychuk,

General Director, KNK-lizing:

Leasing is a form of credit, and every creditor needs to have guarantees. Leasing companies are unlikely to insist on collateral specifically, since collateral is generally one of the least liquid forms of guarantee. There are plenty of other kinds of guarantees for traditional credit transactions: bank guarantees, sureties from financial agents, etc.

The leased asset can also serve as a guarantee, but only under one condition: it has to be liquid. If the leased asset is a unique piece of equipment that nobody but the lessee could possibly use, then it will obviously be difficult to sell if it has to be repossessed. Furthermore, most leasing companies do not really have the right sort of personnel to sell used equipment. Therefore, considering its liquidation value, leased equipment can only serve as a partial guarantee, and the rest has to be covered in some other way.

In my opinion, a company's liquidity ratio is one of the most important factors defining its potential for development. The liquidation value of a lessee's property is a resource that can be used to cover the gap between the leased asset's liquidation value and its original book value. This is a standard situation when planning a lease. Life would be much easier for all of us if the guarantee mechanisms for leasing improved. For example, if the Russian banking sector would become more sophisticated, we might see new kinds of guarantees, such as credit against turnover.

As for potential lessees that are starting up from scratch, I would strongly recommend that they form a clear idea about what kind of equipment they need, and how much. They should then calculate the liquidation value of the equipment they are planning to lease. They shouldn't attempt to do this independently; rather they should do it in conjunction with the lessor and the lending bank. Finally, they should calculate the difference between the leased asset's purchase price and its liquidation value: this is the amount that they will have to provide in guarantees. These guarantees will have to come from the newly formed company's capital stock.

Leasing is a very convenient way to acquire new equipment - the most convenient, in my opinion. But as with any kind of business transaction, one has to be prepared to meet certain requirements.

VARIOUS ASPECTS OF CONFISCATING AND SELLING PLEDGED ASSETS

*Stanislav Kovynyov, Attorney
IFC Leasing Development Group*



*Stanislav Kovynyov, Attorney,
IFC Leasing Development Group*

One of the most common means of guaranteeing the lessee's obligations under a lease agreement is obtaining a pledge of the lessee's assets. If we take a close look at court practice, we find that many of the conflicts that arise over the course of the execu-

tion of a pledge agreement have to do with the specific procedures for confiscating and selling off pledged assets. In this article, we would like to focus on several of these issues.

When does the lessor have the right to confiscate the lessee's pledged assets?

The grounds and procedures for confiscating pledged assets are defined under Articles 348 and 349 of the Russian Civil Code. According to Article 348, the beneficiary of the pledge may confiscate an asset when the lessee's obligations are not fulfilled or if they are fulfilled improperly. Considering the relatively long duration of leases and the periodic nature of lease payments, it is important to determine just how far the lessee must fall behind on his obligations before the leasing company has the right to confiscate an asset. Current legislation only provides an answer to this question if the pledged asset is a piece of real estate. According to Article 50 of Law #102-FZ on Real Estate Mortgages (07/16/98):

If an asset was pledged as a guarantee against liabilities that must be settled by means of periodic payments, the recipient of the pledge has the right to confiscate the asset in the event that the borrower systematically reneges on his obligations - i.e., if he fails more than three times in a twelve-month period to make his payments in full and on time - unless otherwise stipulated in the pledge agreement.

Since the law does not make any such provisions for confiscating moveable assets, the parties must be careful to define the precise grounds for confiscating the pledged asset. If they fail to do so, even the slightest violation of the lease payment schedule, which technically entails a violation of the obligations guaranteed by the pledge, could serve as grounds for confiscating the pledged asset.

When defining the grounds for confiscating a pledged asset, the parties may choose to adopt the provisions of the Law on Mortgage, or any other relevant law; or they may come up with their own provisions to suit their particular needs. In our opinion, the pledge contract should allow the recipient of the pledge to confiscate a pledged asset if the lessee fails to make his lease payments for three or more consecutive periods, since these are currently the legal grounds for annulling a lease agreement.¹ However, we should emphasize that the parties are free to define whichever criteria they prefer.

The Procedures for Confiscating Pledged Assets

There are different procedures for confiscating pledged assets, depending on whether these assets are classified as real estate or moveable assets. Article 349 of the Russian Civil Code stipulates the following procedures for confiscating pledged assets:

Real Estate

As a general rule, pledged real estate must be confiscated by court proceedings. The only exception to this rule is if the parties agree to settle out of court. Out of court settlements must meet the following requirements:

- a) The agreement must be notarized
- b) The agreement must be signed after the onset of the grounds for confiscation

We can illustrate this principle with the following example. The lessee reneges on two consecutive

¹ Article 13 of the Federal Law on Leasing.

lease payments, which, according to the pledge agreement, gives the lessor (i.e. the pledge holder) the right to confiscate the pledged asset. The lessee recognizes the lessor's right to confiscate the pledged asset and agrees to let him do so without any court proceedings. The parties sign a notarized agreement to that effect.

Moveable Assets

If the pledged asset consists of moveable assets, rather than real estate, then the parties must agree on the procedures for confiscation. Russian law does not stipulate a time frame for this agreement, so the parties may either include it in the original pledge agreement, or they may draft a separate agreement after the guaranteed liabilities have gone into effect. If the parties fail to reach an agreement on the procedures for confiscating the pledged asset, then the lessor will only be able to confiscate the asset through the courts.

If the parties wish to write these procedures into the pledge agreement itself, they should keep the following points in mind. First, it is clearly to the leasing company's advantage to allow for confiscation out of court, since court proceedings will only increase the time it takes to obtain compensation. On the other hand, if the lessor has the right to confiscate the pledged asset without resorting to the courts, this obviously puts the lessee at greater risk, since his lawful rights can only be defended in court.

