

CONSULTANCY REPORT

Recommendations to ABAD for Facilitation of Leasing Services

Financial Institutions and Leasing Companies:
What is the potential to increase access to leasing services in Azerbaijan?



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ABBREVIATIONS:

AAC	Azerbaijan Agribusiness Center (RECP - Pragma Corporation)
ABAD	Azerbaijan Business Assistance and Development project
ALDP	Azerbaijan Leasing Development Project (IFC)
BDS	Business Development Services
CIS	Commonwealth of Independent States (former Soviet Union)
DCA	Development Credit Authority
DEG	German Development and Investment Company
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
FAO	Food and Agriculture Organization of the United Nations
FI	Financial Institution
GoAJ	Government of Azerbaijan
IAS	International Accounting Standards
IBA	International Bank of Azerbaijan
IFC	International Finance Corporation
IRC	International Rescue Committee
MFI	Micro-finance Institution
MIS	Management Information System
PEP	Private Enterprise Partnership
RECP	Rural Enterprise Competitiveness Project
SECO	State Secretariat for Economic Affairs in Switzerland
SME	Small and Medium-sized Enterprises
USAID	United States Agency for International Development
VAT	Value-Added Tax

1. Executive Summary

1.1. Background:

The Azerbaijan Business Assistance and Development (ABAD) program seeks to increase access to leasing services for private-sector enterprises in Azerbaijan. The ABAD program operates primarily in rural regions of Azerbaijan, in areas known as economic corridors. In this context, FLAG International (FLAG), a subcontractor to ABAD, was tasked to evaluate the leasing environment in Azerbaijan, assess the constraints to the provision of SME leasing and to develop recommendations that will enable ABAD to develop a strategy to reduce these constraints and thereby increase access to leasing services for SMEs in ABAD project areas.

FLAG conducted an examination of the demand for leasing and other credit services in Azerbaijan,¹ distributing survey forms on the demand for credit products that were returned by 960 individual SME respondents in the economic corridors. Additionally, a complete overview of the formal-sector leasing services was conducted, including the results of a credit supply survey of 18 credit institutions in Azerbaijan, addressing their perception of key constraints in the credit provision market. Current leasing products are examined in detail through a competitive analysis including lease amounts, terms, flexibility, grace periods and interest rates. Integrated in the analysis are the processes surrounding the leasing products including: speed of processing, appraisal, approval, selection of asset, mode of disbursement, follow-up, collection and payment. A definition of leasing services is also provided in the report, with an explanation of the legal environment and the advantages of leasing for Azeri businesses.

Given the lack of presence and branch network of financial institutions in areas where ABAD is active, particularly in providing credit to the SME sector, this report provides particular focus on the potential role of ABAD in the development of private-sector institutions as suppliers of leasing and leasing services in the economic corridors.

1.2. Key findings:

Although the banking sector in Azerbaijan currently enjoys significant international support (e.g. by USAID, IFC, GTZ), leasing and credit institutions in the ABAD economic corridors are virtually non-existent, so that most SMEs in these areas lack credit access. Leasing companies and banks interviewed show a slow rate of expansion of financial services in the ABAD areas, and a high level of risk aversion to lending in these areas. At the same time, however, significant demand for credit services was expressed by potential individual and SME borrowers, with an estimated demand size in the ABAD economic corridors of over \$110 million. Although many borrowers expressed reluctance to pay, in their view, “excessive” interest, most conceded that they would access any credit that would be available in order to expand their businesses.

Therefore, any potential ABAD leasing access initiative will need to reduce these constraints to lending and at the same time, due to limited ABAD resources, mobilize private capital to support innovative solutions to lack of credit services. This will support SME businesses in the ABAD areas and at the same time provide impetus to financial institutions to provide credit in these

¹ Although the focus of this assignment is on facilitating access to leasing services, in many cases there is significant overlap in terms of consumer demand for leases and for “traditional” bank credit services. Therefore, many sections of this report are equally relevant for lending as well as leasing, and the recommendations made to support SMEs in the economic corridors are applicable in many cases to both of these types of debt finance.

areas over the long term. As ABAD has a grant fund and technical assistance resources to support this initiative, the consultant's findings outline the amount and combination of resources necessary to facilitate credit access and increase employment for SMEs in the ABAD areas.

1.3. Recommendations:

The consultant's recommendations for ABAD to facilitate SME leasing and credit provision in the rural areas of Azerbaijan include an array of interventions across the spectrum of financial institutions active in leasing, with an emphasis on 1) reducing constraints to leasing operations; and 2) promoting leverage of the ABAD grant fund with private capital. The recommendations focus on reducing two of the top three constraints to SME leasing in the economic corridors as identified by the survey of 18 Azeri financial institutions - high risk and high costs.

The consultant's recommendations (in progressing order of complexity) are for ABAD to:

1. Provide a grant to microfinance institution CredAgro (ACDI/VOCA) of \$50,000 to fund their development of a micro-leasing loan product. CredAgro will, in turn, on-lend at least \$250,000 of their own capital in ABAD economic corridors as result of the grant, leveraging ABAD resources at a 5:1 ratio.
2. Provide a \$100,000 grant to cover SME legal costs for collateral registration and to train local staff at the local ABAD Market Centers (MC) to increase capacity for leasing and finance facilitation activities. Grants will enable MCs to resolve legal challenges for SMEs and will increase their ability to serve as "credit brokers" for ABAD partner financial institutions. The resulting credit access by ABAD SME clients is estimated at over \$300,000, leveraging ABAD resources at a 3:1 ratio.
3. Develop a new methodology for using ABAD grants, setting aside \$250,000 to fund only 30% of the overall costs of grant projects, with a minimum 70% contribution required from financial institutions and/or entrepreneurs. For example, if an SME needs a new processing line that costs \$100,000, then an ABAD grant could contribute \$30,000 while self-contributions and loans from ABAD partner financial institutions could total \$70,000. This grants methodology will leverage ABAD resources at a 3:1 ratio.
4. Provide a series of small grants totaling \$100,000 to selected Azeri financial institutions for software acquisition, market research and operating costs to facilitate entry and expansion of lease providers into ABAD economic corridors. Grants should be provided through a public tender against a contractual agreement with ABAD for FI's to conduct a total of at least \$300,000 in additional leasing or lending activities in the ABAD economic corridors. This will provide leveraging of ABAD resources at a 3:1 ratio.
5. Establish an "ABAD Loan Guarantee Fund" of \$200,000 to provide a 50% first loss guarantee to selected FI's on leasing / lending portfolios in ABAD economic corridors. This would in essence be a "mini-DCA" activity. Although leverage amount will depend on overall eventual losses on the portfolio, the minimum leverage of ABAD resources would be 2:1 while the expected leverage (based on DCA experience) could reach 10:1.

The implementation of these recommendations will extend the operations of existing Baku-based financial institutions into the ABAD economic corridors. The provision by ABAD of \$700,000 in grant funds to facilitate credit will increase the amount of leasing and private-sector debt finance in the economic corridors by at least \$2,200,000, engaging private-sector capital at an average 3:1 ratio to ABAD funds. This will generate job creation and sustainment activities and contribute to the achievement of ABAD program goals in the economic corridors.

2. Background

The USAID-funded Azerbaijan Business Assistance and Development (ABAD) project seeks to increase access to credit and leasing services for private-sector enterprises in the rural areas of Azerbaijan. The ABAD project, which started its activities in August 2004, is implemented by the International Rescue Committee (IRC), Chemonics and FLAG International (FI). In accordance with its subcontract, FI was tasked to evaluate the leasing environment in Azerbaijan, assess constraints to SME leasing and to make recommendations that will enable ABAD to develop a strategy to reduce constraints and increase access of SMEs to leasing services.

The ABAD program's primary goals are to assist SMEs in the rural regions of Azerbaijan to increase sales and create new employment opportunities. ABAD achieves these goals by working directly with rural enterprises and local communities to create market linkages, improve technical and business skills and enhance the regulatory environment. Over the 5-year life of the project, the primary deliverables of ABAD are to increase sales in the economic corridors by at least \$15 million and to create at least 4,000 new jobs through project activities.

ABAD has a grant fund of \$1.25 million to facilitate these project goals, which is administered by FI under a subcontract. In accordance with the USAID-approved ABAD Grants Manual, grants can be provided by ABAD to SMEs, trade organizations, farmer associations or other legal entities that engage in activities to increase jobs to sales in ABAD economic corridors.

