Equipment Leasing and Financing Foundation

State of the Industry Report
2001

Prepared by:

FIC

Financial Institutions Consulting, Inc.
October 2001

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The Equipment Leasing and Finance Foundation wishes to express appreciation to the following company for providing sponsorship funds to support this year's State of the Industry Report:

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October 2001

In commissioning the first State of the Industry Report in 1999, the Equipment Leasing and Finance Foundation intended to analyze and build on available data on the leasing industry. We thought it beneficial to frame the raw numbers of studies like ELA's Annual Survey of Industry Activity with the interpretations and observations of lessors from across the business, and provide a a more complete picture of equipment leasing and finance. With the release of this third State of the Industry Report, clearly it is not just beneficial, but crucial.

Once again, Financial Institutions Consulting (FIC) conducted the research for the 2001 Report. This year, however, they found a far different industry. As FIC notes in it's preface to the Report, even before the September 11th attacks and the economic uncertainty they caused, 2001 required modification of the analysis used in previous Reports. The deteriorating economy has aggravated the industry's already serious funding difficulties. Defaults are on the rise. Companies are exiting the market or failing outright. Consolidation continues. And everything is happening fast. So, while the Report is still built on ELA's Survey and interviews with lessors, you'll note that the emphasis has changed somewhat.

That ability to change is, I believe, a strength of both the State of the Industry Report and the Foundation. The Foundation exists to build and enhance the body of knowledge about equipment leasing and finance. Changing times call for different types of knowledge, and the Foundation continues to identify areas where the industry would be well-served by research and analysis.

I hope that the 2001 State of the Industry Report proves valuable to you and your company in strategic planning, or simply in increasing your understanding of these turbulent times for equipment leasing. The Equipment Leasing and Finance Foundation will continue to provide more tools to help you thrive in leasing.

Sincerely,

Thomas C. Wajnert

Thomas C. Wajnert
Chairman
Equipment Leasing and Finance Foundation

4301 North Fairfax Drive ■ Suite 550 ■ Arlington, Virginia 22203-1627 ■ (703) 527-8655 ■ Fax: (703) 465-7488 ■ www.leasefoundation.org

Preface

For the third year, the Equipment Leasing and Finance Foundation has selected Financial Institutions Consulting, Inc. (FIC) to prepare its State of the Industry Report. The mission of the Foundation is to focus on and evaluate future trends and their impact on the leasing industry. The Foundation and FIC have designed this Report to analyze and interpret the performance of members as presented in the Equipment Leasing Association's (ELA) 2001 Survey of Industry Activity (SIA) and, using this and other information, project and discuss future implications for the industry.

FIC is a strategy consulting firm focusing on bank and non-bank financial services firms and the vendors that support them. Our areas of specialization include working with clients on strategic issues related to commercial finance/leasing, small business and middle market financial services, commercial cards, and the affluent market.

The FIC Methodology for this analysis incorporates statistical data, our past client experience, and in-depth personal interviews. Both FIC and the Foundation wanted to take advantage of the leasing industry's valuable human capital. Therefore, in addition to presenting data from the SIA, the Report includes FIC proprietary research and analysis as well as the insights and perspectives of leasing industry executives and analysts. FIC conducted in-depth interviews with 16 industry experts representing a cross-section of lessor types, ticket sizes, and industry vendors.

Given the rapidity of the economic slowdown, FIC feels that the static performance numbers represented in the SIA, reflecting year-end 2000 performance alone, cannot present a true picture of the leasing industry today. Of course, the current uncertainty has been heightened by the unknown economic impact of the September 11th terrorist attacks.

Therefore, even prior to September 11th our interviews focused less on recent performance and more on qualitative assessments of current issues and the critical challenges facing the industry. The industry experts who shared their insights include:

Al Berzett
Jesse Crews
Burt Feinberg
Steven Grosso
Joseph Lane
Paul Larkins
Michael Rizzo
Irving Rothman
Scott Shannon
Matthew Shieman
Thomas Uehling
John Unchester
William Verhelle
David Wiener
Frederick Wolfert
Paul Zediker

We thank these individuals for their generous commitment of time and candid insights into the intricacies, opportunities, and challenges of the leasing industry. Throughout this monograph, we include direct quotations from these interviews; however, to preserve confidentiality, we present quotes on an anonymous basis.

The lessor types analyzed in this Report fall into three categories: bank lessors (either subsidiary or integrated), captive leasing companies, and independent lessors. As in the 2000 State of the Industry Report, we aggregate data for financial advisors with independent lessors. Additionally, this Report includes vendor finance as a lessor activity.

We think it is important to clarify the definitions of various lessor types. Captive leasing companies are the subsidiaries of dealer or manufacturing companies. They are primarily engaged in financing parent company products. Occasionally, they will also finance other companies' products sold as a solution set by their parent. Independent lessors are usually finance companies offering leases directly to businesses and not affiliated with any particular manufacturer or dealer; alternatively, independents may also be the financial services subsidiary of a corporation that does not restrict its financing activities to the parent company's product and actively generates new business outside of those products. A vendor is the seller or dealer of the equipment to be leased.

The SIA captures four lease size segments: micro ticket ($0-$25,000), small ticket ($25,000-$250,000), middle market ($250,000-$5 million), and large ticket (over $5 million). In most cases, there were not enough micro ticket respondents to provide data; whenever possible, we aggregate this data with small ticket.

We begin this report with an overview of the leasing industry's recent performance and projections of future industry growth and activity. We then discuss current performance, ongoing challenges, and key opportunities by type of lessor and ticket size. The Report then goes on to discuss the major issues that senior managers are now addressing.

Finally, as strategy consultants to the leaders in the financial services industry, we conclude this Report by offering our summary perspective on the major trends and some recommendations for surviving the challenges and capturing the opportunities facing the equipment leasing and finance industry.

Charles B. Wendel
President
Financial Institutions Consulting, Inc.
475 Fifth Avenue
19th Floor
New York, NY 10017
212-252-6700
cwendel@ficinc.com

Executive Summary

The economic downturn of the past twelve months has had a quick and negative impact on much of the leasing industry. By the end of the second quarter 2001, overall leasing volume had declined nearly eight percent since the end of 2000 (Figure 1), second quarter 2001 volume for participants in the ELA Performance Indicator Report fell thirteen percent in the same period.

Margin and profit performance for SIA respondents declined over previous years, but remained strong in 2000; net operating margin averaged 16.4 percent and ROE averaged over 15 percent (Figure 2). However, we expect that 2001 will show a sharp drop in profitability for the industry as a whole. The National Association of Business Economists forecasts a two percent decline in business equipment investment for 2001, bringing total leasing volume down to slightly more than $240 billion (Figure 3 and 4).[1]

Independent lessors will continue to face significant challenges into 2002 as funding issues become more severe. The good news for independents is that they have the opportunity to become the lessors of choice for businesses with less than sterling credit that cannot access bank financing. This results in increasing yields for independents but also increasing costs, credit risk, and delinquencies for this already struggling group.

Banks will continue to be strong competitors with their preferred access to capital and customers. At the same time, captives may face increased challenges because of declining parent company product sales. Additionally, at least some captives are facing demands from their parents to increase their contribution to overall company profitability. In light of that demand, several are evaluating business expansion beyond parent company support.

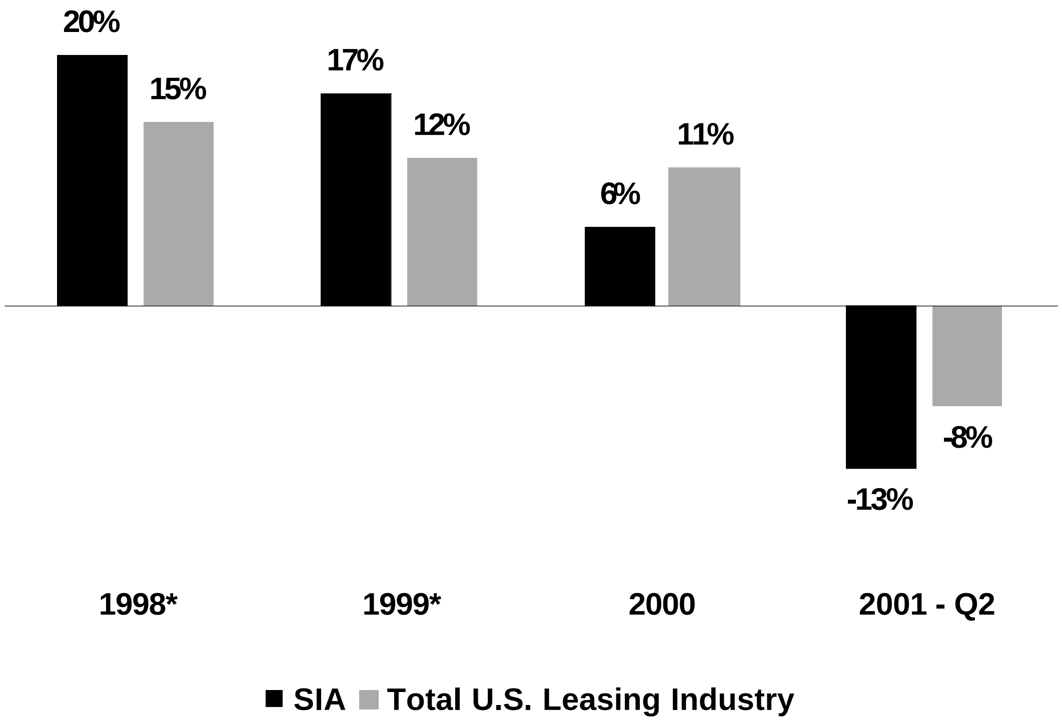
Assessing performance by transaction size, we believe that large ticket transactions will continue to perform well, with banks dominating this segment. However, we expect that severe sector weaknesses will plague the segment in the coming year. The transportation industry will be particularly hard hit, notably in aircraft and railcars. Origination and underwriting costs as well as intense competitive pricing will continue to erode the profitability of middle market transactions. Large ticket and small ticket lessors are increasingly making incursions into what once was considered the middle market, focusing, respectively, on the upper and lower reaches of that segment.