For example, the court may defer the sale of the pledged asset for up to one year, revise the asset's assessed value or reject the lessor's claim altogether on the grounds that it is disproportionate to the value of the pledged asset. These legal rights obviously make court proceedings the more attractive option from the lessee's perspective. At the same time, the longer the court proceedings drag on, the more the lessor will suffer as the lessee's principal obligations remain unfulfilled. On the other hand, if the court rules in favor of the lessor, the lessee will have to cover all of the court expenses, which will increase his indebtedness even further.

Considering that the parties may agree at any time to settle out of court anyway, we believe that it is in the lessee's best interests to stipulate in-court settlement within the pledge agreement itself. If the lessee later chooses not to dispute the lessor's claims, he can always draft an agreement authorizing the lessor to confiscate the pledged asset. At the same time, we should note that the lessor will

most likely refuse to include any provisions for court proceedings within the pledge agreement; and even if he does allow for such provisions, he will probably try to make up for the heightened risks by raising the overall cost of the lease. The lessee will have to decide whether the increased cost is justified by the reduction in risk.

Legal Measures Protecting the Rights and Interests of Companies and Individuals Pledging Assets

According to Article 250, Clause 2 of the Russian Civil Code, the courts may defer the sale of a pledged asset by public auction for up to one year. However, this deferral does not release the debtor from the obligations that were guaranteed by the pledge or from compensating the claimant for further losses or damages incurred during the deferral period.

No less important, the courts may decide to reassess the value of the pledged asset.² This can be crucial for lessees, since lessors usually require the pledge contract to state an artificially low value for the pledged assets. The courts derive their authority to reassess the value of a pledged asset from Article 350 of the Russian Civil Code, according to which the arbitration courts are to fix the starting sales price of a pledged asset up for public auction. The court's decision to reassess a pledged asset is based on evidence presented by both parties. The parties are also free to submit evidence demonstrating that the asset's assessed value corresponds to its real market value. On the basis of the evidence, the arbitration court may allow the parties to reach a mutually acceptable agreement, or it may simply determine the asset's starting sales price in accordance with the evidence, regardless of the figure stated in the pledge agreement.³

Another positive aspect of the legal procedures for confiscating a pledged asset is the fact that the courts may, in accordance with Article 348 of the Russian Civil Code, prohibit the lessor from confis-

² Under certain circumstances, it may be to the lessor's advantage to reassess the value of the pledged asset. In particular, considering the relatively long duration of a standard lease, market factors may alter the value of the pledged asset. As a result, the asset's market value may end up being dramatically lower than its original sales price, making it far less liquid.

³ See Informational Letter #26 of the Plenary of the High Arbitration Court, January 15, 1998, Clause 6.

cating the pledged asset if the lessee has committed only a very minor violation of the agreement and the lessor's claims are disproportionately severe. However, lessees should remember that three violations of the lease payment schedule in the course of one year, no matter how insignificant, will serve as sufficient grounds for confiscating the pledged asset.

Selling off a Pledged Asset

The procedures for selling off pledged assets (whether real estate or moveable assets) are defined under Article 350 of the Russian Civil Code. According to this article, pledged assets must be sold by auction in accordance with established procedures, unless otherwise stipulated by law. The only law that contains different provisions is the Law on Mortgage (Article 55), which allows the recipient of the pledge to assume ownership of the pledged asset or transfer it to a third party after deducting the asset's purchase price from the outstanding debt. However, if the parties do not agree to this arrangement beforehand, then the pledged asset can only be sold by auction, in accordance with established procedures.

The procedures for public auctions are defined under Articles 447-449 of the Russian Civil Code. Whether the pledged asset is a moveable asset or a piece of real estate, the auction procedures will largely depend on the manner in which the asset was confiscated. If it was confiscated through the courts, then court bailiffs will oversee the sale, except for cases where a specialized agency oversees the auctioning of a piece of real estate.

If the pledged asset was seized out of court, then the parties must agree on the terms of the auction. According to Article 447 of the Civil Code, the auction may be overseen by either the owner of the asset or a specialized agency. The asset must be sold to the highest bidder. If the auction is declared invalid, the lessor may, with the lessee's consent, purchase the pledged asset and deduct its purchase price from the lessee's debt. If the parties cannot reach such an agreement, the asset must be auctioned a second time. If the second auction is also declared invalid, the lessor may keep the asset after crediting the lessee with at least 90% of the starting sales price established at the second auction.

According to Article 334 of the Russian Civil Code, the money received for the pledged asset must be

allocated to the lessor before other creditors. However, this rule only applies to cases where the pledged asset was forfeited by law. When a pledged asset is sold by order of the arbitration courts, the courts have generally given precedence to the claims defined under Article 78 of the Law on the Execution of Writs,⁴ particularly compensation for damages and any unpaid taxes or duties.

If the revenue from the sale of the pledged asset exceeds the lessor's claim against the lessee, the lessor must refund the difference to the lessee.

If, on the other hand, the revenue from the sale of the pledged asset is insufficient to cover the lessor's claims, the lessor may, unless otherwise stipulated by law or the pledge contract itself, recover the remaining sum from the lessee's other assets, though these assets can only be seized by normal procedures, not the special procedures stipulated for pledged assets. This statute does not apply in cases where the party pledging the assets is a third party, rather than the principal debtor (the lessee).⁵ In such cases, the lessor's claims are limited to the sum of revenue from the sale of the pledged asset. He may only recover the remaining sum from the principal debtor (the lessee), and only by normal procedures, not the special procedures stipulated for pledged assets.

Termination of the Pledge Agreement Due to Termination of the Principal Obligations When the Parties Agree to Indemnification or Novation

Considering that current legislation does not allow the lessor to assume ownership of the pledged asset (any agreement to the contrary being subject to annulment), and the fact that selling off a pledged asset is a rather complicated procedure, it is very important that the parties have the option of terminating the obligations guaranteed by the pledged asset by concluding an agreement for indemnification or novation. The courts have generally allowed parties to terminate the obligations secured by the pledge agreement using such an arrangement.