ABAD operates within economic corridors focused not on geographical borders, but on natural economic ties, defined by the commercial flows between rural areas and trade routes to Azerbaijan's major cities and neighboring countries: Iran, Georgia, Russia and Turkey. Each economic corridor is considered as a single economic unit. Each economic corridor has 1-3 Market Centers that serve as ABAD project offices and assist SME's in the rural areas with achieving increased sales and job creation. ABAD Economic Corridors and Marketing Centers are located as listed below:

- *GUBA-KHACHMAZ ECONOMIC CORRIDOR:*
 1. Guba marketing Center
- *LENKARAN ECONOMIC CORRIDOR:*
 1. Jalilobod Marketing Center
 2. Lenkaran Marketing Center
 3. Salyan Marketing Center
- *KHAZAKH ECONOMIC CORRIDOR*
 1. Tovuz Marketing Center
 2. Khazakh Marketing Center
- *ZAGATALA ECONOMIC CORRIDOR*
 1. Zagatala Marketing Center
 2. Sheki Marketing Center

The ABAD Marketing Centers are staffed by capable local employees and short-term consultants, knowledgeable about SME development and selected for their roles by an ABAD competitive public tender that was issued in each economic corridor.

In the context of the ABAD project and its goals, the consultant was tasked to:

1. Conduct a survey of existing leasing entities in Azerbaijan to evaluate the current supply of leasing services in the ABAD economic corridors;
2. Conduct an assessment for leasing product demand in the ABAD economic corridors;
3. Based on the surveys, desktop research and interviews with international and multilateral institutions (IFC, GTZ, USAID), identify constraints that inhibit the development of leasing services in the ABAD economic corridors;
4. Summarize the surveys, assessments and identified constraints and prepare recommendations to ABAD that will serve to increase leasing services in the economic corridors, which will lead to non-extractive industry job creation.

In accordance with the consultant's scope of work, the credit and leasing facilitation approach is to be designed to increase the amount of private-sector capital available in order to increase leasing programs throughout the ABAD economic corridors. ABAD leasing facilitation programs should be coherent and be based on SME demand. At the end of the assignment, the consultant is to propose a strategy to facilitate leasing for ABAD-supported SMEs.

In developing these recommendations, the consultant worked closely with ABAD, its local staff and the eight ABAD Market Centers (MC) to complete the assessment of the leasing environment in Azerbaijan. The consultant also consulted with relevant Azeri government, IFC, and private sector credit and leasing institutions to maximize cooperation and efficiency. As a result of the assignment and in response to the findings outlined in this report, ABAD should develop grant-funded projects to mobilize capital and facilitate financing to support innovative leasing solutions, using private capital to the maximum extent possible. *The goal of the consultancy is to increase access to credit and leasing services by ABAD-supported SMEs and agricultural producers in the economic corridors.*

3. General Information on Leasing

3.1. Leasing—An Overview²

A lease can be defined as a rental agreement that extends for a year or more and involves a series of fixed payments. More formally, leasing is a contract between two parties, where the party that owns an asset (the *lessor*) lets the other party (the *lessee*) use the asset for a fixed and predetermined amount of time in exchange of periodic payments. In leasing, legal ownership and use of an asset are separated. Leasing gives enterprises that either do not wish to purchase equipment (because leasing is cheaper) or cannot do so (because they do not have the required funds and/or lack access to bank finance) the opportunity to use equipment without having to own it. The basic concept that underlies leasing is that profits are earned through the use, rather than the ownership, of productive assets (Gallardo 1997).

Leasing is not a new phenomenon, but in Azerbaijan, access of small and micro-enterprises to leasing services, particularly in regional areas outside of Baku, is still very infrequent. This is surprising because, as outlined below, leasing has many distinct advantages over credit in developing economies such as Azerbaijan. Regulations on leasing activities allow the lessor to

² Sources: Breal and Meyers (2003), World Bank Rural Finance Paper #7 (2004), in-country interviews.

use the leased asset as collateral, and there many other advantages to leasing that are not understood by, or marketed effectively to, SMEs in Azerbaijan.

Typically, a lease's term is structured to have some correlation with the useful life of the leased asset. In many cases, depending on the type of lease (see below), the lease term may stretch up to 70% of the estimated useful life of the asset. In this way, should a leased asset need to be recovered due to delinquency, the value of the lease is not depreciated to a significant extent beyond the resale value of the asset.

From the lessor's perspective, the lessor has a stronger security position compared to that of the lender as the lessor continues to own the equipment until the lease payments are completed. In contrast, in a normal bank loan transaction, the borrower owns the equipment; the lender only has a charge on the collateral (which usually includes the equipment). In the case of default, repossessing a leased asset is much easier than repossessing collateral. In the consultant's view, this is of particular advantage in Azerbaijan, where creditor rights are weak and a lender is usually forced to be involved in lengthy court proceedings in order to take possession of borrowers' collateral.

3.2. Types of Leases

Leases in rough terms consist of two types: *finance leases and operating leases*. In a *finance lease*, the lease period typically extends for the entire period, or a major period, of the equipment's economic life and the risks of equipment obsolescence, maintenance, and insurance are borne by the lessee. Finance leases are usually not cancelable, making them similar to term-loans (both oblige the equipment user to make a series of future payments—lease payments in the case of a lease, and interest and principal for a loan). When a lease amortizes the full equipment cost, the lease is a *full payout lease*; such leases usually establish a token price, such as one dollar, at which the lessee can purchase the equipment at the end of the term. SMEs and most leasing companies surveyed in Azerbaijan indicated a desire for financial leasing services.

In an *operating lease*, the lease is over a period that is substantially less than the asset's economic life. The lessee does not intend to purchase the asset. The lessor recovers the asset cost through multiple leases and the equipment's final sale. Hence, estimation of residual value of the asset (value at the end of a lease term) is important in operating leases. Maintenance costs and obsolescence risks lie with the lessor. To provide operating leases, lessors may also need additional infrastructure such as warehouses, retail operations and maintenance personnel. Major providers of operating leases include rental car companies and providers of agricultural machinery services, among others. Operating leases, for the most part, are of little use to Azeri SMEs who need equipment over a longer term with an option for purchase at the end of the term.

3.3. Advantages of Leasing

Leasing offers several advantages over loans in Azerbaijan, both to the lessees and to the lessors. For SMEs and rural enterprises in the ABAD economic corridors, particularly those currently having no access to bank loans, this could possibly be their only means. In addition to simple access to finance, leases are in many cases more affordable than loans since down payments are lower than bank requirements, and additional collateral is seldom required.

Listed below are a range of reasons for SME businesses to access leasing services:

- **Conserves Cash and Working Capital.** Cash is not tied up in equipment. Instead, it is available for opportunities such as working capital, marketing or seasonal cash flow;
- **Payment for Usage.** Monthly payments allow use of the property immediately, with initial cash outlay being the first and last rental payment. The new equipment, with its operating efficiencies, pays for itself as it is used over time. Profits are generated by the use rather than the ownership of equipment;
- **Leasing is 100% Financing.** Leasing can finance up to 100% of the cost of the property, including "soft" costs such as shipping, training, and installation;
- **Eliminates Equipment Obsolescence.** Leasing allows regular upgrades of equipment to a state-of-the-art level, eliminating the inefficiencies of owning out-dated equipment;
- **Leased asset used to secure payments.** The fact that the leasing company retains legal ownership of the asset enables it to focus on the lessee's ability to generate cash flow rather than on its credit history, assets, or capital base. This makes leasing particularly well-suited for financing investments made by new or small companies, or companies operating in Azerbaijan where collateral laws are weak.

In sum, leasing can serve as an innovative and inexpensive method for SMEs to access credit. Financial institutions in Azerbaijan offering leasing, however, are still in their infancy. An examination of the causes of this phenomenon is conducted below.

4. The Leasing Environment in Azerbaijan

Currently, there are 3 banks and 14 leasing companies providing leasing-related financial services in Azerbaijan.³ The overwhelming majority of these leases are being made to large companies operating within the construction, transport and oil sectors. As shown by the information derived from the ABAD Leasing Demand survey, below, the portfolio sizes and current operations of these companies are for the most part insignificant in comparison to the estimated demand for leasing products, particularly in areas outside of Baku. Although this report will demonstrate that few legislative or regulatory constraints exist that inhibit the expansion of leasing services, other constraints are identified that reflect the challenges perceived by the financial institutions themselves in providing leasing services in ABAD areas.