Success in the small ticket segment will continue to demand strong cost management and excellent collection skills. As volume decreases in a down economy, it will become even more critical to drive costs out of origination and servicing. As the economic slump increasingly impacts small businesses, delinquencies will likely increase.

As with most financial services players, the leasing industry faces many challenges in the coming quarters. Success, and perhaps even survival, requires a focused approach, emphasizing operational efficiency, technological leverage, and strategic clarity.

[1] This forecast was prior to September 11

SIA and Total U.S. Leasing Industry New Business Dollar Volume Growth Rates

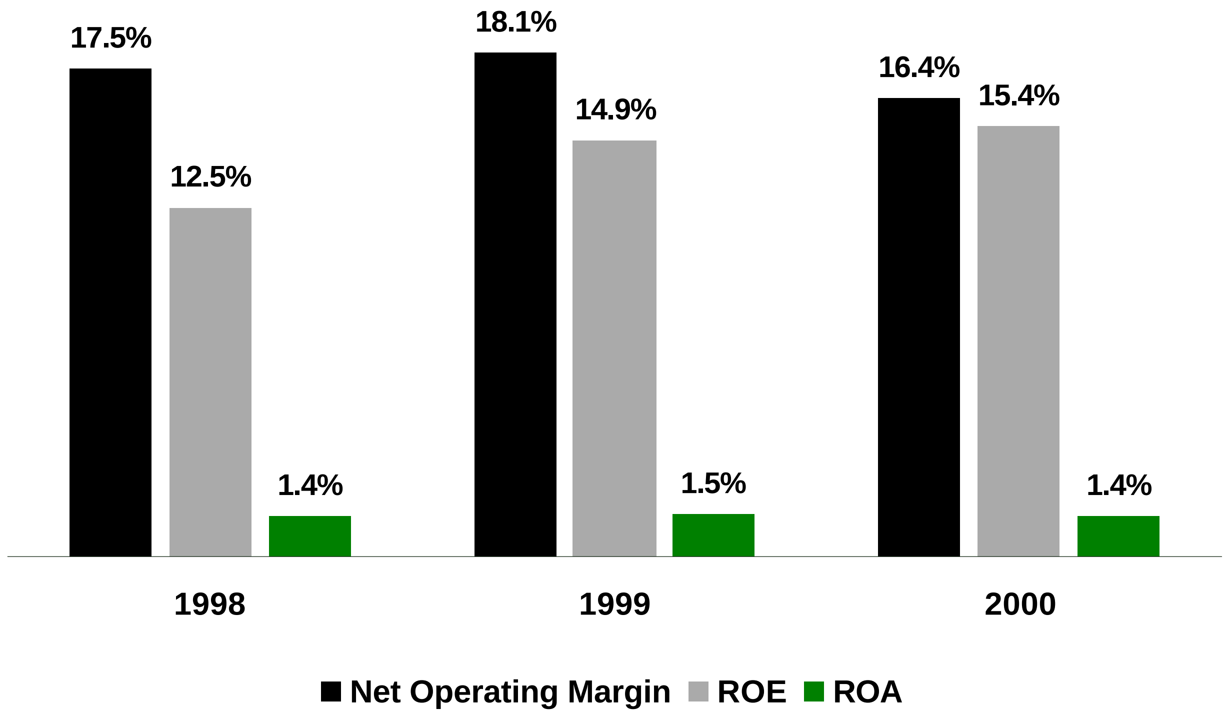


* Revised

Source: 2001 ELA Survey of Industry Activity Report, ELA Performance Indicators Report, U.S. Department of Commerce

Figure 1

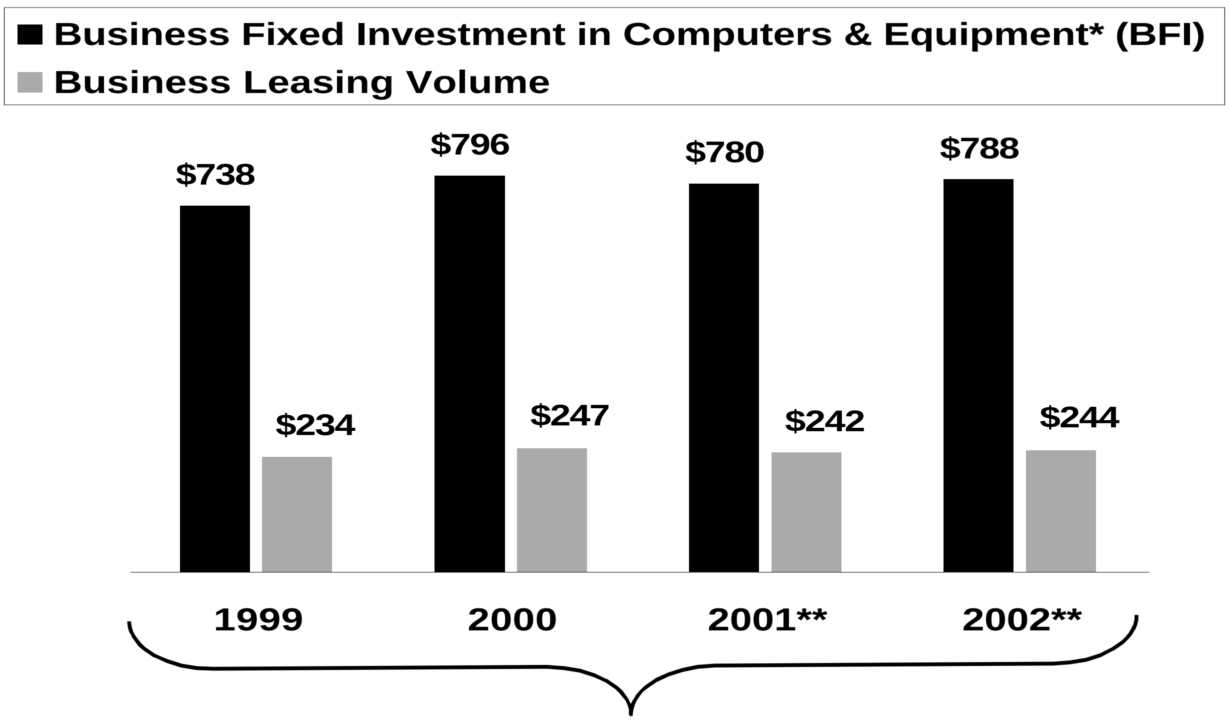
Key Financial Ratios



Source: 2001 ELA Survey of Industry Activity Report

Figure 2

Total Domestic Business Fixed Investment and Lease Financing Volume ($ in billions)



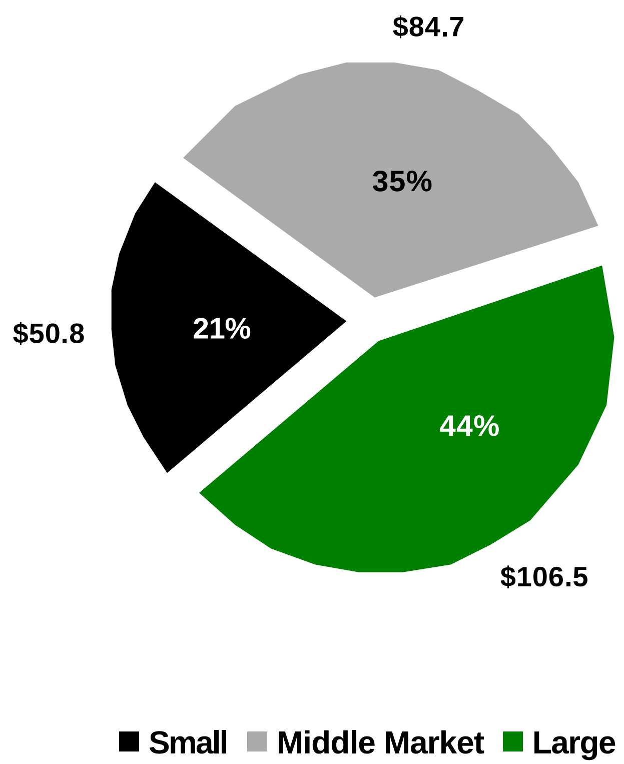
1% CAGR* - BFI in computers and equipment**

2% CAGR* - Business Leasing Volume**

* Does not include software
** Estimates
*** Compounded Annual Growth Rate
Source: ELA, FIC Analysis, National Association of Business Economists

Figure 3

2001 Estimated Total New Business Volume by Ticket Segment (100% = $242 billion)



Source: 2001 ELA Survey of Industry Activity Report

Figure 4

Leasing Industry Overview

Until the third quarter of 2000, the equipment leasing industry had enjoyed unprecedented growth. Gross domestic product (GDP) increased at an annual rate of around four percent each year since 1996, and the annual rate of economic growth for 2000 was five percent (Figure 5). Demand for business equipment and software increased at double-digit rates, translating into similar growth for the equipment leasing and finance industry.