⁴ See the Federal Arbitration Court of the Northwest Region's ruling on case #A52/2072/99/1 of May 30, 2000.

⁵ See Informational Letter #26 of the Plenum of the High Arbitration Court, January 15, 1998, Clause 7.

In this context, compensation means the provision of money, property, etc., in lieu of fulfilling the principal obligation, while novation means replacing the original obligation with a new obligation, between the same parties, allowing for a different subject matter or means of fulfillment (Articles 409 and 414 of the Russian Civil Code). According to Article 352 of the Civil Code, terminating the obligations guaranteed by the pledge agreement automatically cancels the pledge agreement itself.

Russian law does not place any restrictions on the terms of an indemnification or novation agreement. Therefore, these two options are clearly an effective way to avoid the complications associated with confiscating and selling off a pledged asset.

Conclusion

In spite of the complicated nature of pledge agreements and all of the difficulties associated with confiscating and selling off pledged assets, pledges are still the most attractive form of guarantee for Russian leasing companies. A pledge contract gives the leasing company a guarantee in the form of tangible assets that might be sold off to recover at least part of its losses, if not all of them. Since pledges are amongst the most effective forms of guarantees available in Russia today (and nothing better is likely to appear in the near future), we advise lessors and lessees to pay very close attention to the questions raised in this article and to be very thorough in drafting the provisions of their pledge agreements. ■

INFORMATION

The Tax Code's Draft Chapter on Profit Tax

On June 6, 2001, the draft Chapter on Profit Tax (Part II of the Russian Tax Code) passed its third reading in the State Duma. The bill will now be sent to the Federation Council, and then to the President, for final approval. The whole procedure will take about one month.

The Key Points for the Leasing Industry

1) Depreciation policy:

- The bill preserves the right to record the leased asset on either party's balance sheet (the lessor's or the lessee's)
- Taxpayers may choose to depreciate the leased asset using either the straight-line method (calculated as $1/n$, where n equals months of useful service life, applied to the asset's original value) or a declining-balance method (calculated as $2/n$, applied to the asset's residual value)¹
 - Taxpayers may depreciate leased assets using an acceleration factor of up to 3, regardless of the depreciation method (straight-line or declining balance)²
 - The leased asset's original value is defined as the amount that the lessor spent on its acquisition (that is, including related costs such as transportation)
 - If an asset is already under lease when the new chapter on profit tax goes into effect, it may be depreciated according to the procedures that were in effect when the lease agreement was signed (i.e., the new regulations will not be applied retroactively)

2) Including lease payments in expenses

- If the leased asset is recorded on the lessee's balance sheet, the lessee should include lease pay-

ments, less depreciation charges, in expenses (hence reducing profits)

- Depreciation is charged normally

3) Including loan interest in total expenditures

- Russian leasing companies may not include loan interest in their total expenses if the loan was provided by a foreign company or organization with a stake of 20% or more in the leasing company and the leasing company owes more than 12.5 times³ its equity on the loan.
 - If the loan is 12.5 times greater than the leasing company's equity

Provisions Affecting All Enterprises, including the Leasing Industry

- The new chapter introduces a profit tax of 24%, of which 7.5% will go to the federal government, 14.5% to regional governments and 2% to

¹ Except for assets with a useful service life of more than 20 years, which can only be depreciated using the straight-line method.

² Except for fixed assets with a useful service life of less than five years that are depreciated using the declining balance method.

³ This ratio only applies to leasing companies and lending institutions; for all other organizations, the ratio is 3 times equity.

local governments. Regional governments may, if they wish, reduce the regional tax by up to 4% (i.e., to 10.5%).

- The new chapter eliminates many exemptions from profit tax, including the exemption for organizations making capital investments
- The new chapter restricts the use of the cash method for calculating revenue and expenditures (it can only be used if an enterprise's average

quarterly sales revenue over the last four quarters was less than 1 million rubles; otherwise the accrual method must be used)

- Losses may be carried over for ten years following the period in which they were incurred.

In future issues of the Leasing Courier we will take a closer look at the Chapter on Profit Tax and its implications for the Russian Leasing Industry.

ANNOUNCEMENT

The Leasing Development Group plans to hold the following seminars in the near future:

MID-SEPTEMBER

Urals Region

Leasing as a Means of Acquiring Fixed Assets (Yekaterinburg)
Principles of Leasing (Chelyabinsk Region)

EARLY OCTOBER

Yuzhno-Sakhalinsk, Vladivostok, Khabarovsk

Leasing as a Means of Acquiring Fixed Assets
Mini-seminar for Women Entrepreneurs

THE LEASING DEVELOPMENT GROUP VISITS NIZHNY NOVGOROD

*Eleanora Veitsman, Public Relations Expert
IFC Leasing Development Group*



Press briefing on the leasing industry in Nizhny Novgorod

In late June of this year, the Leasing Development Group traveled to the city of Nizhny Novgorod to promote leasing and provide training. On June 21, the Group held a seminar on Leasing as an Effective Means of Acquiring Fixed Assets for local entrepreneurs. More than 60 people attended the seminar, including both potential and experienced lessees. The Novgorod Chamber of Commerce and Trade and the Nizhny Novgorod Regional Department for Business Development provided organizational support. On

the following day, June 22, the Group held an introductory seminar on the Effectiveness of Leasing for 37 local female entrepreneurs. The Nizhny Novgorod Women's Society helped organize the event.

