

# Effects of Lease Finance on Performance of SMEs in Bangladesh

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**Abstract:** *Over the years, Lease finance has been consented as one of the cornerstones of modern financial sources and a field of crucial decision for corporate organizations globally. As such, the purpose of this paper is to ascertain the effects of lease finance on the financial performance of SME's located on Munshiganj and Kushtia in Bangladesh and whether lease finance has a relationship with the Return on Equity (ROE) /Return on Assets (ROA) of organizations. This study uses content analysis with the usage of questionnaire instrument is adopted using a multi-stage random sampling population of 53 SMEs. Respondents are entrepreneurs of SME's and a study of SMEs' 2012 annual reports. This study investigated 23 Medium enterprises SMEs and 30 Small enterprises SMEs. This paper studies the relationship between lease finance and firm performance in cross-sectional data for each group of SMEs. The results show a positive correlation between lease finance and Return on Equity (ROE)/Return on Assets (ROA) through simple regression statistics. These findings suggest that SMEs in Bangladesh should be consistently involved in their lease finance practices because lease finance has a significant impact on improving the financial performance of Bangladesh's SMEs, especially Medium enterprises SMEs.*

**Keywords:** Lease finance, Performance, ROE, ROA, SMEs, Bangladesh.

## 1. Introduction

Lease financing was first introduced in Bangladesh in the early 1980s. Industrial Development Leasing Company of Bangladesh Ltd. (idlc), the first leasing company of the country, was established in 1986 under the regulatory framework of Bangladesh bank [1]. Lease finance companies are known as Non –Bank Financial Institutions (NBFIs). It play a vital role to meet up the financial needs of various sectors of an economy and thus contribute to the economic development of the country as well as to the deepening of the country's financial system. Lease financing has been a popular mean of financing over the years to the entrepreneurs. The leasing industry recorded an estimated growth rate in 2001-2002 of 25.5% over the previous year. The growth trend in the country reflects the preference and shift towards lease finance due to faster services, tax benefit and simplified documentation [2]. Based on the new definitions of SMEs, which includes industries with investments of Tk. 50 cores, around 95% of the existing industries in the country can be classified as SMEs [3]. According to a survey conducted by Bangladesh Small & Cottage Industries Corporation (BSCIC), it was found that there were total 197 types of small industries with 38,294 industrial units in the country. Based on 2002-03 data, the sectoral contributions to GDP in Bangladesh were 11.20% for large and medium industries, 4.71% for small industries, the total being 15.91%, as against 18.23% for Agriculture and forestry and 67.05% for others [4]. In fact, SMEs provide over 87% of the total industrial employment and responsible for the creation of over 33% of industrial value added goods of Bangladesh [5]. The contribution of the entire manufacturing industry to GDP is still very low, particularly for small industries of the country and so it clearly shows that there is room for growth in the SME sector especially for small manufacturing industries. SMEs huge contribution to employment generation and the role they play in sustainable development prompted many countries around the world to come up with special programs and support organizations for the development and growth of this sector [6]. The study of this paper is to investigate the

effect of lease finance activities on performance in SMEs located on Munshiganj and Kushtia in Bangladesh.

## 2. Literature Review

SME remains one of the most reviewed topics in literature, especially as its impact on all kind economies cannot be over looked. Worldwide, the SMEs have been accepted as the engine of economic growth and for promoting equitable development. Without finance, SMEs cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms [7]. A major barrier to rapid development of the SMEs sector is a shortage of both debt and equity financing [8]. Globally, leasing is another widely-used service for SMEs, although the lack of leasing law is constraining development of this sector in Nigeria [9]. Although leasing has a tremendous potential to address effectively the shortage of medium to long-term finance, in particular SMEs in Nigeria, it is however underdeveloped [10]. This is also the same in China where leasing companies and other non-financial companies" total asset account for around 1 percent of all financial sector assets [11]. Employment of a large number of skilled manpower at low cost due to high operational capital would result to increased productivity and customer satisfaction [12]. The trade off theory supports the opinion that leasing leads to tax allowable and thus high financial performance. Moreover, additional debt reduces agency cost, frees cash flow for use in making interest payments [13]. Long-term debt has a significantly positive relation with good performance on Ghanaian SMEs [14]. A firm is to increase in resorting to leasing with the increase in the risk of bankruptcy. Although the conservation of the legal ownership is a protection for the lessor yet it allows the firm to carry over the risk of obsolescence to the lender [15, 16]. The impact of the use of debt on a firm's profitability can be positive or negative. Leverage (debt) is positive when it is used to generate a return on assets that is higher than the before-tax cost of debt, thereby enhancing the return on equity. This results in profitability and wealth maximization. Positive leverage usually occurs when a firm operates under

