COUNTRY REPORT: THERE IS 'MORE' IN THE PHILIPPINES

Last May 2, 2013, the Philippines received its second investment grade rating in the last 40 days, this time from debt watcher, S & P Ratings. This declaration lends credence to the earlier assessment given by Fitch Ratings. S & P remarked that the upgrade on the Philippines reflects a strengthening external profile, moderating inflation, and the government's declining reliance on foreign currency debt.

Earlier, Fitch raised the country's long-term foreign-currency Issuer Default Rating (IDR) to 'BBB-' from 'BB+" while lifting the local-currency denominated IDR to 'BBB' from 'BBB-.' The outlooks on both ratings are stable. The agency also upgraded the Country Ceiling to 'BBB' from 'BBB-' while the short-term foreign-currency IDR to 'F3' from 'B'.

These historic developments augur well to the investment climate of the country, and in particular to the thriving leasing and finance sector, which has been benefitting from the growing demand for capital equipment arising from the close to seven percent annual growth, a huge consumer market of almost 100 million Filipinos, growing international reserves and balance of payment levels, and tamed inflation and lending rates. With the expected inflows from this investment grade boost, truly there are plenty of bright leasing opportunity spots ahead, there is plenty more room of opportunities for the quinquagenarian Philippine leasing industry!

LEASING INDUSTRY

Origin

The Philippine leasing industry traced its beginnings in the late 50s when then American leasing giant, US Leasing, joined forces with the Philippines' Ayala Group and formed what was then called Makati Leasing Corporation, the forerunner of BPI (Bank of the Philippine Islands) Leasing Corporation. Other leasing companies followed suit like First Malayan Leasing, Mercator Finance, Far East Chemco Leasing, FNCB Finance, BA Finance, Consolidated Orient (now Orix Metro) Leasing, CityTrust Finance, and PCI (now BDO) Leasing. This group was principally catering to small-and-medium-scale enterprises (SMEs) to finance vehicle fleet, production machinery and office equipment capital expenditures. During the credit crunch of the late 70s and early 80s, leasing got a boost when foreign companies operating in the Philippines had to meet certain domestic borrowing restrictions. Their obvious alternative was leasing.

Through the years, the pioneers invested time and effort in educating the market on the why and why nots of leasing over traditional bank loan products. In due time, the industry evolved from SMEs to servicing the requirement of key players in construction, real estate development, transport and logistics and manufacturing fields.

Fast forward: The last three years

By and large, the performance of the leasing and finance industry has shown even greater strides over for the last three years, mainly due to the country's sound economic policies and political stability as well as implementation of the government's various infrastructure and Public Private Partnership (PPP) projects, a number of which had already taken off. There are as well, quite a number of equipment financing equipment from the private development projects capitalizing on the sustained growth in key sectors such as Business Process Outsource, Tourism, and Overseas Filipino Workers (OFW) remittances.

To date, the value of the financial leasing industry is estimated to be around P70 to P80 billion, with an annual growth rate of around 13%.

At present, the market is driven and dominated by the major leasing companies operating in the country. Most of these are wholly owned subsidiaries and affiliates of top domestic banks namely, Banco de Oro (BDO), Bank of the Philippine Islands (BPI), Metropolitan Bank and Trust

Corporation (MBTC), United Coconut Planters Bank (UCPB), Land Bank of the Philippines (LBP), Philippine National Bank (PNB), and Rizal Commercial Banking Corporation (RCBC). Relative newcomer, Toyota Financial Services Philippines Corp. (TFSP) surged as an industry leader in recent years because of the market reach and brand equity of Toyota cars nationwide.

As the acceptability of leasing became widespread, it is no wonder that scores of authorized enterprises followed suit. Most of these firms were formed and personally-managed by former executives of pioneer leasing companies, hence the unity and camaraderie within the industry still prevailed despite the growing number of market players. They have, in fact, banded together to form an association that would serve as the main venue for common concerns and the official voice of the industry.