Numerous positive changes in the leasing environment in Azerbaijan have occurred over the past few years, with the support of the International Finance Corporation (IFC) under a leasing facilitation project supported by the Swiss State Secretariat for Economic Affairs (SECO). The IFC was a key supporter in the foundation of the Azeri Leasing Association and provides support and recommendations to the Azeri government on legal issues related to leasing.

4.1 Operations of Leasing Companies in Azerbaijan

According to the IFC, over \$7 million worth of equipment was leased to private sector companies in Azerbaijan by local financial institutions in 2004. Also during the year, the total registered capital of the leasing companies more than doubled, reaching \$2.5 million. As a result of ongoing reforms in leasing legislation and the IFC's professional training programs and

³ Many other leasing companies, at least an additional ten as of August 2005, have registered and announced that they intend to provide leasing services in the future, however this report deals only with active leasing providers.

consultations on leasing practices, the number of Azerbaijan’s leasing companies has grown from seven to twenty-four, and many more companies are in the process of registration (albeit many of these companies have non-existent or miniscule leasing portfolios at this time).

Although these numbers seem impressive from a macro perspective, the truth is that only a small fraction of this portfolio is to non-extractive industry players and SME borrowers. The majority of this portfolio size, well over 80%, is located in the areas in Baku or the Absheron peninsula. Therefore, the majority of the activities of leasing companies in Azerbaijan are irrelevant to SME operators in the ABAD economic corridors, as shown by the charts and tables below.

The following table summarizes the activities of the most active Azeri leasing companies:

Company	Capital	Disbursed to date	Outstanding portfolio (USD)	No. of lease agreements	Minimum down payment	Lease amount	Interest rate (APR)
Azerilizing	\$750,000	\$12,167,119	\$11,571,452	102	20%	Min \$20,000	16-17%
SLC - AZERLIZING	\$220,143	\$940,000	\$780,000	96	20-25%	\$1,000-\$60,000	20-25%
ATA Leasing	\$531,123	\$999,700	\$856,316	16	25-30%	Min \$ 5,000	22%
UniLeasing	\$212,314	\$3,702,503	\$2,811,431	32	20%	min \$15000	19%
AG Leasing	\$630,000	\$630,000	\$630,000	15	20-50%	\$5,000-\$100,000	20-24%
Mugan Leasing	\$5,000	\$5,000	\$5,000	1	20%	\$5,000-\$300,000	20%
Parex Leasing	\$2,333,000	\$1,166,562	\$1,166,562	24	20-30%	\$5,000-\$150,000	17%
Texnika Leasing	\$10,600	\$10,600	\$10,600	2	20%	\$1,000-\$100,000	15%

Table 1

Currently, one of most important issues for the majority of companies active in the Azeri leasing market is increasing sources of financing, both domestically and internationally, for the expansion of their leasing operations. Many companies are seeking additional capital through their shareholders, or from international lending institutions, for on-lending. Recently, the AG Leasing company was able to raise \$500,000 in local currency through an innovative bond issue, the first of its kind in Azerbaijan. Of note, access to capital was the major constraint to expansion of services that was identified by the consultant’s survey of leasing companies.

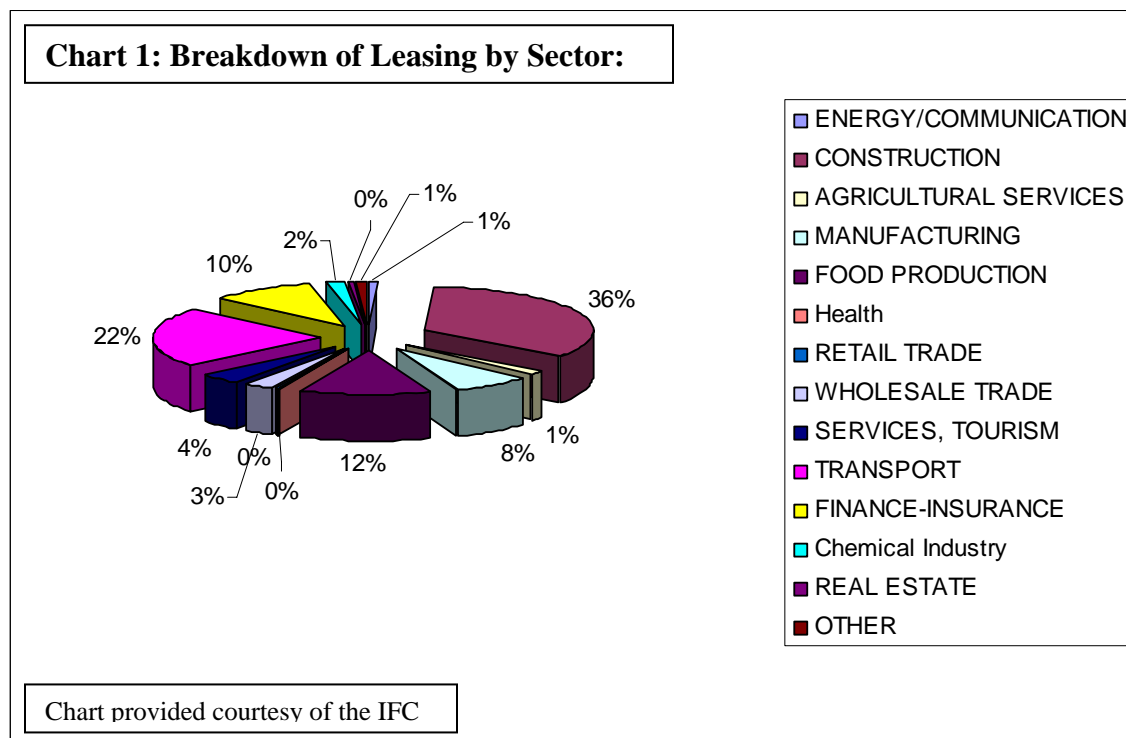
4.2. Leasing Operations of Banks in Azerbaijan

Banks are authorized by Azeri legislation to engage in leasing activities, but most banks do so through subsidiaries established for this purpose. A few banks, most notably Respublika Bank and Debut Bank, are engaged in leasing operations directly and not through subsidiaries. This is unusual, although allowed by the National Bank of Azerbaijan. However, the below banks indicated a desire to form a leasing subsidiary in the near future.

The following table summarizes the activities of Azeri banks involved in leasing activities:

Bank	Capital	Disbursed to date	Outstanding leasing portfolio (USD)	No. of agreements	Minimum down payment.	Lease amount	Interest rate
Respublika Bank	\$32 million	\$32 million	\$3,571,452	102	20%	Min \$20,000	16-17%
Debut Bank	\$4.5 million	\$940,000	\$780,000	96	20-25%	\$1,000-\$60,000	20-25%
Gunay Bank (leasing)	\$100,000	\$150,000	\$93,000	12	40%	\$5,000-\$50,000	24%

Table 2



Of note is the fact that the IFC, through its Azerbaijan Leasing Development Project (ALDP), has signed a formal memorandum of understanding with Bank Respublika. According to the memorandum, ALDP agreed to provide technical assistance, including: preparation of a business plan, establishing an effective organization structure, preparation of a financial plan, hiring and training of staff, setting up credit and operational policies and procedures, reviewing software needs and reviewing the marketing strategy and other related issues.

4.3 The Legislative Framework for Leasing in Azerbaijan

In the consultants view, the legislative framework for leasing operations in Azerbaijan is appropriate and generally positive. The Cabinet of Ministers of Azerbaijan has exempted value-added tax and custom duties on the majority of imported leased assets, a move that is designed to increase the volume of lease finance in the country. By adopting the exemption decrees, Azerbaijan has created new incentives to support its rapidly-growing leasing industry. Additionally, customs regulations have been modified to facilitate the customs-free import of

equipment for leasing, although five of the financial institutions surveyed for this report have identified the customs regime as insufficient and ripe for modification.

These measures were advocated by the International Finance Corporation (IFC) through its Leasing Development Project, with support from Azerbaijan's Ministry of Economic Development. Drawing on its global and regional expertise in the leasing sector, IFC identified specific areas of leasing legislation that needed reform in order to improve the market for leasing. IFC then drafted the legislative amendments that were passed by the government's decrees. As a rule, all financial institutions surveyed were aware of, and grateful for, IFC's activities in this sphere.⁴

Azeri legislation establishes that a leased asset can be any non-consumer good including enterprises, property complexes, buildings, constructions, equipment, transportation means and any other movable and immovable property which are used for (commercial) entrepreneurial activities. Leased assets cannot be land and other objects of nature, or property barred from general public circulation or trade.