favorable conditions, when sales and profit margins are high and when the company is able to generate a good return on assets. The final impact of positive leverage is on the return on equity, which increases at a rate faster than if the firm had no debt [17]. The minimization of the cost of capital and maximization of profitability through the use of debt finance might not hold for SMEs [18]. Studies on the effect of lease on returns have generated mixed results ranging from those supporting a positive relationship hypothesis to those opposing it [19]. The tax benefits of leverage are insignificant. They find that the use of debt has been found to have a negative impact on the profitability of the firms quoted on the Johannesburg Stock Exchange [20, 21]. Some of the most interesting questions in SME finance relate to the extent to which the theories of corporate finance fit the SMEs. These researchers question whether these theories, which were developed within the context of large and publicly owned firms, actually work when they are applied to small firms [22]. Although the study of the capital structures of listed and large firms may be of the greatest importance to the financial community, the interests of academics are broader. Academics are interested in studying the whole universe of firms and not just large firms. This means that long term leasing could have a significant positive relation with financial performance of SMEs [23]. However, in Bangladesh, leasing is one of the main forms of finance in Bangladesh SMEs. There remains no empirical evidence on the influence of lease structure on the performance of SMEs in Bangladesh. This paper aims to investigate the effects of lease finance on firm performance in SMEs located in areas favored by entrepreneurs. The hypothesis is that the relationship between lease finance and firm performance in the SMEs in Munshiganj and Kushtia in Bangladesh is positive. Thus, there are four hypotheses of this research. The first two hypotheses focus on Medium enterprises SMEs, whereas the other two hypotheses emphasis on Small enterprises SMEs.

**H1:** There is a positive relationship between lease finance and ROA for Medium enterprises SMEs.

**H2:** There is a positive relationship between lease finance and ROE for Medium enterprises SMEs.

**H3:** There is a positive relationship between lease finance and ROA for Small enterprises SMEs.

**H4:** There is a positive relationship between lease finance and ROE for Small enterprises SMEs.

### 3. Methodology

To verify the linkage between lease finance and performance of SMEs, The data was collected from both primary and secondary sources. Secondary information was collected from Ministry of Industries, SME Foundation, Bangladesh Bureau of Statistics and other SMEs related organizations. In order to collect primary information we have prepared semi-structured questionnaire for entrepreneurs. To assess the validity of the scale of the present study, content validity was used. For collecting information 53 SMEs were selected multi-stage randomly and purposively. Respondents are entrepreneurs of SME's. This study emphasized on Medium enterprises and Small enterprises. 23 out of 46 SMEs were selected from Medium enterprises and 30 out of 106 SMEs were selected from Small enterprises. Financial and time constraints along with ease of communication played the

major role in selecting the study area. I chose the two districts because it was easier for me to collect data as Munshiganj was work place and Kushtia is the home districts. Influential statistics were applied to analyze the data. Simple regression used to analyze the relationship between lease finance and return on assets (ROA), return on equity (ROE). Data for this study were calculated ROA and ROE of 23 Medium enterprises and 30 Small enterprises SMEs. All data include both SMEs that do concern themselves with lease finance and those that do not. The data on financial performance was generated from 2012 annual reports.

#### 3.1 Lease Structure

Leasing is an alternative means of financing plant, equipment and business vehicles. It is a contract between an owner of equipment (the lessor) and another party (the lessee) giving the lessee possession and use of a specific asset in return for payment of specific rentals over an agreed period. The lessee may or may not be entitled to acquire title to the goods through the exercise of an option to purchase, usually at the end of the lease term. The lessor's role is to finance the acquisition of equipment required by the lessee who will have selected the goods and dealt directly with the supplier in determining their performance attributes and suitability [24]. There are two main types of leasing, namely: operating and financing leasing. This study focused on these types but in relation to leased equipment.

#### 3.2 Scope of SMEs

Different countries and organizations classify SMEs differently. The Government of Bangladesh has categorized SMEs into two broad classes I. manufacturing activities enterprises II. Non-manufacturing activities enterprises and manufacturing and Non-manufacturing activities enterprises can be divided into two categories; Small enterprises: an enterprise should be treated as small if it has less than 25 workers, in full-time equivalents; Medium enterprises: an enterprise should be treated as small if it has between 25 and 100 employees [25].