In the third quarter of 2000, with inflation-controlling interest rates increasingly taking effect, Y2K-induced technology demand gone, and the rupture of the dot.com bubble, the rate of economic growth slowed considerably. In September 2001, economists forecast the overall economic growth rate (GDP) to fall by more than 50 percent from one year ago to less than two percent[2]. In the same period, the slowdown has impacted business equipment and software sales. Analysts project that sector to contract by two percent this year. The National Association of Business Economists projects 2002 economic growth to increase to nearly three percent, but also projects investment in business equipment to grow an anemic one percent in the same period. Post- September 11, many economists forecast even weaker performance over the coming year.

The contraction of investment in business equipment varies by industry sector. As shown in Figure 6, computers and IT equipment suffered the sharpest drop-off, led by PCs and telecom equipment. Growth in industrial equipment remained relatively flat while transportation equipment shrank by nearly ten percent. Even within the transportation sector, growth varied greatly with annualized demand for commercial, corporate, and fractional aircraft increasing. However, in the third quarter 2001, demand for commercial aircraft declined dramatically. Truck and trailer and railcar demand (representing over 25% of total leasing volume) also decreased sharply.

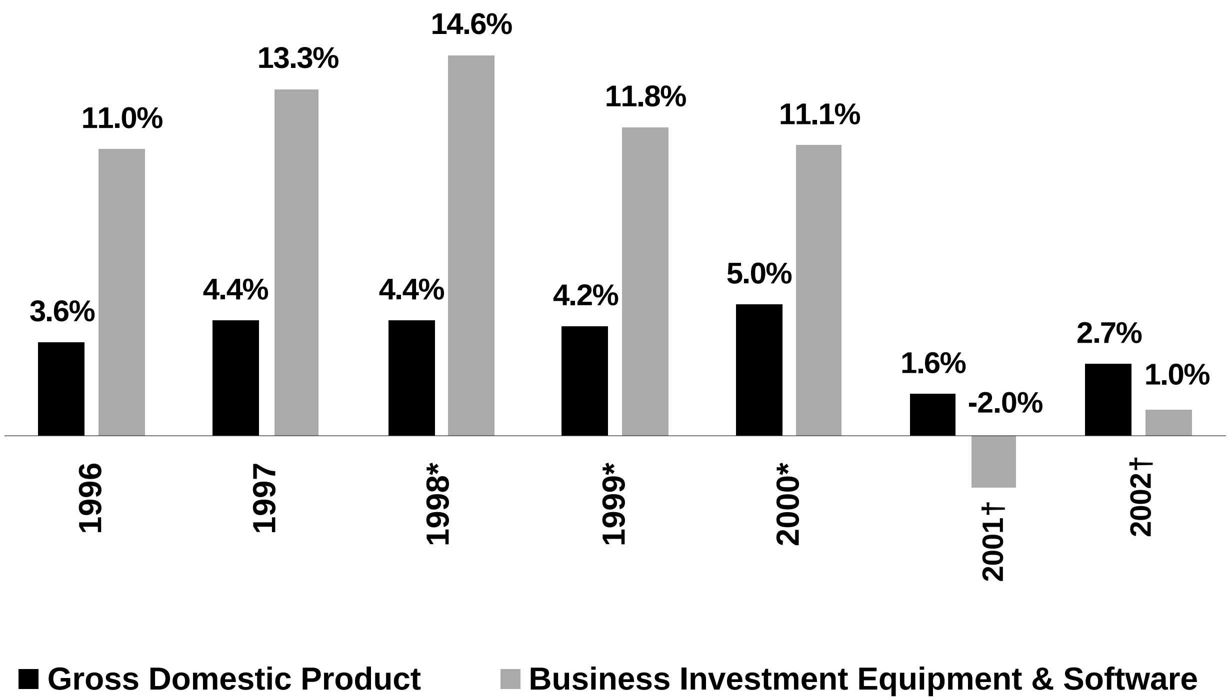
The leasing industry continues to finance approximately 30 percent of all business equipment, a penetration rate virtually unchanged over the past ten years. Dominant reasons for choosing leasing over other finance options continue to be increased cash flow, convenience and flexibility, tax benefits, and the opportunity to transfer the cost of equipment upgrades to the lessor (Figure 7). However, as one interviewee noted, “Leasing is becoming just another financing option. Unless the industry begins to present value beyond tax benefits, which may disappear anyway, and reduced cash outlay, we will see other forms of financing taking away market share.” Increasingly, industry leaders are repositioning their companies to provide financing options beyond leasing alone and are telling clients that they provide “total financing solutions” rather than only leasing.

While interest rate increases drove the average cost of funds higher in 2000, several industry executives indicated that an easing of competitive pressures allowed stricter adherence to risk/return pricing and resulted in average pre-tax spreads for the industry to increase over 1999 (Figure 8).

Across the leasing industry, growth and profitability vary by both type of lessor and ticket segment. Within both areas, further variance in profitability exists by the size of the lessor. In 2000, independent lessors reported the highest rate of new business volume growth at 9.5 percent

[2] This forecast was prior to September 11

Leasing Industry Growth Indicators

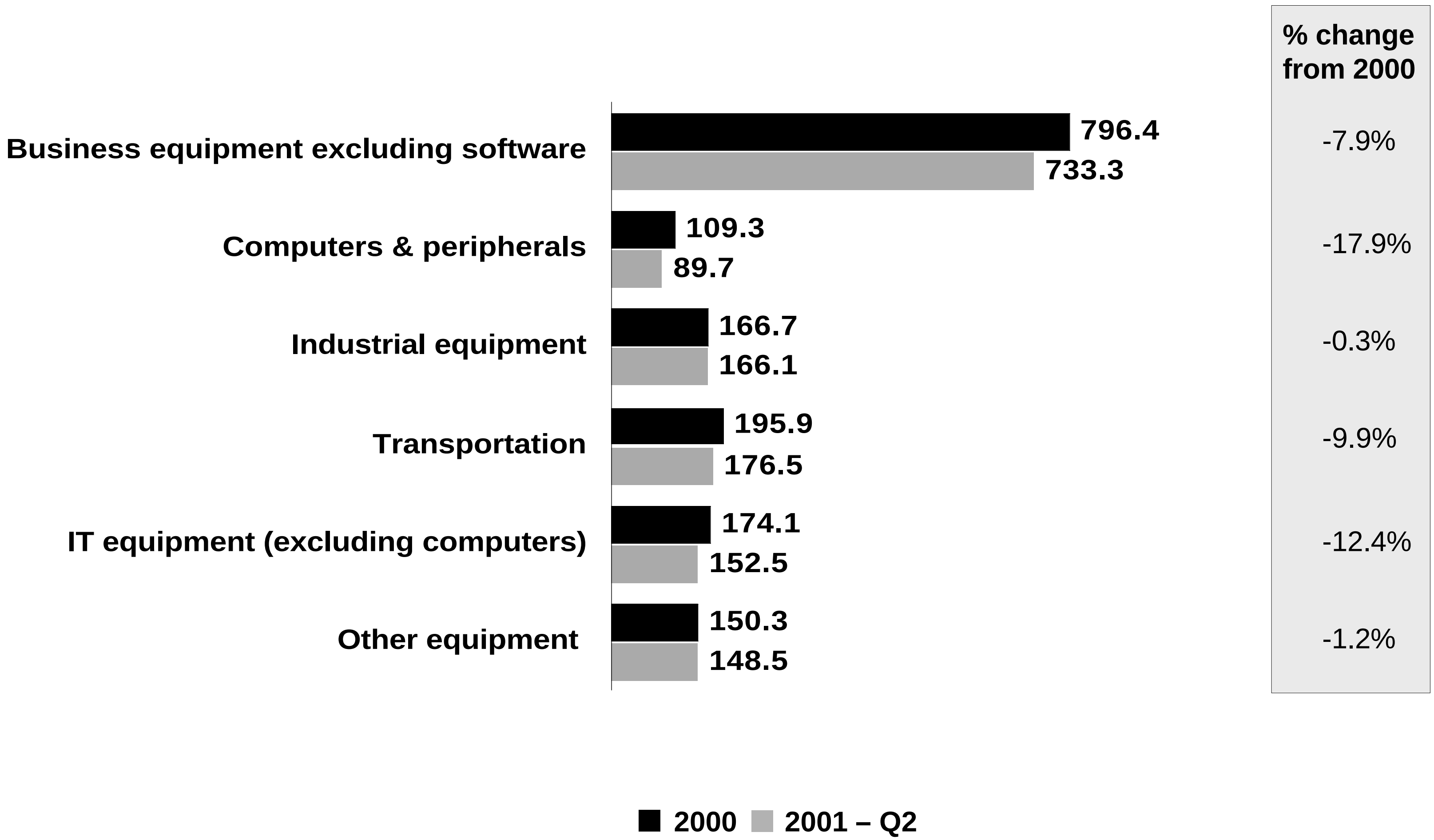


* Revised, † Projected

Source: BEA, Federal Reserve, Office of Management and Budget, National Association of Business Economics, FIC