PHILIPPINE FINANCE ASSOCIATION (PFA)

Since its establishment in 1962, the Philippine Finance Association, Inc. (PFA), formerly the Philippine Association of Finance Companies, Inc. (PAFCI), has been a major catalyst in the dynamic change of the leasing and finance landscape in the country. In particular, PFA was mainly responsible for the industry's governing manual “The Financing Company Act of 1969”, as well as its implementing rules and guidelines. In response to the changing financial picture, PFA dutifully spearheaded its revision through “The Financing Company Act of 1998”, which was signed into law on February 28, 1998 by then President Fidel V. Ramos.

PFA continues to lead in implementing sound, ethical and best business practices amongst its member institutions. It remains as the premier resource and institutional partner on seminars, workshops and short courses for leasing and consumer finance. It likewise liaises with government regulatory bodies such as the Securities and Exchange Commission (SEC), Bangko Sentral ng Pilipinas (BSP), Bureau of Internal Revenue (BIR) and other government agencies on matters that affect the industry's business finance activities, policies and procedures.

Role in the establishment of AFSA

In 1981, PFA organized and hosted the First Regional Leasing Conference in Manila. The conference attracted delegates and speakers from around the world, with Asian participants optimistic about the future of leasing.

The success of the conference spawned the 1982 organization of the Asian Leasing Association (Asialease), which was spearheaded by former PFA president and presently Chairman Emeritus Atty. Rodolfo Publico, who was its first founding chairman. From Asialease, the association changed its name to Asian Leasing & Finance Association (ALFA) on July 26, 2005 and eventually to Asian Financial Services Association (AFSA) on June 4, 2010.

INDUSTRY PLAYERS

Quo vadis leasing pioneers?

Far East Chemco was a joint venture between Far East Bank and Chemical Bank which later became wholly-owned by the former and eventually renamed “FEB Leasing”. Far East Bank, together with the leasing subsidiary, was later acquired by the Bank of the Philippine Islands.

Already affiliated with the then formidable Makati Leasing Corporation, Bank of the Philippine Islands also acquired CityTrust Bank which included CityTrust Finance. The latter was the former FNCB Finance of the First National City Bank of New York. FNCB Finance introduced into the country what may be termed as the “professionalization of credit management”. This company started the practice of hiring young yet innovative Master of Business Administration (MBA) graduates to run finance companies.

PCI Leasing was a subsidiary of the then Phillipine Commercial & Industrial Bank (PCIB) and later, Equitable PCIB after the merger of Equitable Bank and PCIB. The company recorded many “firsts” in the industry being a listed leasing company to the Philippine Stock Exchange and issuer of short-term commercial papers (STCPs) to fund its growing lease portfolio. Equitable PCIB merged with BDO (Banco de Oro) Unibank in 2006 and subsequently, the entity was renamed BDO Leasing and Finance, Inc. in 2007.

Consolidated Orient Leasing was a tie-up between Orient Leasing of Japan and the Solid Bank Group. The former later diversified into several businesses and changed its name to Orix, which was eventually adopted by the Philippine operations. In May 2000, Metropolitan Bank and Trust Company acquired Solid Bank and with it came what is now Orix Metro Leasing.

First Malayan Leasing and Finance Corporation (FMLFC) started its operations in 1957. After 55 years of independent operations, parent bank Rizal Commercial Banking Corp. (RCBC) took the company under its wings and reinvigorated the same what is now known as RCBC Leasing.

Updates on Present Market Leaders

Toyota Financial Services Philippines Corporation

Toyota Financial is a key player in the auto leasing sector. It is 60% owned by Japan-based financial services group Toyota Financial Services Corporation and Toyota Motors Corporation. The remaining 40% is held by the Metrobank Group. Bangko Sentral ng Pilipinas (Central Bank of the Philippines) recently awarded the company a quasi-banking license, which allows the firm to borrow funds from the public for re-lending.

For the past three years, Toyota Financial capitalized on the demand for vehicles and strength of the dealership network and brand equity of Toyota Motors Philippines, being the country's top selling car company. Toyota Financial attributes its growth based on the increase in vehicle sales that was brought about by a rise in consumption spending that was fueled by an increase in OFW remittances, BPO revenues, and low sustainable interest rates.