#### 3.3 SMEs Performance

General measures of financial performance fall into two broad categories: investor returns and accounting returns. The basic idea of investor returns is that, the return should be measured from the perspective of shareholders. Accounting returns focus on how firm earnings respond to different managerial policies. This paper focuses on two accounting-based performance measures: return on assets (ROA) and return on equity (ROE). These are the two most commonly used measures for financial performance and will therefore provide the most comparable results. ROA and ROE were used separately to measure a firm's financial performance [26, 27; 28]. ROA is defined as the ratio of net income after tax to total assets, and ROE is defined as the ratio of net income after tax to outstanding capital. Information on ROA and ROE was collected from 2012 the annual report.

4. Findings

The casual relationship between firm performance using ROA and ROE with different SMEs to concerning and did not concerning on lease finance. This result emphasized of 23 Medium enterprises SMEs and 30 Small enterprises SMEs were investigated the relationship between lease finance and ROA and ROE. The result found that Medium enterprises were statistically significant positive correlated in a linear between lease finance and ROA (F= 8.672, p< 0.05). Lease finance activities can explain the variability of ROA 25.9% (Adjusted R2 = 0.259). Examine the relationship between lease finance and ROA for Medium enterprises are correlated in a linear that means if lease finance increase ROA will also increase and if the ROA is decrease with lower lease finance. Results are summarized in Table1.

Table 1: Regression Analysis Using ROA as Dependent Variable for Medium enterprises SMEs

Independent	Coefficient	Standard Error	t-Value
Lease finance	B 11.548	9.32377	2.94
Model Summary			
Adjusted R Square	0.259		
F-Statistics	8.672		
	Sig 0.008		

The result found that the Medium enterprises were statistically significant positive correlated in a linear between lease finance and ROE (F= 9.542, p< 0.05). Lease finance activities can explain the variability of ROE 27.9% (Adjusted R2 = 0.279). Examine the relationship between lease finance and ROA for Medium enterprises are correlated in a linear that means if lease finance increase ROE will also increase and if the ROE is decrease with lower lease finance. Results are summarized in Table 2.

Table 2: Regression Analysis using ROE as Dependent Variable for Medium enterprises SMEs

Independent	Coefficient	Standard Error	t-Value
Lease finance	B 10.862	8.37168	3.084
Model Summary			
Adjusted R Square	0.279		
F-Statistics	9.542		
	Sig 0.006		

The result found that the Small enterprises were statistically significant positive correlated in a linear between lease finance and ROA (F= 14.953, p< 0.05). Lease finance activities can explain the variability of ROA 34.8% (Adjusted R2 = 0.348). Examine the relationship between lease finance and ROA for Small enterprises are correlated in a linear that means if lease finance increase ROA will also increase and if the ROA is decrease with lower lease finance. Results are summarized in Table 3.

Table 3: Regression Analysis Using ROA as Dependent Variable for Small enterprises SMEs

Independent	Coefficient	Standard Error	t-Value
Lease finance	B 7.271	4.96208	3.867
Model Summary			
Adjusted R Square	0.348		
F-Statistics	14.953		
	Sig 0.001		

The result found that the Small enterprises were statistically not significant between lease finance and ROE (F= 0.171, p> 0.05). Results are summarized in Table 4.

Table 4: Regression Analysis Using ROE as Dependent Variable for Small enterprises SMEs

Independent	Coefficient	Standard Error	t-Value
Lease finance	B 2.753	17.56897	0.414
Model Summary			
Adjusted R Square	-0.029		
F-Statistics	0.171		
	Sig 0.878		

5. Summary and Conclusions

On the basis of the afore-mentioned findings, the following deductions are expedient: Evident from this study found that firm performance of Medium enterprises SMEs depend on lease finance activities, suggesting that SMEs in Bangladesh should be consistently involved in their lease finance practices because lease finance has a significant impact on improving the financial performance of Bangladesh’s SMEs, especially Medium enterprises SMEs. Although the Small enterprises SMEs found that the returns on equity are not related to lease finance, but even returns on assets that are positively correlated. This support previous studies that found a positive affected of lease finance and financial performance SMEs. Although lease finance institutes in Bangladesh are faced with insufficient funds problems which militate against their efforts to grant sufficient loans to SMEs, yet their tendencies to augment the financial needs of SMEs is considerably acknowledge. This study is useful for businesses and services in Bangladesh. Due to lease finance, supported in business circles which suggest that the benefits of the operation and is regarded as strategically important for entrepreneurs to understand the relationship of the activities lease finance the results of operations of the company. The study examined data from only one year. The results could have been more solid had they considered longitudinal data. This has a lot of implications on the economy and the nation at large, because if the businesses are doing well at the micro level due to availability of lease options, then Gross Domestic Product at the national level too would be influenced positively. Finally, the study considered SMEs that implemented lease finance, but did not take into account how long the lease finance activities had been in place. Moreover these studies not concern on control variable that previous research suggested have a relation with SMEs performance.

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