Figure 5

Gross Domestic Production of Business Equipment
in $ billions*

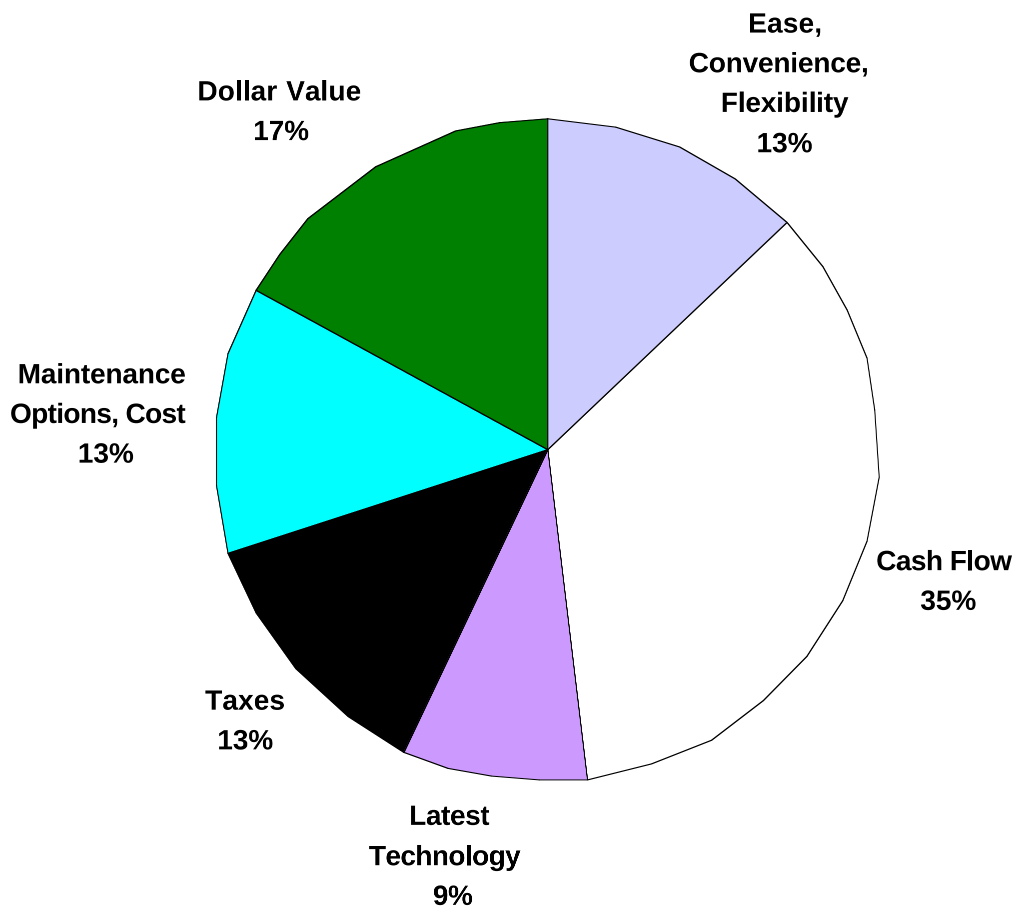


* May not total due to rounding

Source: Federal Reserve

Figure 6

Primary Leasing Decision Drivers



Source: ELA

Figure 7

2000 vs. 1999 Pre-tax Spreads

	Pre-tax yield	- Cost of funds	= Pre-tax spread
2000 (overall)	**10.2%**	**6.6%**	**3.6%**
1999 (overall)	**9.6%**	**6.2%**	**3.4%**

Source: 2001 ELA Survey of Industry Activity Report

Figure 8

while banks reported the lowest rate at 3.7 percent (Figure 9). Captive lessors, however, dominated profitability, in terms of pre-tax margins, and, largely because of their debt leverage, bank lessors reported the highest ROE for 2000 (Figure 10).

For the second year running, large ticket transactions represented the largest market segment, capturing 44 percent of all new business volume (Figure 11). The large ticket segment also reports the highest profitability in net operating margin and ROE. The middle market, while generating 35 percent of all new business volume, produces the lowest net operating margin of any ticket segment.

Lessor Profitability

In 2000, overall profitability remained strong for the leasing industry. Net operating margin was reported at a respectable 16.4 percent, a 170 basis point decline from the previous year. Given overall pricing improvement, the decline in net operating margin indicates that lessors may have failed to reduce their cost structure while growth declined. ROE increased slightly from 14.9 percent in 1999 to 15.4 percent in 2000 indicating that lessors as a group became more highly leveraged.

Among specific lessor types:

- Independent lessors provided the lowest profitability ratios in 2000. Net operating margin was driven down by high sales and operating costs and ROE was hampered by relatively low leverage. The dominance of a few large industrial lessors best explains independent’s low interest expense (17.6 percent of total revenue compared with 43.2 percent and 26.1 percent for banks and captives, respectively).

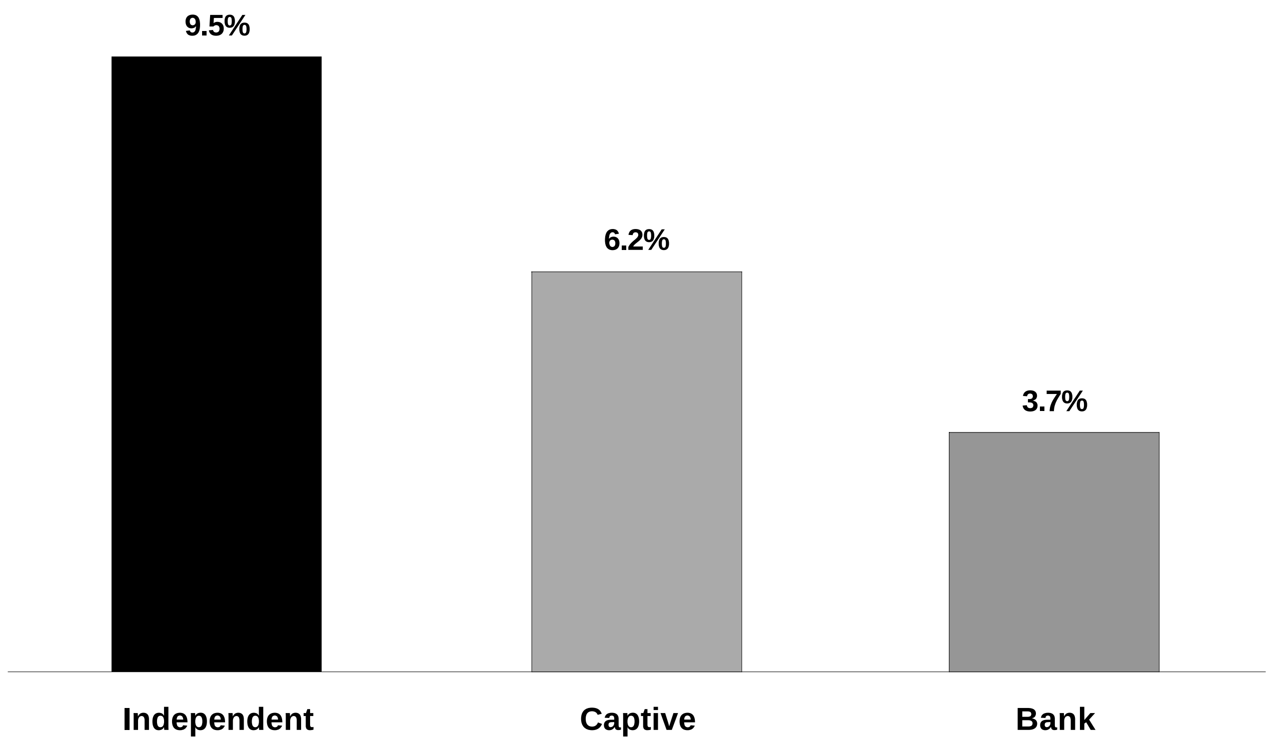
- Captive lessors command the highest net operating margin at 18.5 percent, driven by their low GS&A cost structure. Depreciation expense of 34.5 percent of total revenues, the highest among lessor types, is driven by “off balance sheet” transactions typical of captive finance companies.

- Bank lessors report the highest ROE, a healthy 17.8 percent, on a net operating margin of 16.9 percent (See Figure 10). Two factors drive bank lessor profitability: relatively higher pricing and their customers’ dependence on finance leases, as evidenced by the low percentage of lease to overall revenue (Figure 12). Bank depreciation expense represents just over three percent of revenue, compared to nearly 25 percent for independent lessors and 34.5 percent for captive lessors. Also influencing ROE is the bank lessor’s higher leverage ratio versus other lessor types.

Independents

Independent lessors continued to control substantial market share and enjoyed relatively healthy growth in 2000. Nonetheless, from a profitability perspective, they fair poorly against other lessor types. Their high overhead makes them appear unproductive versus the industry, and funding issues continue to be a major, and in some cases insurmountable, challenge.