The supply chain disruption, which was caused by the unfortunate 2011 Japan Tsunami and Thailand floods was among the major challenges faced by Toyota Financial. However, the lost business attributed to this one-time calamity was immediately recovered in the succeeding period.

For 2013 and the years ahead, Toyota Financial is focused in bringing about growth through quality and operational excellence.

BDO Leasing & Finance, Inc. (**BDO Leasing**)

BDO Leasing is the second biggest player in the industry. It continue to capitalize on the synergy with parent BDO Unibank Inc., which is the Philippines' leading bank. It continue to establish a sterling track record of service and innovation by way of customized leasing structures and products. The company opened branches in progressive cities outside the nation's capital and enjoys the market reach of the 750 plus-strong BDO branches and its nationwide commercial lending operations as well as referral from the country's leading investment house (BDO Capital Inc.). Its growth in the past three years came from key industries such as construction, mining, medical, transport and logistics.

For 2013 and beyond, BDO Leasing will continue with its vendor collaboration and direct client selling in the aforementioned key industries while at the same time, securing cheapest source of funds within the company's mandated scope.

Orix Metro Leasing & Finance Corporation (**Orix Metro**)

Orix Metro is a veteran leasing giant in the industry having started operations on June 28, 1977. For 35 years, Orix Metro's continued growth has been spurred by its services to various companies engaged in trucking, trading, manufacturing, commercial, mining, construction, and various agricultural businesses.

Orix Metro established two wholly owned subsidiaries namely Orix Rental Corporation, which offers long-term full service operating lease for motor vehicles, computers, and materials handling equipment, and Orix Auto Leasing Philippines Corporation, which offers car rental service as well as hotel and limousine service.

At present, Orix Metro's head office in Makati Commercial Business District is backed by a strong 50-branch network spread nationwide.

BPI Leasing Corporation (BPI Leasing)

This industry pioneer has been a consistent top performer since its Makati Leasing days. Its president, Danilo T. Reyes observed that finance and leasing industry has been on an upswing for the past three years and the good economic climate has helped a lot in the offering of operating leases to the large corporations. “This opportunity enabled finance and leasing companies, more particularly BPI Leasing, to offer low rates that were unheard of in the past,” he said.

BPI Leasing's recent loan portfolio growth has been attributed primarily from higher demand for transport/logistics industries and hospital equipment. Moving forward, BPI Leasing intends to fortify their stronghold in its market niche and establish bigger provincial market presence through the Parent Bank's more than 800 branches and 115 Express Banking Centers.

Top Four's Performance Highlights

IN MILLION OF PESOS	TOTAL		% GROWTH
	2012	2011	
Leases Booked (Gross Equipment Cost)	20,567	16,815	22%
Total Loans and Leases Booked	31,528	29,877	6%
Lease Portfolio Balance (LCR-net of UDI+RV-GD)	35,970	28,708	25%
Total Portfolio Balance (Loans & Leases) with OL	53,462	44,115	21%
Total Assets	73,123	64,845	13%
Total Equity	11,365	10,203	11%

The Top Four Leasing & Finance industry players has had an impressive business performance in the previous year. The growth of P3.7 Billion or 22% in combined Leases Booked by the top leasing and finance companies, has been attributed mainly to the expansion of business operations in both local and multinational enterprises.

Given the figures for Leases Booked and Total Loans and Leases Booked, it was deduced that combined Total Loans of P11 Billion, which basically decreased by P2 Billion or 15%, cornered only 30% of the entire amount of Total Loans and Leases Booked.

Notably, as a result of the additional requirement for capital funding and machineries and equipment, consolidated Total Portfolio Balance of the top industry players grew by P9.3 Billion or 21% in 2012.

Combined Total Assets and Total Equity rose by as much as P9.2 Billion or 13% and P1.1 Billion or 11%, respectively.