To popularize leasing in Nizhny Novgorod, the IFC Leasing Development Group held a press conference for local media on the development of leasing in the region. Speakers included the Group's own team of experts; Deputy Governor of Nizhny Novgorod Oblast and Director of the Department for Business Development, V.A. Bulanov; the General Director of the Nizhny Novgorod Leasing Company, A.V. Blinov; and the General Director of Datavision-CIS, A.V. Timin.

Leasing began to develop in the Nizhny Novgorod region in 1996. According to Deputy Governor Bulanov, it was Boris Nemtsov, former governor of Nizhny Novgorod, who gave the first real impetus to the development of the local leasing industry by obtaining relatively cheap funding from Sberbank of Moscow. Ever since then, the Nizhny Novgorod region has included a leasing development program within its small-business development program. The leasing development program aims to facilitate leas-



Advertisements for leasing services are increasingly common in Nizhny Novgorod

ing in a variety of ways, including direct financial support.

There are currently two active leasing companies in the Nizhny Novgorod region, the Nizhny Novgorod Leasing Company and the Volgo-Vyatsky Interregional Leasing Center, although this may be changing. The state-owned Nizhny Novgorod Small Business Development Fund also holds a leasing license, and Delta Leasing

has recently opened an office and plans to offer leasing services to local entrepreneurs. In spite of the small number of active leasing companies, more and more of the region's enterprises are beginning to appreciate the advantages of leasing over other forms of finance. By the beginning of this year, the Nizhny Novgorod Small Business Development Fund had financed more than 700 leases, while the Nizhny Novgorod Leasing Company had financed more than 100 projects worth a total of 50 million rubles. The Volgo-Vyatsky Interregional Leasing Center, which opened relatively recently, serves clients not only in the Nizhny Novgorod region, but



More than 60 businesses attended the Leasing for Lessees seminar

also in the neighboring regions of Mordovia, Chuvashia, Mariy El and Kirov.

The most important industry in the Nizhny Novgorod region is the automobile industry, led by the giant Gorky Auto Plant (GAZ). Several other industries, such as machine building, food processing, chemicals and petroleum, also play an important role in the local economy. Local leasing companies reflect the preponderance of these industries in their lease portfolios. For example, the Nizhny Novgorod Leasing Company's portfolio breaks down as follows: 40% GAZ automobiles, MAZ and KAMAZ trucks and buses, 15% food-processing equipment (baking ovens and production lines for dumplings and pasta), and 10% shop equipment. The remaining 35% consists of computers, printing equipment, and equipment for gas stations and dry cleaners.

The general director of the Nizhny Novgorod Leasing Company, A.V. Bliinov, concluded the press conference by pointing out that «Nizhny Novgorod's leasing industry has begun to develop more actively, but that development could be greatly accelerated if some way could be found to give local leasing companies greater access to funding».

LEASING IN THE NIZHNY NOVGOROD REGION

Information from the Nizhny Novgorod Regional Department for Business Development

The Nizhny Novgorod Department for Business Development runs a small-business lending program that consists of three main parts: a leasing program, a guarantee fund, and a micro-credit program. The Department is funded by the Nizhny Novgorod regional government, which allocated 6 million rubles for business development in 1997, 11 million in 1998 and 15 million in 2000. Over the same

three-year period, the federal government did not allocate any funds to us for business development in the region; the last time we received funding from Moscow was in 1997, when the Federal Fund for Business Development allocated 5 million rubles to our region.

Our largest program is our leasing program, which has already leased over 20 million rubles' worth of

automobiles and equipment to local enterprises. That equipment has included wood-processing machinery, shoe-repair equipment, dental equipment, a production line for ceramic tiles, etc.

Over the last five years, since leasing first began to develop in the Nizhny Novgorod region, the Nizhny Novgorod Small Business Development Fund has financed over 700 leases.

Table 1 **Automobile Leases**

| Year | Number of Leases | Value (in millions of rubles) | Number of New Jobs Created |
|--------------|------------------|-------------------------------|----------------------------|
| 1996 | 115 | 4.63 | n/a |
| 1997 | 213 | 11.01 | n/a |
| 1998 | 68 | 4.15 | 204 |
| 1999 | 89 | 8.05 | 267 |
| 2000 | 99 | 14.8 | 273 |
| Total | 584 | 42.64 | 744 |

Table 2 **Equipment Leases**

| Year | Number of Leases | Value (in millions of rubles) | Number of New Jobs Created |
|--------------|------------------|-------------------------------|----------------------------|
| 1996 | 3 | 1.16 | n/a |
| 1997 | 10 | 7.66 | n/a |
| 1998 | 5 | 0.943 | 60 |
| 1999 | 8 | 2.8 | 96 |
| 2000 | 11 | 3.0 | 108 |
| Total | 37 | 15.563 | 264 |

Table 3 **Type of Lease**

| | Nizhny Novgorod Leasing Company | | | | Volgo-Vyatsky Inter-regional Leasing Center | |
|------------|---------------------------------|-----------------------|---------------------|----------------------|---|-----------------------|
| | 1997 | 1998 | 1999 | 2000 | 1999 | 2000 |
| Automobile | 14 leases, 2.181m rub. | 41 leases, 11.9m rub. | 5 leases, 1.9m rub. | 8 leases, 5.2m rub. | 3 leases, 1.5m rub. | 10 leases, 1.68m rub. |
| Equipment | | | | 12 leases, 3.7m rub. | 4 leases, 1.87m rub. | 10 leases, 4.13m rub. |

The Nizhny Novgorod Leasing Company facilitated the creation of 54 new jobs in 1999 and another 105 in the year 2000. The Volgo-Vyatsky Interregional Leasing Center made it possible to create 64 new jobs in 1999 and 83 in the year 2000. Average annual interest rates were as follows:

- 1997: 27%
- 1998: 27% (pre-crisis) and 60% (post-crisis)
- 1999: 37%
- 2000: 34-35%

The Nizhny Novgorod Small Business Development Fund is now focusing on leasing as

its main form of activity. The main aspects of its leasing program are defined under the Statute on the Organization of Leasing, which was ratified by the governor of Nizhny Novgorod. According to this document, priority should be given to the consumer goods industry, the food-processing industry, rural transportation, day-to-day services and traditional crafts industries. The statute also defines the basic financial and organizational terms of our lease agreements. Most important, the statute requires the leasing program to award its funding on the basis of fair and open competition.