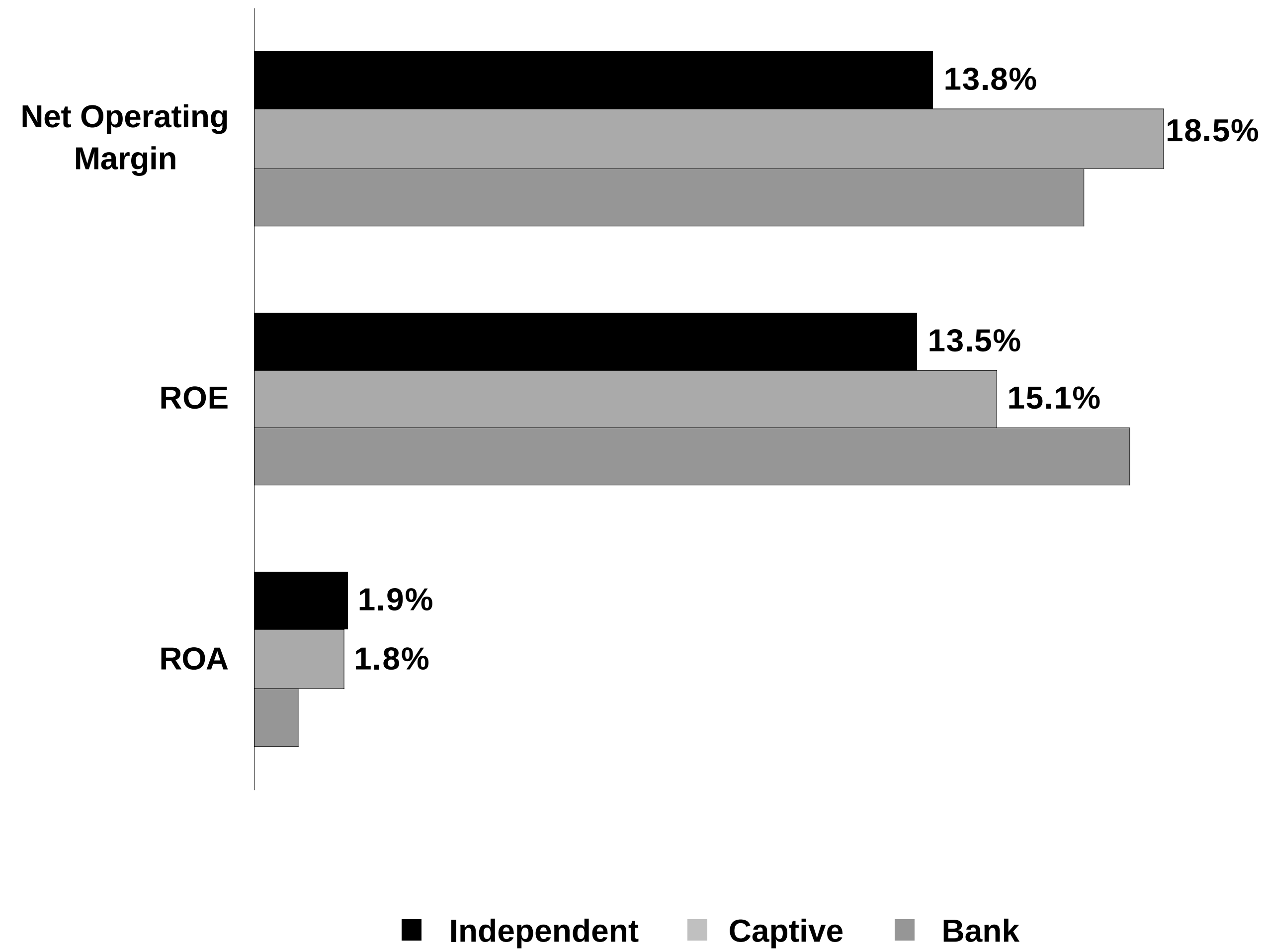
2000 New Business Volume Growth Rate by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 9

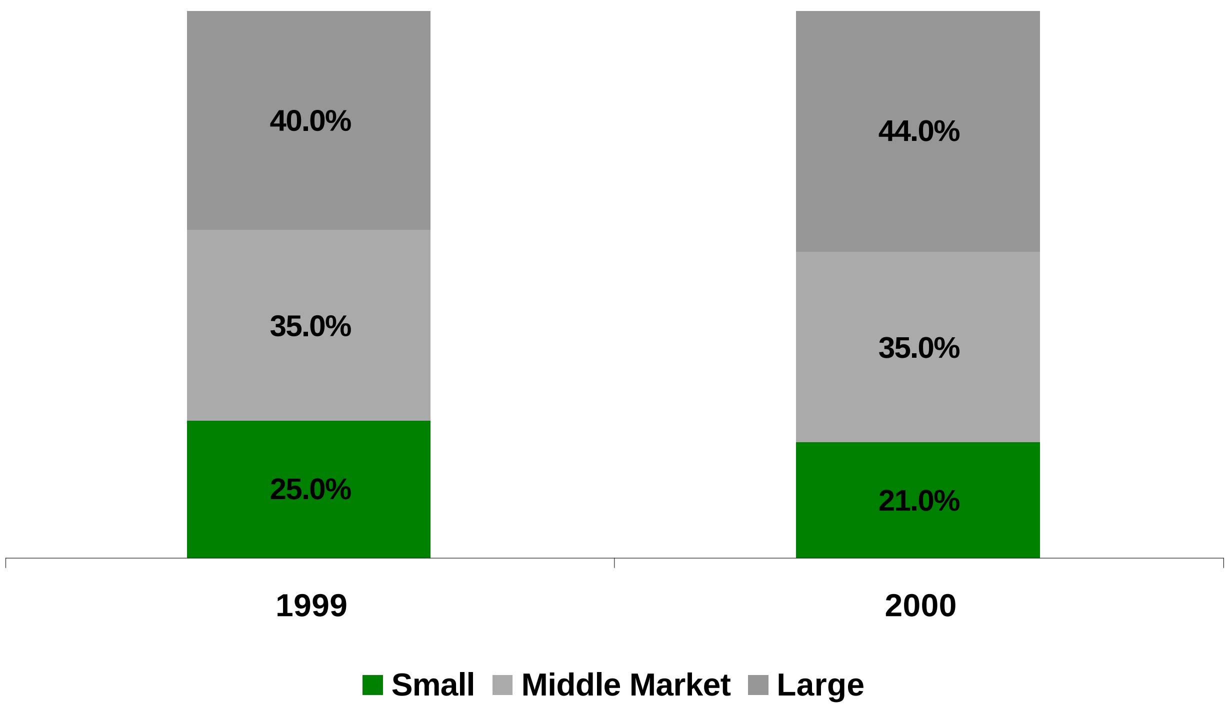
2000 Profitability Ratios by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 10

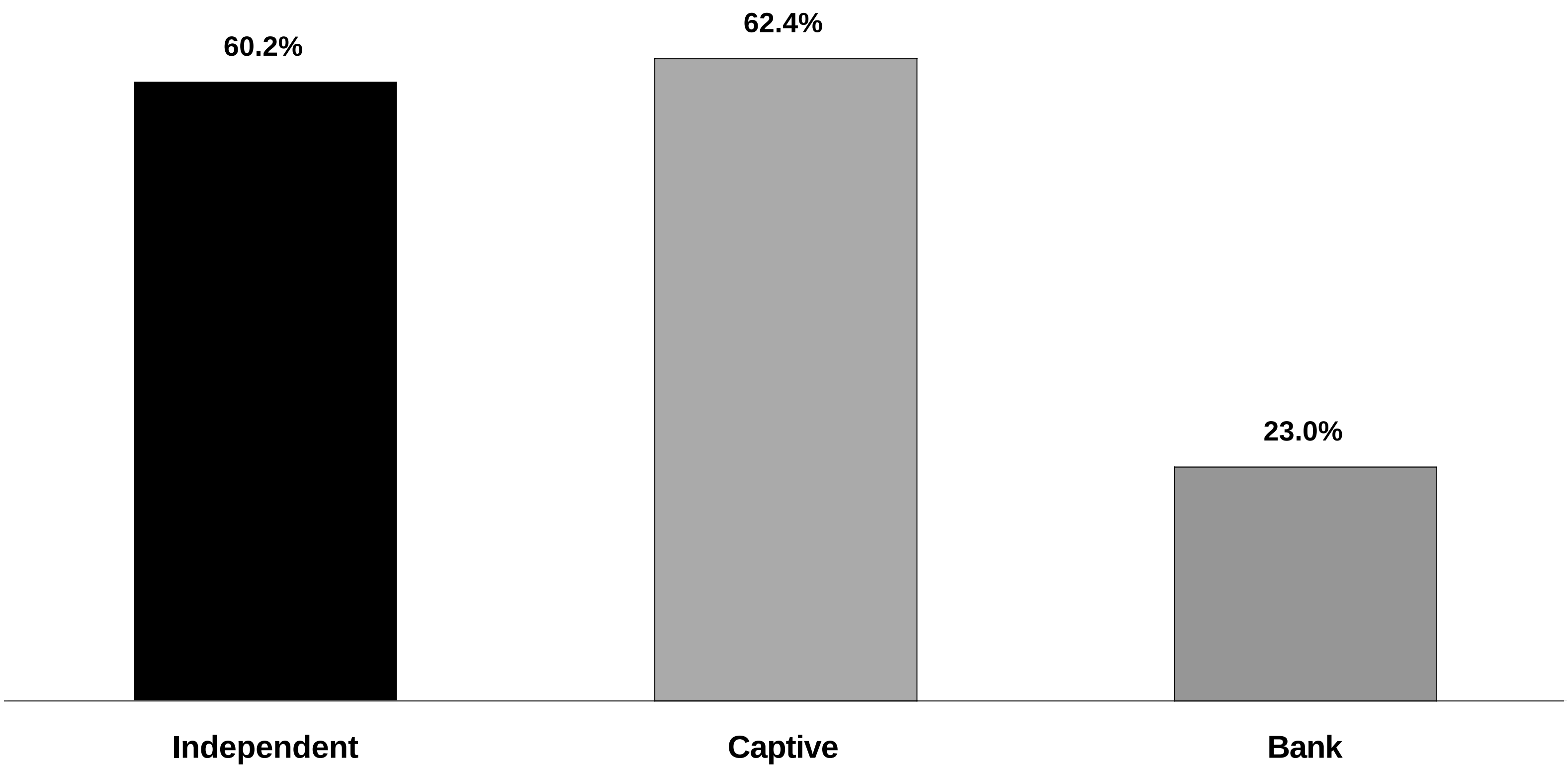
Total New Business Volume by Ticket Segment
(% of total)



Source: 2001 ELA Survey of Industry Activity Report

Figure 11

2000 Lease Revenue as a Percentage of Total Revenue by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 12

In 2000, independents generated 37 percent of new business (Figure 13), compared with 52 percent in 1999. New business volume growth in 2000 was the highest of the three lessor types at 9.5 percent, but at least some of this new business generation was through acquisition, not representing true expansion of the overall leasing market.