The Azeri law on leasing allows the lessor to use the leased asset as collateral. By law, the lessor must notify the lessee prior to signing off on a pledge, but is not required to receive approval from the lessee. This limits the right of the lessee, even though the law on leasing gives the lessee the right to immediately pay off the lease amounts and transfer ownership of the asset. This may not be sufficient legal protection for the lessee in some cases, since the lessee may not have sufficient funds to immediately purchase the asset.

Of note is the fact that Azerbaijan does not require special licensing for the formation of leasing companies or the registration of leasing transactions, which is a positive factor in the leasing legislation of Azerbaijan. The National Bank of Azerbaijan is not a supervisory authority for leasing companies (although it is for those Azeri banks engaged in leasing operations); this is the responsibility of the Ministry of Finance. Licensing requirements are not burdensome and, to date, formal supervision is relatively light.

4.4. Activities of the GoAJ to facilitate leasing

As noted above, the government of Azerbaijan has implemented a number of measures designed to increase the provision of leasing services. Many of these measures, particularly those on the legislative and regulatory spheres, have been implemented in accordance with recommendations and guidance from the IFC. As a result of these legislative activities, there are few constraints to leasing in these areas.

In the operational arena, as a part of the Rural Development Fund administered by the Ministry of Economic Development, subsidized government funds are provided to financial institutions for on-lending under a competitive tender process. These funds have been provided to a number of banks over the past few years for on-lending at subsidized, below-market interest rates. Most recently (2004) over \$20 million was provided to a number of state and private-sector banks, while apparently \$30 million will be provided in 2005, for on-lending to SMEs. Under this

⁴ The consultant is also grateful for the support and information provided by the IFC while conducting research for this report. Much of the information in section 4.3, in some form, was provided by the IFC.

program, the banks borrow funds from the government at roughly 3% annually and on-lend with a cap of 7% annual interest.

In 2004, the GoAJ announced a similar program to facilitate leasing in the regions of Azerbaijan, announcing subsidized loans of \$20 million mainly to state-owned financial institutions to procure farm equipment from CIS countries and Turkey for on-lending to the Azeri agricultural sector. Terms announced by the government include a relatively long (6-12 month) grace period, a 7% annual interest cap and unspecified equipment maintenance assistance. This program follows up a similar but separate \$20 million project funded by the Japanese government in 1999 that, according to the CEO of Agrar Credit, is facing non-payment rates of over 50% on the portfolio (an example of the perils of subsidized leasing).

In the consultant's view, these and similar programs by the GoAJ have led to "pollution" of both the lending and leasing environments in Azerbaijan. Significant levels of government advertising and news updates have led many potential borrowers to believe that they, too, can access a loan or lease through the government program at 7% annual interest. This was indicated in the credit demand survey (see below) where over 28% of the respondents indicated that they would be willing to pay a 7% interest rate, but not more, on a loan or lease.

However, these subsidized loans are extraordinarily difficult for the average Azeri SME to access, with only \$12 million disbursed to an estimated 850 borrowers in 2004. The funds provided last year, \$20 million, do not address even a fraction of the credit demand in Azerbaijan for SME lending. Additionally, the majority of SME respondents to the ABAD lending survey expressed both confidence that they could access a 7% loan "if they wanted" and strong suspicion that this would require paying bribes to loan officers, or accessing the informal services of relatives and friends in the banks or the Azeri government.

As a result of these government programs, many lending institutions feel that the Azeri government is distorting the lending environment by subsidizing interest rates through state subsidies and by disseminating political propaganda making potential borrowers believe that cheap loans are available to everyone. In many cases, this has served to weaken demand for "market rate" loans (currently set from 16-24% per year, on average) and weakens borrower repayment rates, as some borrowers feel that the market rates are usurious in comparison with state-subsidized lending. This was identified as one of the top ten constraints by the 18 respondents to the ABAD Leasing Supply survey.

4.5. Constraints that restrict expansion of leasing services in Azerbaijan

As noted above, there are no formal constraints to leasing, as the legislative environment is generally positive and the licensing requirements for new entrants are not burdensome. Although many companies mentioned that changes should be made in the VAT regime that could increase the appeal of leasing, this was not identified as a major constraint and in any case, the macro-environment is beyond the scope of this consultancy. The leasing sector in terms of macro-level and other regulatory constraints is currently well-supported by the IFC.

However, a number of other constraints on the operational level, outside of the legislative environment, are examined in this report in the sections below.

5. Leasing Services – Summary of Demand and Supply Surveys

As outlined in the Scope of Work, this report provides an examination of the demand for, and supply of, leasing services in Azerbaijan. The ABAD Leasing Demand Survey analyzes the responses of 960 respondents in the economic corridors to questions about their perceptions of credit requirements, access and costs. The ABAD Leasing Supply Survey analyzes the responses of 18 financial institutions to questions about leasing and credit provision. In the latter survey, credit and leasing products are examined in detail through a competitive analysis including lease amounts, terms, flexibility, grace periods and interest rates. Integrated in the analysis are the processes of the lease products including speed of processing, appraisal, approval, selection of asset, mode of disbursement, follow up and collection, payment incentives and repossession.

5.1. Leasing and Credit Demand Survey

The consultant designed and, through the eight ABAD Market Centers, distributed a comprehensive survey to assess leasing demand, including desired use of leasing services by potential borrowers and local perceptions of the availability and cost of leasing services. The demand survey was filled out and returned by 960 potential borrowers through the Market Centers in the ABAD economic corridors, which provided enough background for a detailed analysis to be conducted. The main purpose was to estimate leasing demand in the economic corridors and provide approximations by ownership, by type of business registration, by gender and by urban-rural location of establishments. Another important objective was to determine the basic profile of prospective customers, both in terms of risk and willingness to borrow.

The ABAD Leasing and Credit Demand Survey, distributed nationwide in the ABAD economic corridors, received responses from 960 SMEs and individuals surveyed. Of these, 911 were registered businesses and 49 were non-registered. In terms of gender, male-owned businesses surveyed amounted to 886, while those owned by women were 74. And, in terms of urban-rural location, 721 responses were from urban and 239 from rural areas.

The survey revealed that the majority (88%) of the potential borrowers indicated a strong demand for access to lease (and other) debt finance for expansion of their businesses. Of these, only 21% of respondents indicated that they had access to loans from relatives, friends and neighbors. The rest lacked access to finance, despite a strong willingness to borrow and the existence of government programs designed to facilitate lending. However, 28% of the respondents indicated that they would be willing to pay a 7% interest rate, but not more, on a loan or lease, mainly due to government advertising of subsidized loan programs.

To estimate overall credit demand, two indicators were used by the consultant. The first was the potential size of demand, determined by the *desire of surveyed establishments to access leasing and credit services*. The second is the effective market demand, which was determined by the *monthly loan installment that SME entrepreneurs can afford to pay*. The latter provided a more accurate approximation of actual market demand for credit.

Potential Demand Size: The demand for leasing and credit services in the economic corridors is estimated at \$110 million. Of this total, \$91 million is attributed to registered businesses and \$19 million to non-registered concerns. In terms of urban-rural location, \$87.6 million of potential

borrowing is generated from urban-based SMEs and \$22.4 million from firms located in rural areas. The following responses from the survey are notable:

- 78% of respondents willing to borrow require loans in a range from \$1,000 to \$30,000;
- Demand for loans below \$200 and above \$100,000 is small, less than 2%;
- Demand for loans below \$1,000 is only 4.5% of SMEs, while for those SMEs interested in loans above \$50,000 the percentage is over 3%;
- 14% of SMEs responding willing to borrow require loans from \$30,000 to \$100,000;
- However, 72% of those surveyed indicated that they faced difficulties with banks due to collateral, business documentation, corruption or other constraints.

These and other results of the survey demonstrate that there is a large unmet demand in the ABAD economic corridors for leasing products. Based on an extrapolation of results, it can be estimated that over 10,000 of Azeri SMEs are seeking medium term (2-3 years) financing ranging from approximately \$1,500 to \$50,000. According to the survey of SME-level entrepreneurs in the regions, most require an average of \$10,000 - \$25,000, which is at the high end of available MFI loans (for example, from MFI CredAgro).