SNEZHINKA BATHWORKS, KRASNODAR

*Viktoria Struts,
Public Relations Specialist
IFC Leasing Development Group*

Continued from page 1

We fully expect our bath-house to be required to operate at a loss for the foreseeable future, so the only way for us to turn the bath-house and laundry complex into a profitable enterprise is by improving our other services. Since our laundry service accounts for some 40-50% of our total volume, we decided to focus on making that more cost-effective. We did some market research and found that we could improve our service dramatically not only for individual clients, but also for corporate clients (hospitals and clinics, kindergartens, etc.). For example, we found that our aging vehicles often failed to make their deliveries on time for the simple reason that they kept breaking down. We began to realize that we would have to improve our whole infrastructure. Based on the business plan that our financial experts had drafted in 1998, we began to develop a whole range of services.»

The company first decided to buy some new vehicles and some dry-cleaning equipment on credit. These were the assets that would bring the quickest payoff, within a month or two. The city's small-business development program provided the company with \$200,000 in guarantees to purchase some German-made dry-cleaning equipment. Then came the August Crisis, and the company had to alter its plans. The idea of purchasing some new vehicles was put on hold.

In 1999, the company's managers attended the IFC Leasing Development Group's seminar on the Fundamentals of Leasing - the Group's first seminar in the Krasnodar region.¹

«After that seminar we understood that leasing would be the best way for us to renovate our facilities,» explained Ms. Olkhovaya. «The establishment that we had inherited was virtually in ruins. The machinery was constantly breaking down; the laundry equipment was 90% worn out; the vehicles had been in service for 20-25 years and were practically falling apart. Moreover, our average employee was owed six months' wages.»



Historical Note:

Krasnodar's bath-house at Dlinnoy St. #120 was founded in 1893 by a local merchant by the name of Likhatsky. It was one of the most advanced bath-houses in Russia, and was every bit as luxurious as the famous «Sanduny» bath-houses in Moscow. During the Soviet era, the establishment changed its name, but never stopped operating.

Snezhinka's managers analyzed leasing very carefully to determine whether it was right for their company, consulting with experts from the Moscow Leasing Company at every stage of their calculations. In the end they came to the conclusion that if they could lease the equipment they needed, they would be able to pay 20-25,000 rubles per month in lease payments, even as they paid off the outstanding arrears to their employees.

In May 1999, Snezhinka signed a lease with the Moscow Leasing Company for a Sobol light pickup truck, and the following September it took out another lease on a Moskvich 2141, both of which are used for delivering dry-cleaning to individual clients, a new service. Both leases were signed for two-year periods, and their total value was 400,000 rubles. By May 2001, Snezhinka had finished paying off its first lease, and it expects to finish paying off the second by this

¹ *The Leasing Development Group held a second seminar on Leasing as a Means of Acquiring Fixed Assets, designed specifically for lessees, in May of this year.*

August. The company has never missed a single lease payment, and at the same time it actually turned a profit last year (for the first time in several years) of 335,000 rubles.

The new vehicles enabled Snezhinka to expand and improve its services. Now that they were finally able to pick up and deliver orders efficiently, they opened several new receiving centers around the city. This allowed them to raise their total volume by 159% and create 27 new jobs - 15 of them for people under the age of 20. The company now employs a total of 275 people. The city of Krasnodar has named Snezhinka its «Business of the Year.»

Since Snezhinka started working with the Moscow Leasing Company, the firm's Krasnodar branch has developed into an independent company called the Municipal Investment Company with its own leasing license. Snezhinka plans to continue working with the newly formed company. It is currently thinking of taking out a large new equipment lease. For its dry-cleaning service it plans to lease some German dyeing equipment, which will be the first of its kind in Krasnodar. For its laundry service it plans to buy some new washing

machines (probably from the Vyazemsky Factory) as well as some German dryers and presses, which would raise the laundry's productivity dramatically. It currently takes the company about 30-40 minutes to dry 10 kg of laundry, whereas the new equipment would cut that time to 4-5 minutes. The new equipment would allow the company to save a great deal on electricity and lower its production costs.

«It would be fair to say that Snezhinka is the leading laundry and bathing establishment in the region,» explained Ms. Olkhovaya. «We currently have a well-functioning network of receiving centers throughout the city. In the future, we would like to expand this network throughout the region. Our market studies have shown that several nearby cities have no dry-cleaning services at all, and their laundries are on the verge of collapse. Every time we draft our plans for the coming year, our goal is to surge forward. In order to do so, we obviously need to expand our production facilities. Leasing has already proven itself as an effective tool for acquiring new equipment, and we plan to use it in the future to modernize our business.»

PRESS DIGEST

EVENTS IN THE RUSSIAN LEASING INDUSTRY

BUSINESS DEALS

Sistema Co. has just finished installing a new set of Swincor Nixdorf automatic teller machines at Sberbank in Altay. Sistema will be leasing the machines to Sberbank, having won a tender in late 2000. As Sberbank's main supplier of bank equipment, Sistema has actually been serving Sberbank Altay since 1997. The new ATMs will enable Sberbank Altay to provide automatic banking services to their 60,000 card-holding customers. The bank also plans to start issuing more cards in the near future.