Despite the size of this segment, independent lessors do not stack up well against other lessor types in terms of profitability. Even with a pre-tax yield of 10.1 percent (300 basis points less than banks), they produce a net operating margin of 13.8 percent. Independents do not have the same origination advantages as banks and captives; therefore, their SG&A expenses are the highest in the industry (Figures 14-16).

Operating with limited leverage, ROE for independents hits just 13.5 percent. Similarly, adjusted ROA is low. Including off balance sheet securitized managed assets into the ROA calculation, ROA drops to less than one percent, the lowest in the industry.

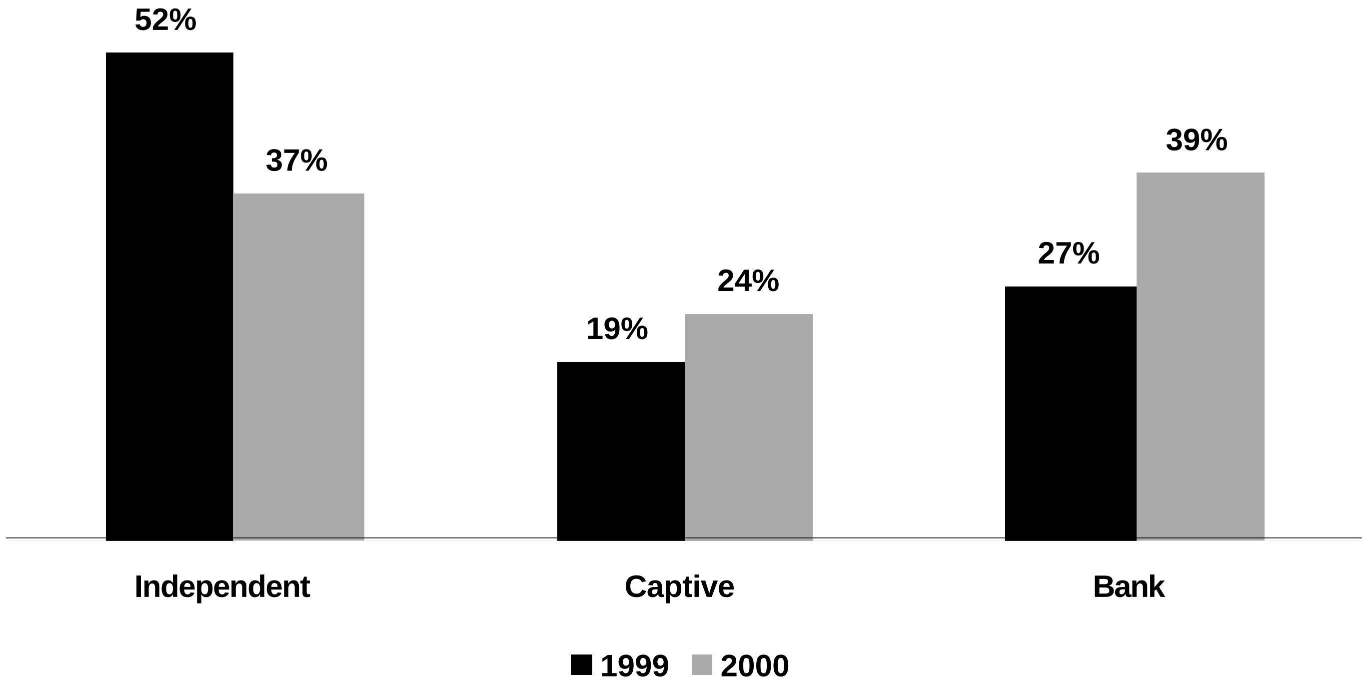
Independents also demonstrate comparatively low productivity, generating just over $9 million in new business volume per sales employee and $1.3 million in lease and loan revenues per sales employee, lagging far behind bank and captive lessors. Since independents operate at a competitive disadvantage to banks and captives in originations, it is important to evaluate application processing costs. Productivity lags in this area as well. Independent lessors average 502 application approvals per credit employee (Figure 17), compared with 2,271 and 1,360 for captive and bank lessors, respectively. They perform slightly better in booking transactions, booking 211 applications per employee. These results suggest that the state of automation and process streamlining for independents may not be where they need to be to compete effectively.

Small independent lessors face challenges on many fronts, but there are also opportunities. Challenge number one involves funding. In years past, securitization of lease receivables provided liquidity for many independents. The transaction was usually rated on the credit worthiness of the receivable, not the lessor. As capital markets have tightened, the balance sheet and track record of the lessor has become as important as the underlying receivable. Many players that previously relied on asset securitization for liquidity have found themselves shut out of the market and without the ongoing cash flow to continue in operation. This is one key factor behind the continued consolidation in the industry.

Many executives we interviewed believe that independents are in very deep trouble, at least in the current environment. As one executive stated, “In the short term, it is going to be extremely difficult for many of them to survive, based on their access to capital. The best way for the independent to make it is to compete on a service and deal structure level.”

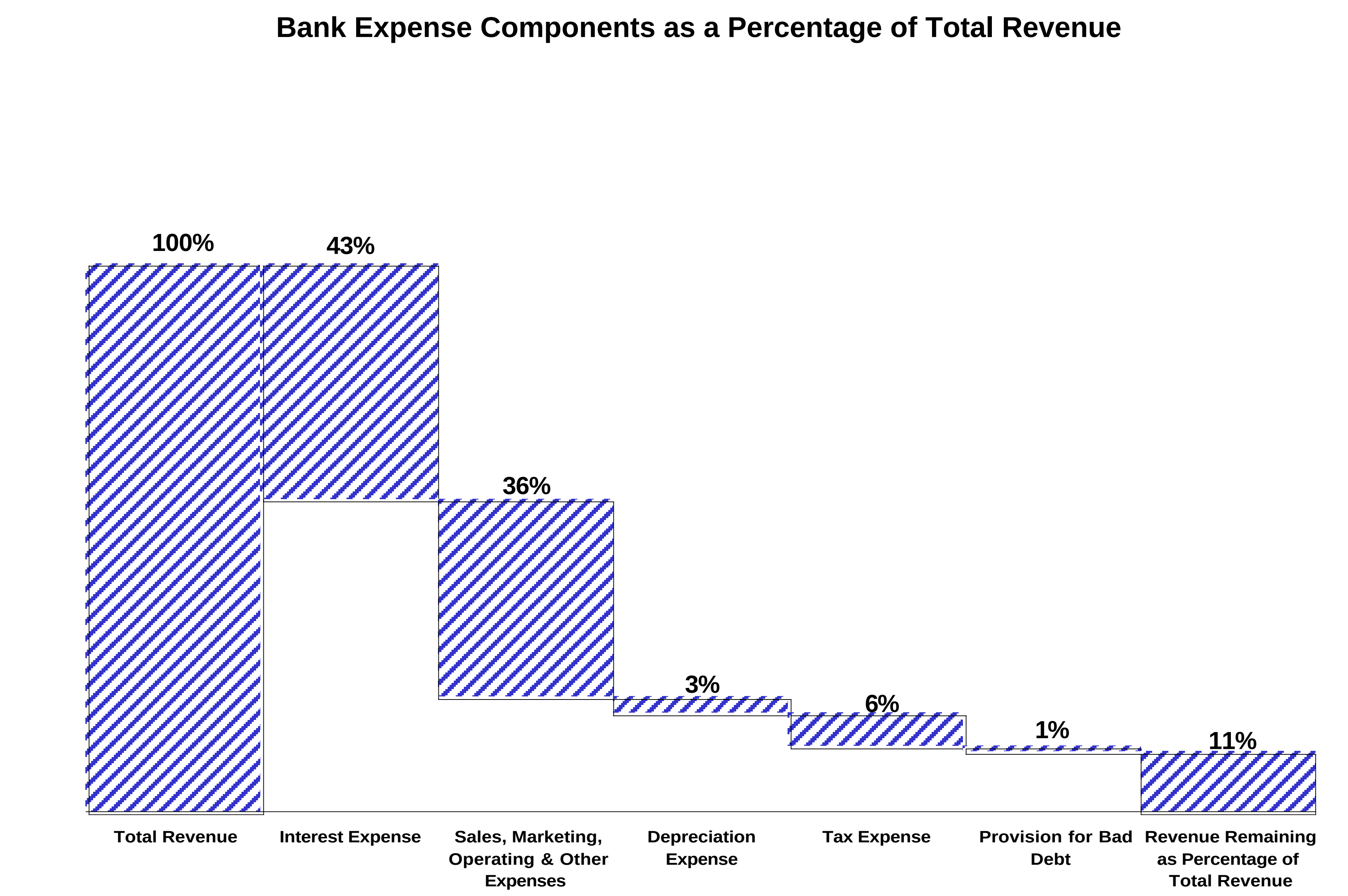
However, most also believe that opportunities exist for independents who are nimble and disciplined. Those firms that can add value through either customized service and deal structure or through value-added services also have a path to continued success. One industry leader summed it up well when he said, “Independents can succeed if they find a knowledge-based specific niche.   You have to adapt and identify where you want to play in this field.”