Equally significant is that the survey indicated that many SMEs desiring to expand their operations prefer to finance expansion from existing cash resources or retained earnings. This fact supports the important finding that entrepreneurs exhibit a certain degree of reluctance to borrow. However, where most SMEs in the survey indicated a lack access to additional cash resources, they also revealed a preference to access credit from commercial banks supported by state subsidies, as indicated in section 4.5 of this report.

Potential Market Size: The effective market demand for credit products, in this survey, is that which is determined by the *monthly loan installment that SME entrepreneurs can afford to pay*. This provides an accurate approximation of actual market demand for credit services. The approximation of actual market demand is provided in the preceding paragraphs. Worthy of note here is the fact that 711 entrepreneurs surveyed indicated a demand for loans of over \$10,000.

According to the responses to the survey questionnaire, the average monthly loan payment that can be serviced by Azeri SMEs in the ABAD economic corridors is \$414, implying an estimated \$11,000 loan at 16% annual interest and a 3-year term (including a 3-month interest-only grace period). Although this is of course a summarized calculation on a wide range of possible lending scenarios (as described above) it further confirms the estimate of the lending market size in the corridors of approximately \$110 million. Obviously, the rough monthly amount can be calculated differently on a wide variety of loan terms and sizes, but the existing lending and leasing market conditions in Azerbaijan support the above calculation. Assuming that the extrapolation of 10,000 SMEs requiring loans in the economic corridors is roughly accurate, this results in a credit demand size of approximately \$110 million.

In sum, the results of the survey demonstrate that extensive demand for credit products exists in the ABAD economic corridors, both from SMEs and individual borrowers. Consumer perception of appropriate interest rates is skewed due to government-subsidized lending programs, but this has not lessened credit demand to a significant extent. The questionnaires used for the demand survey are attached in the appendices.

5.2. Leasing and Credit Supply Survey

The ABAD Leasing and Credit Supply Survey analyzed the responses of 18 financial institutions to questions about credit provision. In the survey, credit and leasing products were examined in detail through a competitive analysis including lease amounts, terms, flexibility, grace periods and interest rates. Integrated in the analysis are the processes surrounding the leasing product including: speed of processing, appraisal, approval, selection of asset, mode of disbursement, follow up and collection, payment incentives and repossession. The details of the credit products and operations of the banks and financial institutions are provided in the competitive analysis section located in Appendix F.

The survey revealed that, for the most part, banks and leasing companies are not conducting lending operations in the ABAD economic corridors of Azerbaijan. According to the survey of the financial institutions, only approximately \$8 million in loans are currently outstanding in these areas, with most of the banks expressing reluctance to lend for a number of reasons outlined in section 6, below. A number of large enterprises, non-SME sized, are being supported (Safi Juice Company, Davachi Broiler, others), primarily by the state-owned banks, but SMEs that have few political connections or direct access to the Azerbaijan Rural Development Fund lack access to credit.

Taking into account the fact that, based on their own data, banks and leasing companies have captured, at most, only 5% of prospective borrowers in the economic corridors, the market segment that can be captured by financial institutions willing to lend in these areas is of considerable size. Given the fact that bank and leasing company activity is virtually insignificant (when measured against demand), the consultant estimates that financial institutions can capture significant additional potential borrowing. However, a lack of capital, as well as risk aversion and other constraints (behavioral and otherwise) has restricted the expansion of Azeri financial institutions into the ABAD economic corridors.

As outlined in the SOW, a major focus of the consultant's assignment was to conduct, as part of the credit supply survey, interviews with financial institutions in an effort to answer the question "Why are financial institutions NOT providing credit services in the ABAD economic corridors?" In this survey, the top 10 constraints to the growth of credit and leasing activities by registered financial institutions in Azerbaijan were identified (in priority order) as below:

1. Excessive **risk** of lending / leasing in the rural areas;
2. Lack of sufficient **loan capital** to expand lending operations;
3. Excessive **operational costs** to provide lending services outside of Baku;
4. Lack of exemption of **import VAT** on leased assets;
5. Low-interest **competition** from the Azeri government (see above);
6. Excessive **monitoring** costs;
7. Lack of **knowledge** of SME businesses in ABAD economic corridors;
8. Lack of appropriate fit into **organizational strategy**;
9. Lack of **skilled lenders** or leasing experts for increased lending;
10. Lack of sufficient **software** for tracking increased leases.

Of note is the fact that, of all the constraints listed by the institutions in priority order above, the top three constraints were identified as being within the top five constraints by each and every

one of the financial institutions interviewed. Therefore, the focus by the consultant is on potential interventions by the ABAD program, and particularly ABAD grant fund and technical assistance resources, to alleviate these top three constraints.

6. Consultant Findings

Although the banking sector in Azerbaijan currently enjoys wide international support (e.g. USAID, IFC, GTZ), lending programs in the economic corridors are virtually non-existent, so that most SMEs and agricultural enterprises in these areas lack credit access. Despite the lack of significant regulatory or legislative hurdles to leasing provision in Azerbaijan, leasing companies and banks interviewed show a slow rate of expansion of financial services in the regions and the ABAD economic corridors, and a high level of risk aversion to lending in these areas.

At the same time, significant demand for credit services was expressed by potential individual and SME borrowers in the economic corridors, with an estimated credit demand size of over \$110 million. Although many borrowers identified a reluctance to pay, in their view, “excessive” (market rate) interest, most conceded that they would access any credit that was available in order to expand their businesses. Although the business ideas of the SMEs were not evaluated by the consultant, an assumption can be made that at least some of them are viable and could be approved by a leasing company or bank implementing cash-flow based lending criteria.

Taking into account that, based on their own data, banks and leasing companies have captured, at most, only 5% of prospective customers in the economic corridors, the market segment that can be captured by financial institutions willing to lend in these areas is of considerable size. Given the fact that bank and leasing company activity is virtually insignificant (when measured against demand) in these areas, the consultant estimates that financial institutions are able to capture significant levels of additional borrowing. However, a lack of capital, risk aversion and other constraints, behavioral and otherwise; have restricted the expansion of Azeri financial institutions into the corridors, as described above.

Therefore, any ABAD credit access initiative to increase lending and leasing in the economic corridors will need to reduce the constraints identified by the financial institutions. As ABAD lacks sufficient resources to provide funds directly to financial institutions for on-lending, financial institutions must be encouraged to mobilize additional lending capital. ABAD can support innovative leasing solutions that resolve the other constraints identified, while using the institutions’ private capital to the maximum extent possible.

As ABAD lacks financial resources to provide funds directly to financial institutions for onlending, but does have a grant fund and technical assistance resources to support the reduction of the other constraints identified by the institutions, the consultant’s findings outline the combination and amounts of ABAD grant and other resources necessary to facilitate credit access in the ABAD economic corridors. These recommendations outline the optimal use of the ABAD grant fund to increase lending, and by implication job creation and revenue increases, for SMEs in the economic corridors. This will increase support for viable SME businesses in the ABAD economic corridors and at the same time provide impetus to credit institutions to provide additional credit resources in these areas on a sustainable basis.

7. Consultant Recommendations

The consultant's recommendations for ABAD to facilitate SME leasing and credit provision in the rural areas of Azerbaijan include an array of interventions across the spectrum of financial institutions active in leasing, with an emphasis on 1) reducing identified constraints to leasing operations; and 2) promoting leverage of the ABAD grant fund with private capital at a minimum 3:1 ratio. The recommendations focus on reducing two of the top three constraints to SME leasing in the economic corridors, those of high risk and high costs, as identified by the ABAD survey of 18 Azeri financial institutions.

Recommendations for providing ABAD grant support to facilitate the expansion of leasing operations into ABAD economic corridors are listed below in progressing order of complexity:

Recommendation 1:

Provide an ABAD grant of \$50,000 to microfinance institution CredAgro for the development of a micro-leasing loan product in the ABAD economic corridors.

CredAgro is the only rural lending institution surveyed with the intention to introduce a micro-leasing product in the ABAD economic corridors. CredAgro has been working for some time on the design of this activity that would target a new group of potential borrowers, particularly in the Lenkoran and Guba areas. However, their current profitable use of available lending capital in non-leasing agricultural lending, as well as a shortage of available operating funds to invest in leasing product development and pilot-testing, has resulted in significant delays in the launch of CredAgro micro-leasing product.