*Vremya-MN
16 June 2001*

The International Finance Corporation's board of directors has approved a \$110m loan project for a new Ford auto plant in the city of Vsevolozhsk (Leningrad region). The IFC will provide half of this sum directly, and private banks will provide the rest through syndicated loans. Ford Motors, which has a 99% stake in the factory, will act as the project's guarantor and general sponsor. St. Petersburg Banking House, a subsidiary of Promstroy Bank, holds the remaining 1% of shares in the Ford Vsevolozhsk Factory. The new factory will be used to assemble Ford's Focus model for the Russian market. Its projected capacity will be 27,000 automobiles per year. The factory will train and employ some 1,000 Russians. In addition, experts predict that ten times as many jobs will be created among Ford's suppliers in Russia.



The total cost of the project is estimated at \$221 million. With \$141.2 billion in sales and \$3.5 billion in profits last year, Ford could easily have afforded to finance the new factory on its own, but it preferred to include the IFC, which is expected to provide Ford with important technical assistance, particularly in creating a network of local suppliers. In time, Ford's partners will also be given access to credit lines and leasing plans. This will be one of the IFC's largest projects in Russia.

*ITAR-TASS
19 June 2001*

The Pervomayskaya Zarya Factory plans to invest \$500,000 in new equipment by the end of 2002.

As part of this project, the company received some German-made Veith machinery on June 21, under a lease agreement with Baltic Leasing and Ermako, the German manufacturer's Finnish distributor. The new equipment is valued at \$75,000. Pervomayskaya Zarya is one of Russia's oldest producers of women's clothing. Last year the company invested \$200,000 in new equipment leases.

This enabled it to acquire some high-tech sewing equipment, to automate its design process using the latest developments in computer software and to reorganize its production facilities around individual steam-generators.

*Rosbalt Information Agency
21 June 2001*

The city of La Plata, a free economic zone in the province of Buenos Aires, Argentina, has hosted an exhibition of Russian KamAZ trucks. Several of KamAZ's most popular models were shipped to Argentina with an eye to working out a long-term arrangement for selling KamAZ trucks on the local market, as well as certifying the Russian vehicles in accordance with local legislation and launching an advertising campaign for KamAZ within Argentina. During a visit to Argentina last year, KamAZ's general director, Ivan Kostin, signed a protocol of intentions with SEMARU to launch a pilot project that would return Russian trucks to the Argentinean market (they were quite popular with local consumers during Soviet times). SEMARU, which stands for Centro de maquinaria rusa, or the Center for Russian Equipment, has been working with Soviet and Russian equipment suppliers for a quarter of a century. It is now KamAZ's official distributor in Argentina, providing not only sales services, but also guarantee maintenance for the full service life of the trucks. During the exhibition, SEMARU actually signed sales agreements for four of KamAZ's exhibition models. SEMARU expects to receive an initial shipment of 50 Russian trucks this October and to begin selling them in November. The company's experts believe that the current market for KamAZ trucks in Argentina is about 300 trucks per year. The company has already worked out a leasing plan for the trucks with two major Argentinean banks

*ITAR-TASS
25 June 2001*

AGRICULTURE

The Siberian Machine-Building Holding Company (Krasnoyarsk Territory) and Ukragrotekhnik Leasing and Manufacturing Company plan to open a Yenisey grain-harvester factory in Ukraine. The new factory will be built on the existing Ozyryansky Agro Technical Service Plant, which currently specializes in repairing Yenisey, Niva and Don combines. The joint venture is expected to produce up to 1,000 new combines per year. By using less costly Ukrainian components and cutting down on transportation costs, the company will be able to reduce the cost of a Yenisey harvester in Ukraine by about 10%. The company plans to sell the harvesters under leasing plans.

*Kommersant
8 June 2001*

The government of Yakutiya has approved a Regional Program for the Development and Expansion of Agricultural Leasing from 2001-2005. The government will promote leasing in the region through state-owned Tuymaada Agricultural Finance, which will act as a lender and guarantor on local leasing projects, and state-owned Tuymaada Lizing, which will act as the lessor. Experience has shown that providing agricultural producers with new equipment through leasing

plans is an effective way for the government to boost the productivity, competitive strength and profitability of local agriculture. Since 1996, Tuymaada Lizing has leased 242,303,400 rubles' worth of equipment to local farmers, including 880 Buran snow-tractors, 90 motor vehicles and 548 tractors (178 DT-75s, 282 MTZ-82s and 88 T-25s and T-30s). It has also acquired 8 milk-processing units from Sweden and 5 potato-cultivators from Holland. In the year 2000, as part of the government's program to support family farms, Tuymaada also provided local farmers with 600 Chinese mini-tractors fitted with mowers and plows, valued at 69,702,800 rubles.

*Sakha-Yakutiya Information Agency
9 June 2001*

A.I. Morozov, deputy director of the Nizhny Novgorod Regional Department of Agriculture, has officially transferred eight Yenisey and Don combines under lease to the region's top farms. The 900,000-ruble machines were given to farms in the Pavlovsk, Vetluzhsky, Shakhunya, Shatki, Pilna, Vorotynets and Buturlino districts. Regional farmers have already received 100 tractors since the beginning of this year through the federal government's leasing program. Forty-eight of these tractors were delivered in time for the sowing season, while the rest will arrive in time for the fodder harvest.

*Nizhegorodskie Novosti
27 June 2001*

SMALL & MEDIUM-SIZED BUSINESS

The Russian Agricultural Bank (Rosselkhozbank) and the Russian Central Union of Consumers' Associations (Tsentroyuz) have signed a partnership agreement. The consumers' cooperative has existed in Russia for 170 years. It focuses on agricultural trade, buying up produce from small plots and processing it at its own factories. The cooperative has more than 90,000 trading companies and 10,900 industrial factories at its disposal, in addition to a well developed network of small-scale food processing plants. It currently has 11.4 million shareholders united into 32,000 consumers' unions. The new partnership agreement between Tsentroyuz and Rosselkhozbank calls for joint efforts to attract additional sources of finance and to create special investment programs for the development of the agricultural sector and the food-processing industry. The two partners will also cooperate on obtaining loans for Tsentroyuz's members, including funding for leasing projects.