Total New Business Dollar Volume Allocation by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

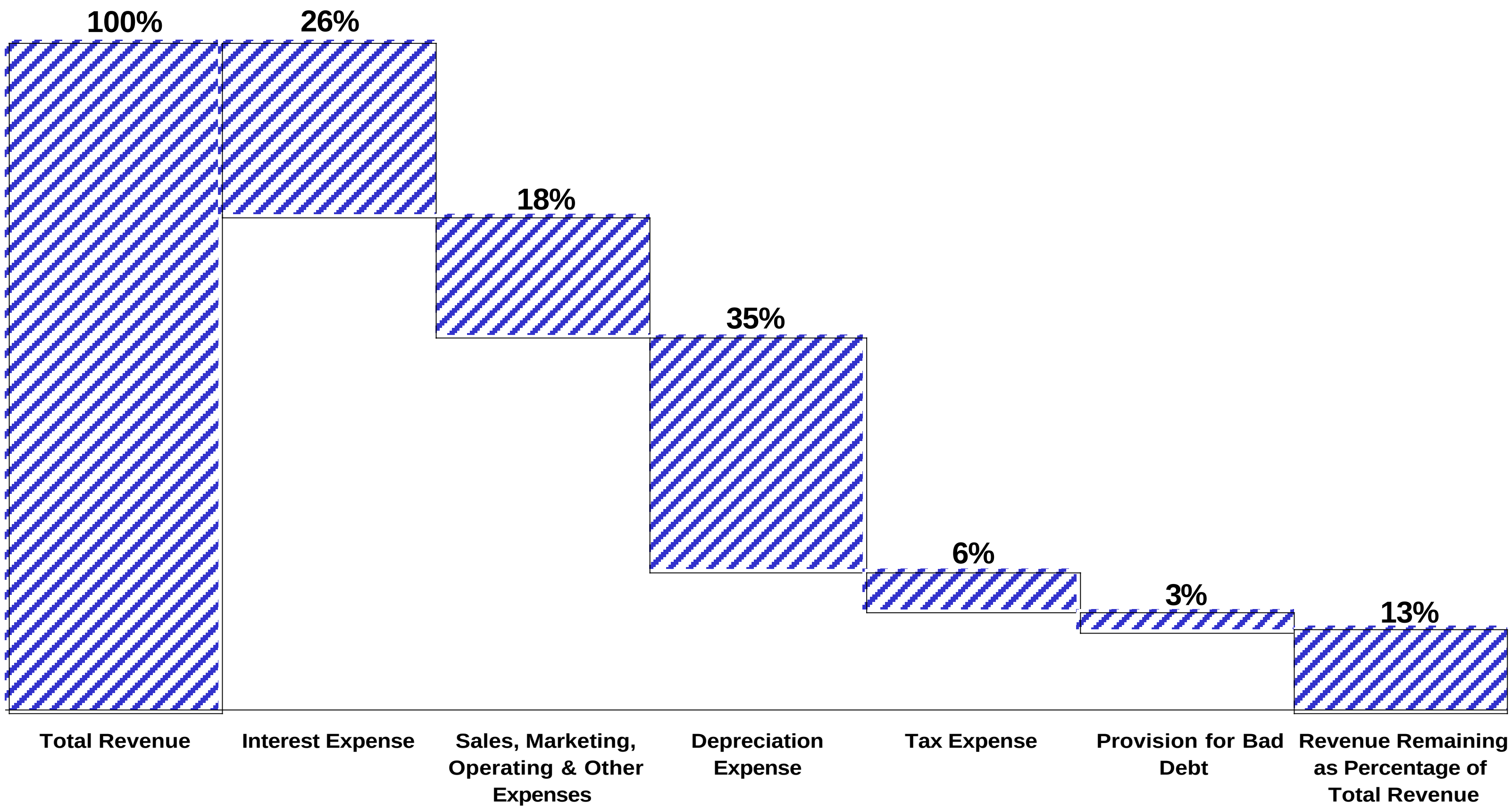
Figure 13



Source: 2001 ELA Survey of Industry Activity Report

Figure 14

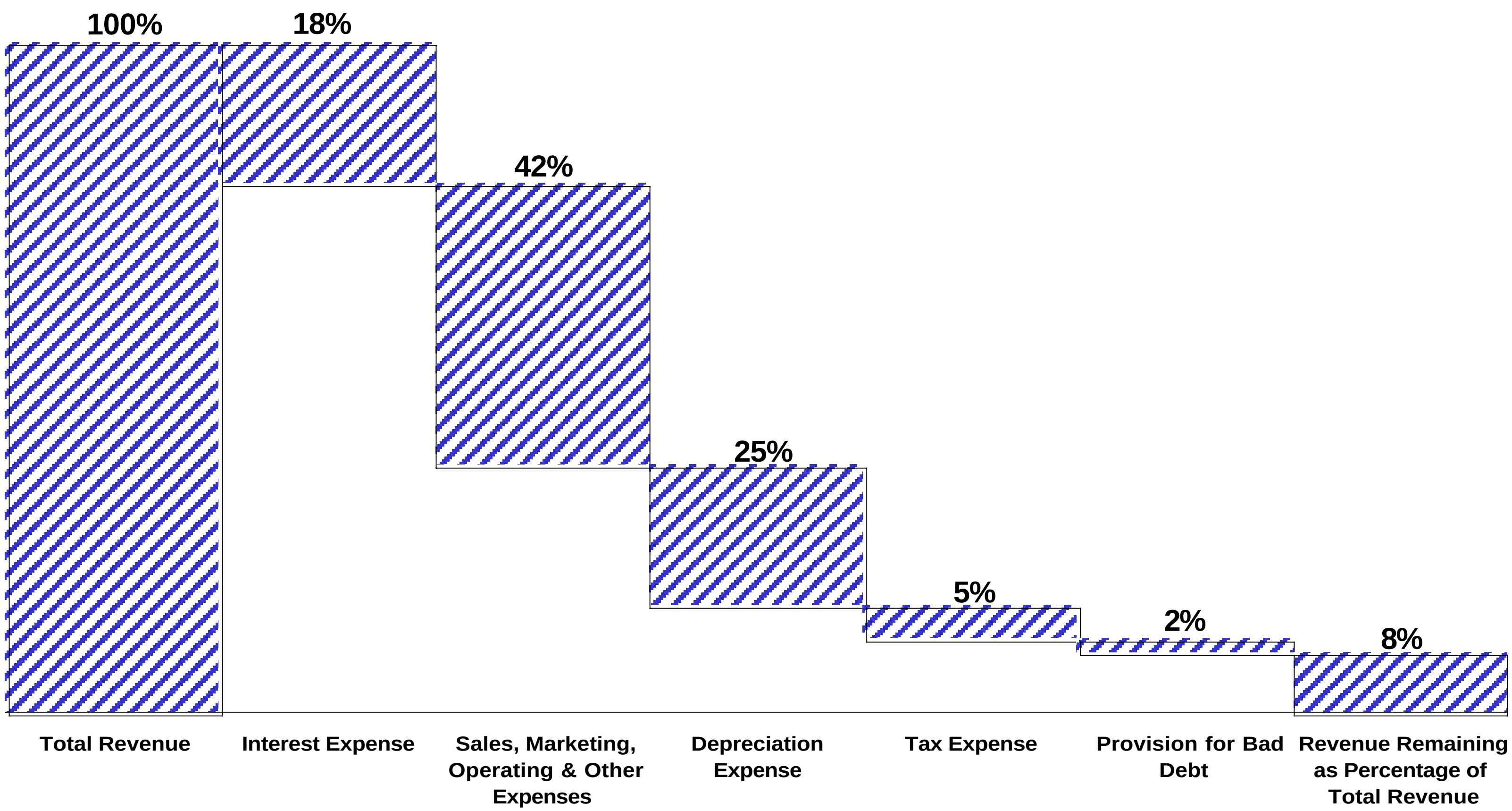
Captive Expense Components as a Percentage of Total Revenue