TOP LEASING COMPANIES FINANCIAL PROFILE RANKING

(Based on year-end 2012 AFS, in Million Pesos)

Company	ASSETS		PAID-UP CAPITAL		PROFITABILITY				ROE	
	Rank	**Amount**	Rank	**Amount**	Rank	**Gross Income**	Rank	**Net Income**	Rank	**%**
Toyota Financial*	1	21,145	4	2,194	3	1,846	4	245	4	12%
BDO Leasing	2	20,736	1	4,634	4	1,762	2	402	6	9%
Orix Metro Leasing**	3	15,335	2	2,422	1	2,358	1	461	1	21%
BPI Leasing	4	13,552	3	2,310	2	2,059	3	293	2	14%
UCPB Leasing	5	3,535	6	1,056	7	292	6	105	5	10%
LBP Leasing	6	3,135	5	1,209	5	533	5	149	3	13%
Japan-PNB Leasing	7	2,802	8	500	6	305	7	61	10	3%
RCBC Leasing	8	2,527	7	578	8	233	8	22	8	5%
Asia United Leasing	9	618	10	199	10	10	9	11	7	6%
Allied Leasing	10	337	9	220	9	36	10	9	9	4%

Notes:
* Toyota Financial Services (AFS as of March 31, 2012)
** Orix Metro Leasing (AFS as of September 30, 2012)
Other leasing companies (AFS as of December 31, 2012)

The P1.2 Billion or 6% growth rate in assets has propelled **Toyota Financial** to be the industry leader in terms of asset size. While ranked 4th in terms of Paid-up Capital, gross income jumped by P106 Million or 12%, deriving a growth in bottomline figure of P44 Million or 19%. Growth in revenues was attributed to the continued leadership of Toyota and wide patronage due to its proven quality and after sales service support.

Coming in at 2nd in terms of total resources is **BDO Leasing**, with an improvement in asset base of P2.9 Billion or 16%. On the other hand, the company ranked 1st in terms of Paid-up Capital with a growth in equity of P273 Million or 6%. With a sizeable revenue growth of P124 Million or 8%, BDO Leasing registered an incremental net income of P98 Million or plus 32% over the previous year. Revenue growth was attributed to contractors and equipment vendor collaboration as well as increased presence in chartered cities outside the National Capital Region.

Orix Metro places 3rd with an asset growth of P3.5 Billion or 35% and ranks 2nd in terms of Paid-up Capital, where rise in equity is seen at P349 Million or 19%. Based on the revenue figures generated in 2012, the company's Gross Income grew by P268 Million or 20% which yielded a climb in Net Income of P82 Million or 23%, which places the company at the number one spot on both categories. The surge in revenues was ascribed to the leases booked, largely from the wholesale and retail trade and construction clientele, which cornered 41% and 19% of the company's portfolio, respectively.

Although ranking 4th in terms of total resources, **BPI Leasing** experienced an uptick of P451 Million or 3% in its assets while recording an equity growth of P607 Million or 43%. For its 2012 income, the company's performance generated a P71 Million or 10% upswing in its gross revenues which translated to an increase in its Net Income figure of P40 Million or 25%. Jump in the company's revenues was mainly credited to the increased business activity in the Services and Wholesale and retail trade sectors, which accounted for 51% and 21% of the Company's portfolio, respectively.

Security Access to Financed Equipment Tally Network (Safe-T-Net)

The PFA, in a joint undertaking with the BAP Credit Bureau (BAPCB), conceptualized and developed a central registry for financed/leased equipment called the Security Access to Financed Equipment Tally Network or Safe-T-Net. The Safe-T-Net was formally launched on Nov. 23, 2012 with the signing of an agreement which covers the terms and conditions of its operations. Safe-T-Net was established to equip financing and leasing companies with an information system that will provide the industry with data on the current status of equipment, machinery and other assets that are used to secure loan or lease products. The system also serves as a clearing house and database for all leased assets and for the mutual protection of its member institutions from fraudulent finance/lease transactions, such as multiple financing schemes or ill-intentioned clients approaching several financial intermediaries for the financing of a single asset.