*RIA Novosti
19 June 2001*

INFRASTRUCTURE

State-owned Vodokanal of St. Petersburg has just received 59 million rubles' worth of new equipment under lease. Petrokonsalt Leasing Company provided the equipment under a deal financed by St. Petersburg Bank. According to Petrokonsalt's general director, E. Tulina, the leased equipment includes water pumps and motor vehicles. The lease was signed for a period of more than three years.

*Delovoy Peterburg (St. Petersburg)
6 June 2001*

EVENTS IN THE FOREIGN LEASING MARKET

America's Metromedia Fiber Network, which specializes in the development of municipal fiber-optic cable networks based on Internet protocol, has signed an agreement with Germany's Deutsche Telekom. According to this agreement, which was signed for a period of 20 years, Metromedia will provide Deutsche Telekom with fiber-optic networks in the north-eastern United States, as well as Washington, DC, and will also provide the German company with operating, administrative and technical services. According to Metromedia, its cable network will give Deutsche Telekom's clients access to virtually unlimited wide-band connections with a high level of security.

*Foreign Business Information Agency (Alliance Media)
7 June 2001*

Georgia's Minister of the Economy, Industry and Trade, Ivane Chkhartishvili, has signed an agreement in Italy for the creation of a joint Italian-Georgian leasing company. The new company is expected to foster the development of small and medium-sized business in Georgia. The Italians have agreed to invest \$350,000 into the company's charter capital. Minister Chkhartishvili has urged the Georgian parliament to act quickly to pass a new law on leasing. The Georgian-Italian joint venture's founders include BNL Bank of Italy (11%), SIMEST Investment Company of Italy (20%), FINEST (20%), the International Finance Corporation (25%), a consortium of Georgian commercial banks (24%) and the Georgian Development Fund for Small and Medium-Sized Business, which will invest around 1 million lari in the new company.

*PRIME NEWS Information Agency (Tbilisi),
12 June 2001*

The International Leasing Finance Corp (ILFC) of Los Angeles has placed a record-breaking order for 111 aircraft, worth a total of \$8.7 billion, with Europe's Airbus Industrie. ILFC will actually pay somewhat less for the aircraft, since Airbus has agreed to a discount of an undisclosed amount. According to ILFC's chief executive officer, Steven Udvar-Hazy, the company has now ordered a total of 376 aircraft from Airbus. ILFC is a subdivision of American International Group Inc. Last year Airbus received orders for 520 aircraft. So far this year, it has received orders for 299. The total value of these orders, according to WSJ, has reached \$13 billion (\$15.23 billion euros).

*UNIAN Information Agency
20 June 2001*

IFC will lend \$6 million to ORIX Leasing Egypt, SAE (OLE), a Cairo-based leasing company that specializes in providing medium-term finance to SMEs. OLE will use IFC's investment to expand its lending to SMEs, thereby supporting their growth and boosting job creation. The investment is in line with IFC's global strategy of strengthening domestic financial institutions and increasing the access to medium and long-term finance by local SMEs. OLE is an unlisted joint stock company established in 1997 by the National Bank of Egypt, Commercial International Investment Company, ORIX Corporation-Japan, ORIX Leasing Pakistan, Ltd., and IFC.

*IFC Press Room,
27 June 2001*

QUESTIONS & ANSWERS



Elena Degtiareva, financial analyst with the IFC Leasing Development Group, answers questions from our readers.

If a lessee purchases a leased asset at a nominal price of 1 ruble, as stipulated under the lease agreement, does it have the right to reassess its fixed assets? Can the depreciation charges using the reassessed value be included in production costs? Will the reassessed value also be applied for the purposes of property tax?

An organization may reassess groups of similar fixed assets no more than once per year (at the beginning of the fiscal year) according to their current value, either by indexation or by direct recalculation, based on the assets'

documented market value.¹ The difference arising from the reassessment should be included in the organization's additional paid-in capital. The property is then reappraised on a regular basis so that the value of the fixed assets in the bookkeeping records does not differ significantly from the current market value.

An organization's ability to include depreciation charges in its expenses in the event of a reassessment is explained in the Tax Ministry's Letter #VG-6-02/288@ of 04/17/00. According to this letter, «when an organization reassesses its fixed assets in accordance with the Accounting Standards and reflects this reassessed value in its bookkeeping records, the reassessment should be used for calculating property tax, as well as profit tax (in particular, when calculating depreciation charges).» Furthermore, the Tax Ministry's Letter of 11/15/00 on Amendments and Additions to the State Tax Service's Instruction #33 of 06/08/95 on the Procedures for Paying

¹ *Accounting Standards Statute PBU 6/01 on Recording Fixed Assets, confirmed by Ministry of Finance Order #26n of 03/30/2001.*

Property Tax also confirmed that the taxpayer should use the results of a voluntary reassessment of fixed assets when calculating the taxable base for property tax.

Thus, an enterprise may reassess a fixed asset at the beginning of the fiscal year (on the basis of documented market prices) and include the depreciation charges in his production costs. Moreover, the enterprise must use the results of the reassessment when calculating his taxable base for property tax.

Nevertheless, in our opinion, it is not clear that reassessing a depreciated asset is entirely legal, even if it is not explicitly prohibited, and it should certainly not be attempted without the permission of the local tax authorities. For example, if the leased asset was recorded on the lessee's balance sheet, its value was already included in production costs in the form of depreciation charges over the course of the lease. The tax authorities may therefore reject any attempt to reassess a leased asset and include its depreciation charges in production costs a second time.