An ABAD grant to CredAgro of \$50,000 would provide them with operating funds necessary to complete their product design and to procure equipment for their micro-leasing operation. The grant would also cover travel costs, technical assistance, market research and equipment evaluations that will allow them to roll out a micro-leasing product for agricultural producers.

Additionally, the grant would also provide a loan guarantee for CredAgro that will enable them to access over \$500,000 in additional funding for on-lending. Of this, once secured, CredAgro will in turn lend at least \$250,000 as part of their leasing product within ABAD economic corridors, and as appropriate directly to ABAD Market Center clients.

The grant would have three components, thereby dividing the grant into three parts.

Component 1 would be a grant of \$20,000 to assist in determining the source of agricultural equipment such as tractors, bailers, etc. for potential borrowers. Obvious markets from which to procure items such items are Russia, Ukraine, Belarus and Turkey. Finding suppliers is time-consuming and costly for any farmer or entrepreneur, therefore CredAgro will conduct this research using the ABAD grant as a resource.

In this context, CredAgro will send their Marketing Specialist and operations staff to various agriculture and equipment fairs in the above-mentioned countries, in order to better understand the market for equipment in Azerbaijan's agricultural sector. CredAgro will then procure the equipment using their own funds, thus securing economies of scale on the purchase and transport price of the equipment that farmers would be unable to achieve individually.

The total cost for attendance of three fairs would be approximately \$20,000. A breakdown of the ABAD grant intervention for Component 1 of the grant is as follows:

Component 1 Item	Cost	Number	Total Cost
Airfare	\$750	4	\$3,000
Hotel	\$100	16	\$1,600
Per Diem	\$50	16	\$ 800
Marketing Materials	\$200	1	\$ 700
Visas, local transport	\$100	4	\$ 500
		Total	\$6,600

At \$6,600 per trade fair, three fairs can be attended with the \$20,000 total for this component.

Component 2 would be a grant of \$20,000 to continue development of their micro-leasing product by funding additional market research and outreach for the product. First, CredAgro would conduct a thorough survey of existing equipment in the markets where they have branch offices. Then, CredAgro would hire short-term consultants and marketing specialists to conduct a formal and detailed market evaluation using the ABAD grant resources. After development of these elements, CredAgro would conduct extensive training for its staff for the new leasing product.

For outreach, CredAgro would participate as an exhibitor in equipment exhibitions in Baku, especially food processing and agriculture equipment if these types of shows occur. In this context, CredAgro would need assistance to develop a booth and marketing materials. Once CredAgro launches the leasing product, it will be necessary to begin a marketing campaign including billboards, posters and other promotional materials.

The total cost for these interventions would be approximately \$20,000. A breakdown of the ABAD grant intervention for Component 2 of the grant is as follows:

Component 2 Item	Cost	Number	Total Cost
Staff Training	\$10,000	1	\$10,000
Outreach Costs	\$5,000	1	\$5,000
Marketing Materials	\$5,000	1	\$5,000
		Total	\$20,000

Component 3 would be a grant of \$10,000 to purchase a loan guarantee which will enable CredAgro to secure additional lending capital from a Dutch Microfinance Equity provider. According to the terms of CredAgro’s tentative agreement with this institution, it can purchase a loan guarantee for approximately 2% of the projected loan value. This means that \$10,000 will assist CredAgro to secure a loan for \$500,000 for on-lending to their current and other potential borrowers. Under a grant agreement with ABAD, CredAgro would ensure at least 50% of these funds went into a micro-leasing product to support SMEs and farmers in the ABAD economic corridors. Additionally, ABAD could place a representative on the CredAgro Credit Committee, if appropriate. This grant would be conditional on more information provided by CredAgro and signed contractual agreements with the equity provider upon approval of the ABAD grant.

A grant to facilitate the creation of a loan guarantee for CredAgro, as well as the resulting leverage that ABAD would achieve by this type of assistance, will greatly increase the amount of micro-leasing services that will be provided in the ABAD economic corridors. Pending more information from CredAgro about the details of the institution to be provided with the ABAD guarantee for lending to CredAgro, this grant can move forward very quickly.

Management of the Grant: The grant to CredAgro would be administered by the Grants Manager as part of his/her regular duties, as provided under the existing IRC-FLAG subcontract.

Impact: An ABAD grant to CredAgro of \$50,000 would provide them with the operating funds necessary to complete their product design and to procure equipment for their micro-leasing operation, as well as to access \$500,000 in additional private-sector funding for on-lending. As a result of this assistance, CredAgro will in turn lend at least \$250,000 as part of their micro-leasing product to SMEs within ABAD economic corridors, and as appropriate directly to ABAD Market Center clients. This results in an estimated leveraging of ABAD resources of 5:1, and will increase the access of farmers and SMEs to credit and leasing services, and result in job creation and sustainment in the ABAD economic corridors.

Recommendation 2:

Provide grants totaling \$100,000 for procurement of technical assistance services and training of local staff at the ABAD Market Centers (MC) to develop a finance facilitation / leasing component to complement MC operations.

ABAD Market Centers are envisioned to be active in brokering deals between buyers and sellers and in providing Business Development Services (BDS) to clients in the ABAD economic corridors. The strategy behind ABAD's establishment of these centers is that they continue to provide BDS to local producers and businesses on a sustainable, fee-for-service basis after the end of the ABAD project in August 2008.

An integral part of BDS can and should be brokering of credit services to support the working capital, equipment and expansion needs of SME clients in the ABAD corridors. However, the local staff at the MCs lacks even a basic knowledge of credit facilitation, including knowledge of business plan development, building relationships with local banks and bankers, and awareness of collateral and other legal requirements for lending.

Additionally, one of the major constraints identified by the ABAD Leasing Demand Survey of potential SME borrowers is that collateral registration, legal documentation and technical assistance services to facilitate banks' loan procedures and application processes do not exist in the economic corridors. There are no legal specialists who are able to provide collateral registration, property evaluation and other services required by banks for collateralization of assets owned by SME borrowers. This constraint has the impact that, in some cases, there is a bank willing to lend to an SME but the entrepreneur lacks the ability to finalize a business plan or secure legal and collateral registration documents that will enable the loan to be approved.

To assist in resolving these constraints, the consultant recommends that ABAD grant funds totaling approximately \$100,000 be "set aside" to provide a legal and technical assistance fund for the eight MCs to use in supporting leasing and credit applications of their SME clients over the life of the ABAD program. The grant total will be allocated across each MC under the

direction of the ABAD Grants Manager in order to enable MCs to hire staff and acquire capacity (either short-term or other technical assistance) in order to increase their ability to serve as “brokers” for ABAD partner financial institutions.

Within this recommendation it is envisioned that each of the eight MCs will be able to access the grant fund set-aside in order to build their capacity to provide the services to SMEs. The accessed technical assistance or training provided can be locally procured, brought in from Baku or procured internationally. The following breakdown is illustrative and demonstrates the possibilities in bringing much-needed capacity-building services and training to the MCs:

1. Technical assistance using skilled local consultants at a specific MC to SME’s to facilitate loan applications;
2. Legal assistance or administrative costs charged by local institutions or by banks for collateral registration, property evaluation and lawyer fees, as applicable;
3. Training assistance and a training fund that MC local staff can access directly to procure training from local providers in credit analysis, SME lending or other relevant area.

A cost breakdown of the allocation of each of these components is provided below:

Recommendation 2 Item	Cost	#	Total Cost
Technical Assistance	\$2,000	20	\$40,000
Legal Costs	\$1,000	36	\$36,000
Training Costs	\$3,000	8 MC’s	\$24,000
		Total	\$100,000

Management of the Grant: The establishment and monitoring of the grant component to MCs will be administered by the Grants Manager as part of his/her regular duties, as provided under the existing IRC-FLAG subcontract. However, 2-3 months of additional level of effort to establish and track the results of this component may be necessary for optimal implementation.

Impact: As a result of these capacity-building and training services to the MCs, the expected increased leasing and credit access by client SMEs in the economic corridors will be \$400,000 over the remaining four years of activities. This results in an estimated leveraging of ABAD resources of 4:1, and will increase the access of farmers and SMEs to credit and leasing services, and result in job creation in the ABAD economic corridors.