The primary objectives of Safe-T-Net are: (1) to prevent the incidence of fraudulent multiple financing or leasing of assets; and (2) to provide statistical data on industry financing and leasing operations which may also be compiled and collated for research and analytical purposes. Since Safe-T-Net is web-based, registered users of the program can directly access information online through the Safe-T-Net website.

LEASING LAWS & REGULATIONS

Updates on Taxation of Leases

Since October 1986, Taxation of Leases in the Philippines has been governed by Revenue Regulation No. 19-86. The regulation prescribed the rules on the tax treatment for lease agreements, whether finance or operating leases, and provided guidelines in distinguishing between a lease and a conditional sales contracts. This regulation, which did not make any distinction between finance and operating leases as far as tax treatment was concerned, remained to be in force despite the implementation of international accounting standards on leases here in the country. Revenue Regulation 19-86 still considered amounts paid to the lessors in a finance or operating lease as rental income and allows lessors deduction for depreciation expense. This was in contrast to the difference in accounting between finance and operating leases based on international accounting standards.

Other than the confusion between accounting and tax, there were also other tax issuances that may seem inconsistent with Revenue Regulation 19-86. Finance and operating leases performed by Non-Bank Financial Intermediaries were subject to gross receipts tax (GRT) based on leasing income for finance leases and on gross rentals for operating leases. GRT being based on gross rentals for operating lease prompted many finance companies doing operating leases to set up separate non-finance VAT-registered rental company subsidiaries which were not subject to GRT but were subject to Value-Added Tax. This made VATable operating leases more attractive to VAT-registered lessees who could take up the input VAT on the rentals and use them to offset against their own output VAT. On the other hand, finance leases were subject to creditable withholding tax (CWT) based on leasing income while operating leases were subject to CWT based on gross rentals.

Revenue Regulation 19-86 may have served its purpose when it was implemented in 1986, having properly distinguished leases versus a conditional sales contract, and helping the leasing industry move forward with a more appropriate tax treatment at that time. However, it may be high time to review the regulation and make it more consistent with existing accounting standards and other recent tax issuances of the BIR.

Updates on Accounting for Leases

Since its implementation in 2004 International Accounting Standards Statement (IAS) No. 17 has been governing accounting for leases in the country. Prior to its implementation, there was no clear distinction between finance leases and operating leases. At that time, most US based companies accounted for leases based on US accounting standards (Financial Accounting Standards Board Statement No. 13). With the implementation of IAS 17, now Philippine Accounting Standards No. 17, lessors and lessees are now properly guided on how to account for leases in their books. Currently, for finance leases, lessee records an asset and a lease liability in their balance sheet, while it recognizes depreciation and interest expense in their income statement. On the other hand, operating leases have no impact in the balance sheet of the lessee. Lessee merely records rent expense every time they pay rent. This, however, will soon change.

Because of the impact of leases in the lessee's balance sheet, it is important that leases are properly recognized in the lessee's books. The existing accounting models have been criticized for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions[1]. International Accounting Standards Board jointly with the US Financial Accounting Standards Board has come up with a draft new standard on accounting for leases that will ensure that assets and liabilities arising under leases are properly recognized in the balance sheet. The draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases. A lessee would recognise an asset representing its right to use the leased asset for the lease term (the 'right-of-use' asset) and a liability to make lease payments. A lessor would recognise an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset would either recognise a lease liability while continuing to recognise the underlying asset (a performance obligation approach), or derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognise a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach)[2].

Effectively what these proposed changes mean is that most, if not all, leases will have to be capitalized in the lessee's balance sheet. For those lessees mostly doing finance leases, the impact to them will not be much, except for the change in the measurement of assets and liabilities. The impact will be more for those doing mostly operating leases since these lessees will have to now record the assets in their balance sheet. This will create new challenges in selling operating leases given that one of the main selling point of operating leases lies in its off balance sheet feature. For lessors with a big portfolio of operating leases, they will have to find other innovative ways to sell operating leases or just concentrate on doing finance leases. At the end of the day, the Philippine leasing industry, which has been struggling to grow in leaps and bounds, will have to find new ways to continue to make the product attractive to lessees.