Furthermore, one has to bear in mind that since an asset may only be reassessed at the beginning of the fiscal year, if the lessee assumes ownership of the leased asset in, say, February 2001, the reassessment cannot take place until January 1, 2002. And if the asset is redeemed at a price of 1 ruble, it will depreciate fully within the first month.

Does the leasing company have to pay sales tax if the lessee is a private entrepreneur and the lease payments are made by bank transfer directly from the entrepreneur's account?

According to Article 20, Clause 3 of Law #2118-1 on the Principles of the Russian Tax System (12/27/91), sales tax is levied on the wholesale or retail sale of goods or services in exchange for cash payment.² In this context, bank transfers by individuals are also considered a form of cash settlement. Since private entrepreneurs are individuals, a bank transfer from a private entrepreneur must be considered a form of cash payment. Therefore, a private entrepreneur's lease payments are subject to sales tax. The Tax Ministry also states that goods or services sold by legal entities to

individual entrepreneurs and paid for by means other than cash are subject to normal sales tax.³ However, the Tax Ministry admits that this puts private entrepreneurs at a disadvantage in relation to legal entities and suggests amending Federal Law #150-FZ on Amendments and Additions to Article 20 of the Law on the Principles of the Russian Tax System (07/31/98). Until this law is amended, however, the Tax Ministry believes that the sale of goods or services to private entrepreneurs in exchange for payment by bank transfer should be subject to sales tax.

The Ministry of Finance holds the opposite view, writing that «goods purchased by private entrepreneurs for commercial, non-personal use and paid for by means other than cash (i.e., by bank transfer), should not be subject to sales tax.»⁴

Furthermore, the Constitutional Court's Ruling #2-P of 01/30/01 established that Article 20, Clause 3 of the Law on the Principles of the Russian Tax System violates the Russian Constitution and shall anyhow go out of force by January 1, 2002.

We should also point out that since sales tax is a regional tax, the regional authorities are free to define their own procedures for paying the tax. For example, until 04/01/00, the city of Moscow did not levy sales tax on non-cash or barter transactions between legal entities and private entrepreneurs.⁵ However, the city was forced to abandon this policy on April 1, 2000, in compliance with a new letter from the Board of the Russian Tax Ministry.⁶

Therefore, private entrepreneurs should turn to their local branch of the Russian Tax Ministry for the final word on this matter.

² We should note that Russian law does not contain the concept of wholesale or retail sale of services. This might serve as grounds for doubting whether Clause 3 should apply to leasing companies, which provide a service in the form of financial leasing.

³ Russian Tax Ministry Letter #AP-8-03/1176 of March 13, 2000.

⁴ Ministry of Finance Letter #04-03-13 of June 8, 2000

⁵ The Board of the Russian Tax Ministry, Letter #11-14/17391 of 06/23/99 (08/02/99 redaction) on the Introduction of Sales Tax within the City of Moscow.

⁶ The Board of the Russian Tax Ministry, Letter #02-14/10266 of 03/23/00



Olga Shishlyannikova, an attorney with the IFC Leasing Development Group, answers questions from our readers.

Is it possible to lease unfinished construction?

Unfortunately, Russian legislation does not provide a clear answer to this question.

On the one hand, unfinished construction cannot be considered a «non-consumable thing,» since the asset will become a full-fledged piece of real estate (building, structure, etc.), subject to

official registration, once it is completed. As soon as the completed construction project is officially registered,

the unfinished construction will cease to exist, legally speaking. Consequently, the leased asset will also cease to exist.

On the other hand, the Federal Law on Real Estate and Real Estate Transactions defines unfinished construction as a kind of real estate, and current legislation places no restrictions or bans on the leasing of real estate. Adherents to this view believe that if the lessee completes the construction project, this should merely be considered as an enhancement of the leased asset. The state inspection agencies support this view.¹ However, we maintain that any lease on an unfinished construction project is likely to be problematic and to result in legal proceedings.

¹ For example, this was the view expressed by Tax Service advisor P.P. Gruzin in his letter of 02/22/99.

If a leasing company takes out a loan from a private individual or a private entrepreneur, is it violating the regulation that says that only lending institutions may accept deposits from individuals?

No, since these are two separate kinds of agreement. The main difference is that a bank deposit agreement is public by nature; that is, the bank must sign the same agreement on equal terms with anyone who wishes to make a deposit. Thus, the bank offers an unlimited group of people the opportunity to deposit money on certain specified terms. A loan agreement, by contrast, involves one specified individual or group of individuals and does not aim to attract investment (deposits) from an unlimited number of people.



Veronika Shtelmakh, an attorney with the IFC Leasing Development Group, answers questions from our readers.

Part I of the Tax Code contains a provision about 20% deviations from the market price. How exactly does this apply to a lease agreement where the total contract value far exceeds the value of the leased asset?

The statute in question appears to be Article 40, «Defining the Value of Goods, Labor or Services for Tax Purposes.» Clause 1 of Article 40 states that unless otherwise stipulated under this article, the price of goods, labor or services that was agreed between the parties is the price that should be used for tax purposes. Clause 2 lists the cases in which the tax authorities have the right to verify the appropriateness of the agreed price. There are four such cases: transactions between interdependent parties, barter transactions, foreign trade agreements and cases where the stated price is more than 20% higher or lower than the taxpayer charged for identical (similar) goods, labor or services within a short period of time.

Indeed, the total cost of a lease usually exceeds the cost of the equipment by more than 20%. However, it would be inappropriate to compare the cost of a sales agreement to the total cost of a lease, even for identical assets. Under a lease agreement, the leasing company provides the lessee with financial services; consequently, the lease payments include compensation for these services.. Therefore, the tax authorities can only compare the cost of a lease to the cost of another lease for analogous equipment involving the same services.

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