Recommendation 3:

Development of a new grant methodology, establishing an ABAD grants maximum of 30% of overall project costs, while mandating a minimum 70% contribution of overall project costs by entrepreneurs and/or financial institutions.

The consultant recommends a modification to the ABAD grants methodology to include a “credit facilitation” component which would serve to increase the amount of private sector capital available to SMEs in the economic corridors. Specifically, a set-aside of the grant fund of \$250,000 could be made to “match” entrepreneur and private-sector financial institution contributions to the overall project amount. An example of this methodology would be if an entrepreneur needs a new processing line of \$100,000 to process pickles for export to Russia, an

ABAD grant could contribute \$30,000 with a self-contribution by the processor of \$20,000 and a \$50,000 loan from a partner financial institution.

In accordance with this new methodology, a focus on the following eligibility criteria for the \$250,000 grant component could include the following:

1. The grant increases the value of SME products, exports or employment;
2. The investment is difficult to finance with commercial credit alone;
3. The recipient is an ABAD MC client with proven entrepreneurial ability;
4. Non-grant financial participation is at least 70% (by loan, lease or entrepreneur);
5. A grant application is provided by the SME, with a complete budget;
6. A client development plan for the SME is completed by the ABAD MC;
7. A business plan and financial projections are completed by the entrepreneur;
8. The grant financing requirement is lower than \$40,000;
9. A partner financial institution (bank or leasing company) has been identified.

Using the grant fund to leverage private-sector contributions to individual SME development projects will have a substantial impact on credit access. Entrepreneurs will be able to use the 30% grant contribution as collateral to reduce their loan sizes, increasing the value of their collateral and their self-contribution to facilitate increased lending by financial institutions.

After review of the current ABAD Grants Manual by the consultant, few changes will need to be made in existing procedures except to edit the evaluation criteria for this component to focus more on private sector “matching” of grant funding. This component fits in well with the capacity building and training services to the ABAD MCs, which will make recommendations to ABAD about potential recipients and sources of funding. No additional ABAD staffing resources will be necessary to begin implementation and to track the results of this component, as outlined in the end of this section, below.

Management of the Grant: The “set side” for this grant component will be administered by the Grants Manager as part of his/her regular duties, as provided under the existing IRC-FLAG subcontract. ABAD staff will need to engage in significant interaction with MC staff.

Impact: The implementation of this recommendation and the establishment of a separately tracked component for “leveraged-grants” will increase the impact of the ABAD grant program. As a result of the new grants methodology, increased leasing and credit access by client SMEs in the economic corridors will total \$750,000 over the remaining life of the program. This results in an estimated leveraging of ABAD resources of 3:1, and will result in significant job creation in the ABAD economic corridors.

Recommendation 4:

Provide \$100,000 in grants to subsidize operating costs, new software, market research and other costs of one or more partner financial institutions, selected through a public tender, to facilitate entry and expansion of lease providers into ABAD economic corridors.

The use of ABAD grant funds is proposed to subsidize the operating costs of private-sector financial institutions, selected in response to a public tender, in order to increase their geographic coverage and lending activities into the ABAD economic corridors. The purpose of the ABAD

grant would be to reduce financial institution COSTS related to expansion, which is one of the primary constraints identified by ABAD. In this context, ABAD should make available a grant fund of \$100,000 to financial institutions for development of a lease or loan portfolio supporting SME enterprises in the ABAD economic corridors.

As outlined above, a major reason that many SMEs have difficulty in attracting finance from leasing companies and banks is their inability to provide sufficient certainty that the loan will be repaid (risk) as well as the increased expense of FI operations in rural areas (operating costs). An ABAD grant will provide resources to FIs that will reduce their operating costs associated with conducting new activities in the economic corridors, resolving one of the primary constraints and increasing the provision of leasing in the economic corridors.

As ABAD has a special interest in providing access to credit and job creation in the economic corridors, grant funds can be used to initiative, support or accelerate private sector plans for opening branches and/or providing services in these areas. A number of grants could be provided; grant sizes could range from \$20,000 - \$50,000 and should facilitate loans or leases to SMEs in the corridors from the institutions' own capital funds. As an example of activities that could be supported by this recommendation, ABAD could provide grant funds to cover the opening of a leasing company branch office in Guba, as well as limited operating funds for the first year of operations. Another example could be providing a grant to the Baku office of a leasing company to procure software for tracking leases made in the economic corridors.

The grant funds would be disbursed to one or more financial institutions selected by the ABAD selection committee in accordance with the public tender documentation. The purpose of a public tender process would be to competitively select one or more financial institutions to provide credit and leasing services to SME's in the economic corridors. ABAD would support institutions geared toward providing lending, financial or operational leasing services in order to fulfill the unmet financing needs of SMEs, entrepreneurs, investors, associations and/or cooperatives in the manufacturing, agribusiness and processing sectors. An example of the public tender documentation is in Appendix F.

The consultant recommends that grants be provided at a 4:1 ratio of leases/leases to ABAD grant funds in the first year of the grant activity. In all cases, grant agreements would be signed with a contractual obligation by the institution(s) to match the amount with lending in the economic corridors of at least a 4:1 ratio. For example, if leasing software costing \$20,000 is granted to an FI, then the FI must be contractually obligated under the grant to engage in at least \$80,000 in leasing activity in the economic corridors.

Management of the Grant: The FI operations grant fund will be administered by ABAD through the services of the ABAD Credit Specialist as provided under the existing IRC-FLAG subcontract. Approximately 2 months level of effort are estimated to establish the grant fund, negotiate and conclude grant agreements with partner financial institutions, and monitor the implementation and effectiveness of the program. The Credit Specialist, or the ABAD Grants Manager in his/her absence, will provide technical assistance as necessary and coordinate with FIs, MCs and/or SMEs in the economic corridors.

Impact: The implementation of this recommendation will facilitate the expansion of existing financial institutions into the ABAD economic corridors. Expanded activities of these leasing

companies and lending institutions will increase access to finance for local SMEs and create employment by developing and expanding the SME sector. Under the terms of the grant, private-sector capital will be engaged in relationship to grant funds at a minimum of a 4:1 ratio, which will increase the amount of leasing and private-sector debt finance in the economic corridors by at least \$400,000, generating job creation and sustainment activities by the supported SMEs, and leading to the achievement of ABAD program goals.

Recommendation 5:

Establish an “ABAD Economic Corridor Loan Guarantee Fund” of \$200,000 in order to provide a 50% first loss guarantee to partner FI’s on credit and leases in ABAD areas.

The use of ABAD grant funds is proposed to establish a \$200,000 guarantee fund for one or more local financial institutions, selected in response to a public tender, in order to increase their geographic coverage and lending activities into the ABAD economic corridors. The purpose of the ABAD grant would be to reduce the increased financial institution RISK of lending in the economic corridors as it is a primary constraint identified by ABAD. However, the financial institution itself would be responsible for using its own sources of capital for lending and for covering its operating costs under this grant. Funds would not be made available for direct loan capital or for on-lending to borrowers. Financial institutions would match their lending resources with those of ABAD at a minimum of a 2:1 ratio, but at an expected 10:1 ratio based on USAID DCA experience.

As ABAD has a special interest in providing access to credit and job creation in the economic corridors, grant funds can be used to initiate, support or accelerate private sector plans for providing services in these areas. In this context, ABAD should make available a grant fund of one or more grants, grant sizes could range from \$50,000 - \$150,000 and should facilitate loans or leases to SMEs in the corridors from the institutions’ own capital funds. The guarantee funds would be provided to one or more financial institutions selected by the ABAD selection committee in accordance with the public tender documentation. An example of the public tender documentation is in Appendix F.

According to Azeri law, guarantees can be issued to credit institutions and insurance institutions by any registered legal entity in Azerbaijan. Provided an institution is licensed, it is allowed to issue guarantees and have the same rights as banks and insurance institutions. In practice, all entities in Azerbaijan can conclude an agreement similar to a guarantee, and their legal position in case of disputes is clear. The ability of ABAD to establish a guarantee fund was verified by the legal opinion issued by a prominent local law firm, attached in the appendix.

Definition of a credit guarantee

To overcome the usual mismatch between banks’ risk mitigation and collateral requirements, and small enterprises’ availability of complete business information and collateral, programs have been developed worldwide that provide guarantees to banks that will compensate them in the event of a default on their loan. In fact, these credit guarantee schemes relieve the financial institution of a portion of the risk that cannot be covered by the small enterprise itself. Typically, without such guarantees, few or no loans would be extended.