LEASING INDUSTRY OUTLOOK

The leasing business outlook for 2013 is looking even better than 2012, as the demand for capital equipment will be boosted by intensive economic activities arising from tourism, BPO, OFW remittances, and Public Private Partnerships (PPP). The Philippine Constructors Association cited these as "growth drivers (that) would result to more civil construction works such as office buildings, roads and bridges, facilities for utilities, and the like." [3]

Tourism. The Department of Tourism (DoT) is targetting 10 million international passengers, 35.5 million domestic tourists, and about Php 2 trillion worth of tourism revenues by 2016. The tourism sector is expected to generate 7 million jobs and contribute 7.43% to the GDP. Related to this, DoT together with the Department of Public Works and Highways (DPWH) launched convergence program in enhancing tourism access, specifically national and local roads network. In the 2013 budget, the program has Php 12 billion allocation for tourism roads across the country.

BPO. The BPO industry has been growing at an annual rate of 20% to 30% over a decade, faster than the growth of the global offshore services market. It also provides significant contribution (approximately 5%) to the country's GDP and it is the third largest foreign exchange earner after tourism and overseas remittances. Per the IT-BPO Roadmap for 2011 to 2016, the target of the industry is to reach US$25 billion in revenue and 1.3 million knowledge workers. This implies the creation of up to 536,000 new job by 2016.

OFW Remittances. The OFW remittances are expected to still expand by 4% to 5% in 2013 onwards despite foreseen strengthening of the local currency against US dollars. It is a fact that OFWs tend to remit more dollars to compensate for a peso appreciation in order to meet the

1 IASB Exposure Draft August 2010
2 IASB Exposure Draft August 2010
3 Philippine Constructors Association Year-end Country Report 2012

peso budgets of their families in the Philippines. The robust remittances continue to boost real estate purchases and retailing activities.

PPP. It's all systems go! From Projects Properly Prepared to Projects in the Pipelines being Procured as the mega-projects gain momentum. Two projects already awarded are US$46M Daang Hari-Southern Luzon Expressway (SLEX) Link Project, and US$ 381M school infrastructure project phase 1 (around 10,000 classrooms). Early this year, the following projects were rolled out for bidding: US$ 378M Ninoy Aquino International Airport (NAIA) Expressway Phase 2; US$136M modernization of Philippine Orthopedic Medical Center; US$ 262M school infrastructure phase 2; US$ 1.4 Bln Light Rail Transit (LRT) Line 1 South Extension; US$ 216M Mactan Cebu International Airport passenger terminal; US$43M automatic fare collection system; and US$ 27.5M rehabilitation, operation & maintenance of Angat Hydroelectric Power Plant auxillary turbines.

Mining. Another industry of interest for leasing is Mining as this sector induces acquisition of earthmoving equipment and related machineries. For 2013, the Department of Environment and Natural Resources' Mines and Geosciences Bureau (DENR-MGB) is expecting US$718M fresh investments to pour in particularly with the recent lifting of the "mining moratorium" last March 2013. MGB reported that investors are lining-up for the the over 1,200 areas open to mining activities. The country ranks among the top 5 in the world in terms of gold, nickel, copper and chromite.

As the economy grow by 6.5 percent this year, it is further projected that interest rates are to remain low to encourage growth in the various sectors of the country and the currency to trade within P39.50/P43 to US$1 range, but to settle at P42.10 to US$1 by year end.

Major leasing players foresee that the last three years' momentum brought about by the sound fiscal and financial reforms by President Benigno Aquino III and his economic team will be sustained if not exceeded in the next three years. The Philippine president's battlecry of better governance and real fight against graft and corruption has indeed resonated well to businessmen and investors both locally and abroad. The recent investment upgrades are signs that the country is now reaping the rewards of the collective effort of the government and hardworking Filipinos in and out of the country.

With the twin votes of confidence from Fitch and S&P Ratings and all the encouraging economic developments, now is the time for the country to scale new and greater heights. There is no other way for the Philippine leasing industry but up! Definitely, there is MORE in the Philippines!