As outlined above, the primary reason that many Azeri SMEs have difficulty in securing loans from financial institutions is their inability to provide sufficient certainty that the money will be

repaid. To rectify this constraint (that of increased financial institution risk), the ABAD grant fund would be used to guarantee 50% of loan amounts to selected bankable projects of SMEs identified through ABAD, the MCs, other USAID-funded projects, or the financial institutions themselves. Financing to the SME would be provided by the financial institutions, using its own selection criteria, which will receive the interest and the principal payments of the loan. The structure of each loan will be flexible, depending on the cash flow of the business.

The proposed guarantee does not crowd out existing private lending to SMEs because there is almost no bank lending to SMEs in the ABAD economic corridors, as shown by the ABAD Credit Supply Survey. While some EU and IFC guarantee funds exist that encourage the banking sector to lend to SMEs, the banks' narrow parameters for qualifying borrowers, lack of outreach to SMEs in ABAD areas and lack of speed and transparency in the credit decision making process makes them unattractive to SMEs in the economic corridors. Hence, there is no overlap between the ABAD guarantee facility and any other existing guarantee fund in Azerbaijan.

With the ABAD guarantee, banks and leasing companies in Azerbaijan will be more willing to move forward with lending to a broader array of SMEs in the economic corridors, or with developing longer-term loan products for SMEs. The guarantee complements and enhances ABAD's and USAID's ongoing investments in increasing the SME lending market, including training, technical assistance, and the development of new financial products. The guarantee will also provide a demonstration effect that lending to SMEs is profitable, both to the partner FI and to the wider banking industry.

Details of the ABAD Guarantee:

1. Partial Risk Coverage

The ABAD Facility will share 50% of the Partner FI net loss of principal for loans to SMEs meeting qualifying borrower criteria. For post-claim recoveries, the FI may reimburse ABAD 50% of recoveries after deducting its reasonable expenses incurred in collection efforts, and accrued and unpaid interest on the loans.

2. Qualifying Borrowers

Small- and medium-sized enterprises (SMEs) operating in Azerbaijan in any sector, defined by ABAD as enterprises with 2 to 200 employees and less than \$1 million in annual revenues. Credit proposals will be evaluated by the Credit Committee of the Partner FI, with participation by an ABAD representative who will have veto authority over the loan.

3. Tender Evaluation Criteria for Partner FIs

Grant applications will be evaluated on the quality of analysis and understanding of market demand; proposed management plans; implementation plans, outreach and projected impact of lending operations; cost effectiveness; cost recovery, repayment, and sustainability plans; and governance structure and systems. Competitive proposals will contain aggressive programs for expanding financial service delivery, while maintaining necessary prudential operational standards and procedures.

4. Operational Criteria for Partner FIs

Financial services proposed should generally follow these guidelines: 1) loans and services should be provided on a non-concessionary basis and should be processed and approved on their

economic and business merits, 2) loan programs should mitigate foreign-exchange risk, 3) the financial services institution should not control or own any portion of any enterprise to which it lends, 4) the FI should diversify its portfolio by size, term, sector and risk, and 5) sufficient training and technical assistance should be available to establish and monitor the portfolio, and 6) at least one ABAD representative will be heavily involved in the loan approval process.

Loan Terms: The Partner FI securing ABAD grant support through the public tender will have the lead in determining appropriate loan terms and conditions. Acceptable terms could include the following, inasmuch as they advance the objectives of the ABAD program. It is understood these can be adjusted as the project progresses.

Amount: The regular amount of a loan funded under this program will generally range between \$20,000 and \$100,000. This range incorporates typical sizes for small and medium sized agribusiness loans in Azerbaijan. Loans smaller than \$20,000 or larger than \$100,000 could be financed on a case by case basis.

Term: It is expected that these will be medium and long-term loans, given the size and nature of projects to be funded but will be limited to a 3-year loan term. The Partner FI will have the lead in deciding the exact term for a particular project.

Interest Rate: It will be the responsibility of the Partner FI to develop an appropriate interest rate for the loans, depending on market conditions and taking into account the relative risk of the individual business. Other loan pricing elements (fees to borrower, etc) will also be determined by the Partner FI.

Other Terms: These will be determined on a case by case basis. The project seeks to be flexible to meet the needs of the entrepreneur, while at the same time ensuring the bankability/viability of the project. The Partner FI will take the lead in formulating policies for the terms of the individual project to be funded.

Management of the Guarantee Fund: The guarantee fund will be administered by ABAD through the services of the ABAD Credit Specialist as provided under the existing IRC-FLAG subcontract. Approximately 3 months level of effort are estimated to establish the guarantee fund, negotiate and conclude grant agreements with partner financial institutions, and monitor the implementation and effectiveness of the program. The Credit Specialist, or the ABAD Grants Manager in his/her absence, will coordinate and ABAD technical assistance provided, coordinate with the MCs and SMEs in the economic corridors, and serve on the financial institutions Credit Committee, as outlined in the grant agreement and operating agreement.

Disposition of Guarantee Fund at End of ABAD At the termination of the ABAD project (currently to end July 2009) ABAD management, with input from USAID, and based upon the overall success of the guarantee fund, will make a determination as to the disposition of the fund, both in the outstanding loan portfolio and the repayment account. Possible outcomes could include the purchase by the Partner FI of the ABAD guarantee fund; the establishment of a separate permanent organization to which management of the guarantee would be transferred (if more funds were to become available); or the assignment of ABAD funds to an existing organization. Review of the situation to develop ideas for disposition of the ABAD fund will be consistent with the decision made on the grant funds to Partner FIs and be based on USAID and IRC input. This will be outlined in the ABAD-FI Operating Agreement, a sample of which is provided in the Appendix.

Impact: The implementation of this recommendation will facilitate the expansion of existing financial institutions into the ABAD economic corridors. Expanded activities of these leasing companies and lending institutions will increase access to finance for local SMEs and create employment by developing and expanding the SME sector. Under the terms of the grant, private-sector capital will be engaged in relationship to grant funds at a minimum of a 2:1 ratio but a possible 10:1 ration. This will increase the amount of leasing and private-sector debt finance in the economic corridors by at least \$200,000, and possibly \$2,000,000 (depending on SME repayment rates), which will result in job creation activities on the part of the supported SMEs.

8. Conclusion

The findings of the consultancy demonstrate that leasing and other lending activities in the ABAD economic corridors is virtually non-existent, so that SMEs in these areas lack credit access. Leasing companies and banks interviewed provide few financial services in the regions and the economic corridors, lack capital for on-lending and in general showed a high level of aversion to lending in these areas. At the same time, significant demand for credit services was expressed by potential individual and SME borrowers in the economic corridors, with an estimated credit demand size of over \$110 million. Although many borrowers expressed reluctance to pay, in their view, “excessive” interest, most conceded that they would access any credit that was available in order to expand their businesses.

Based on these findings, any potential ABAD credit access initiative needs to reduce these constraints and at the same time mobilize additional capital to support innovative leasing solutions. This will support viable SME businesses in the economic corridors and encourage credit institutions to provide credit in these areas over the long term. As ABAD has a grant fund and significant technical assistance resources available to support this initiative, the consultant’s findings outline the ABAD resources necessary to facilitate credit access in these areas.

In this context, the consultant’s recommendations for ABAD to facilitate leasing in the rural areas include an array of interventions across the spectrum of financial institutions active in leasing, with a focus on 1) reducing financial institution constraints; and 2) promoting leverage of the ABAD grant fund with private capital. The proposed interventions will serve to reduce two of the top three constraints to SME leasing identified by the ABAD Credit Supply Survey of 18 Azeri financial institutions. The third constraint identified in the survey, access to additional capital for lending, is not be addressed by this report or by ABAD, as providing capital for on-lending is not within the scope of the project.

The implementation of these recommendations will facilitate the expansion of existing Baku-based financial institutions into the ABAD economic corridors. Expanded activities of these leasing companies and lending institutions will increase access to finance for local SMEs. The provision of \$700,000 in ABAD grant funds to facilitate credit will increase the SME access of leasing and private-sector debt finance in the economic corridors by at least \$2,200,000, engaging private-sector capital at an average 3:1 ratio to ABAD funds. This will generate job creation and sustainment activities on the part of the supported SMEs and contribute to the achievement of ABAD program goals in the economic corridors.