Source: 2001 ELA Survey of Industry Activity Report

Figure 15

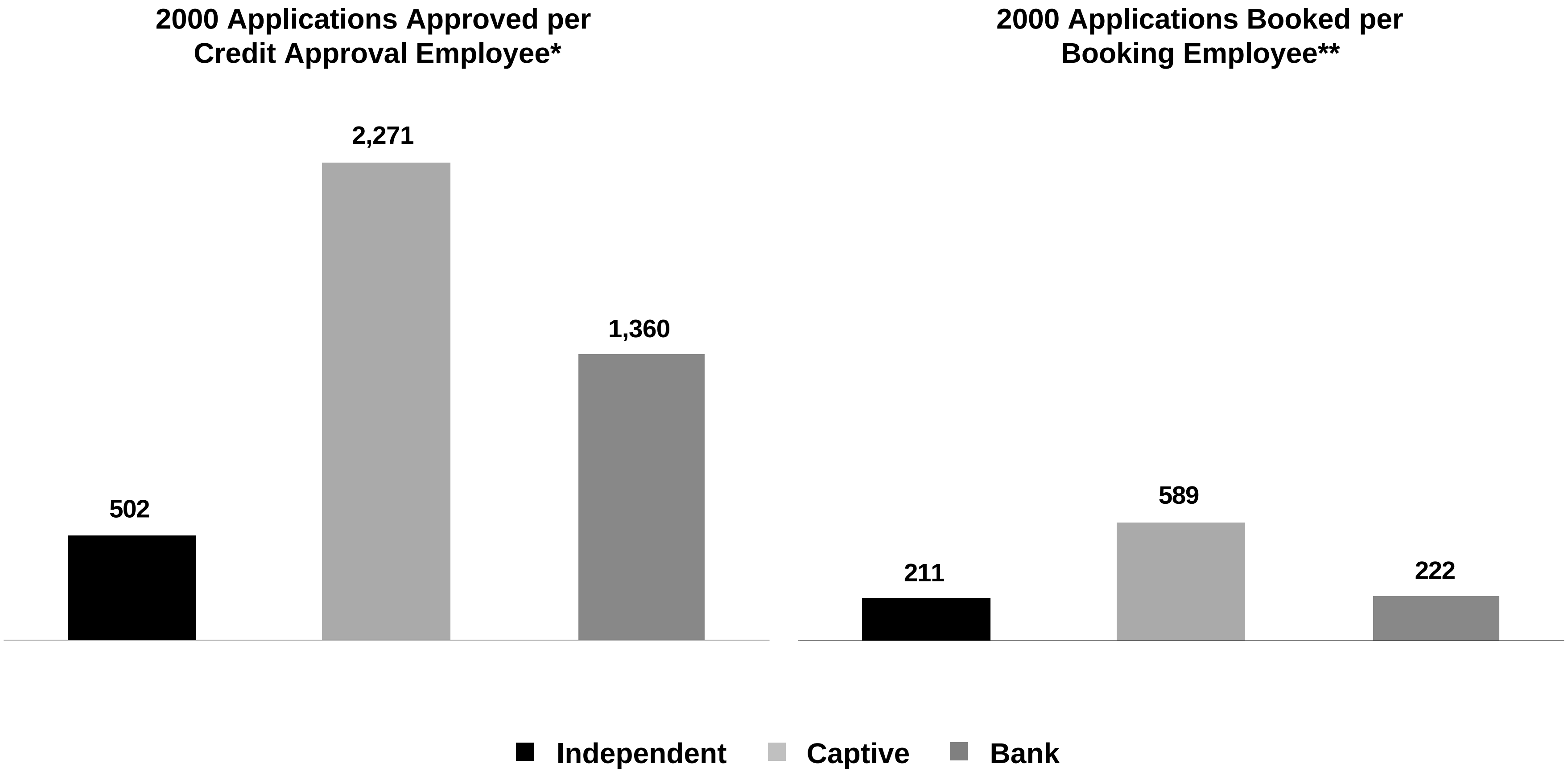
Independent Lessor Expense Components as a Percentage of Total Revenue



Source: 2001 ELA Survey of Industry Activity Report

Figure 16

Application Processing Efficiency
2000



* Mean credit approval per employee

** Mean booking activity per employee

Source: 2001 ELA Survey of Industry Activity Report

Figure 17

Independent's Day

With the exception of independents themselves, the leasing industry executives we interviewed were almost unanimously pessimistic about the future for independents. Yet, two independents were remarkably upbeat about their future prospects. They told us they have successfully staked out niche markets, addressed funding issues, and effectively controlled their costs.

The first independent interviewed has staked out territory in two narrow, specialized markets. They picked markets that were relatively "recession proof" and that had modest but steady growth. Their narrow concentration in these markets enabled them to become known as market leaders. This strategy has allowed them double-digit growth every year and even in 2001, a year in which most other lessors have flat or declining volume, they are enjoying 30 percent growth.

In fact, their rapid growth, rather than balance sheet or credit issues, in effect caused their funding crisis. Alert management recognized early on that such rapid growth would soon outstrip their ability to borrow. In order to preserve growth and maximize stakeholder value, management sought out and obtained a stable, low-cost funding partner. While still operating independently, this "independent" is now owned by a bank.

Another independent lessor has taken a different tact. Rather than narrowly concentrating on a particular industry segment or equipment type, they set about differentiating themselves based on their experience. They have built a business around partnering with other leasing companies on specific deals. This company supplies the knowledge and their partner supplies the capital, an effective solution to funding issues. In the process, they have built partnering into a strategic advantage, learning how to evaluate a potential alliance for strategic, as well as cultural, fit.

One of their core competencies is asset management. According to a company manager, their strategic partners are often companies with capital to invest but lacking the skill set required to manage lease receivables. The key to their success is simple: "When you manage other people's assets, you have to go the extra mile to safeguard those assets. We have even made business decisions to safeguard our partner's assets that came at the expense of our own assets. This is what builds trust and reputation. We need our partners as much as they need us."

By leveraging their core competencies, this independent has been able to overcome the funding issues plaguing this lessor group and remains truly independent.

Captives

Generating nearly a quarter of 2000 new business volume, captive leasing continues to be profitable. Although at a slower growth rate than in previous years, the captive leasing market grew at a rate of 6.2 percent in 2000. As the manufacturing sector has been hardest hit by the economic downturn, it is likely that captive leasing volume will contract in 2001.

Captive lessors operate with a clear advantage over independents and banks through their point-of-sale origination base, their ability to subsidize finance costs with product sales, their proprietary knowledge of asset residual values, and their ability to profitably resell the asset at end of lease. According to one executive, "The biggest advantage of being a captive lessor is that we can sell the finance product at the same time we sell the equipment product. We can also slice and dice the cost any way we want, we can lower the interest rate, or lower the machine cost; either way, we make money."

Captives are high profit generators. They rank first in net operating margin, 18.5 percent and second in ROE, 15.1 percent. These numbers are somewhat lower than previous years, suggesting that the cost structure grew faster than volume or overall pricing was forced down competitively. However, captives do report the tightest operating cost structure. A relatively high depreciation expense suggests that captives write the highest number of operating leases, keeping the depreciable asset on their own balance sheet. Captives offer the lowest pricing of any of the lessor types (Figure 18), suggesting that they use low-price sales financing as an incentive to close equipment sales. A tight cost structure supports the captives' profitability.

Captives were also highly productive and efficient in 2000, replacing banks as the most productive segment. On a per employee basis (mean total employees), captives generated over $2.6 million per employee in lease and loan revenue (Figure 19). New business volume on a per employee basis was over $8.5 million, slightly less than banks. On a per sales employee basis (mean total sales), captives far outperformed the other two lessor types, generating over $66 million in new business and over $22 million in lease and loan revenue (Figure 20).

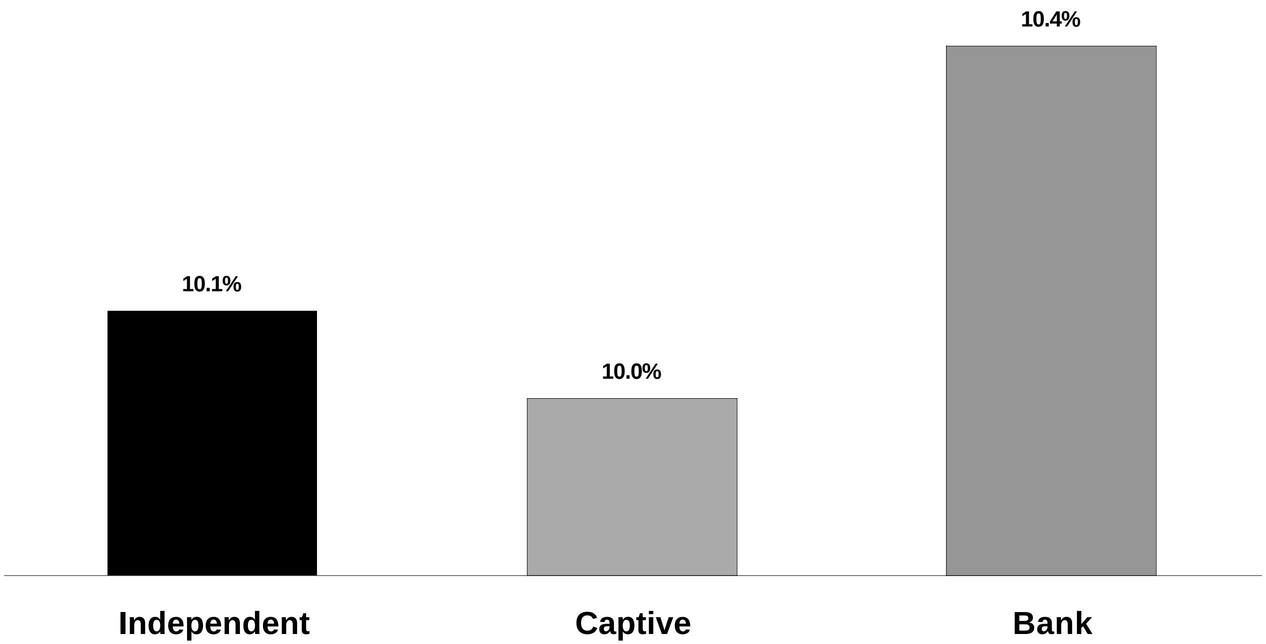
However, bad debt charge-offs create a drag on captive profitability, running 50 percent higher than independents and nearly three times that of banks. A delinquency rate nearly double that of banks and independents (seven percent, Figure 21) drives the high charge-off rate. The high lease approval rate generated by captives may indicate that their credit requirements are less stringent than either banks or independents. Captives approve 88 percent of all applications received, compared with 60 percent for banks and 70 percent for independents. They fund 68 percent of all applications, compared with 32 percent and 51 percent for banks and independents, respectively. Logically, their relatively higher funding rate is tied to their lower pricing and their point-of-sale convenience.

Opportunities for captive lessors continue to exist in solution-based transactions. More manufacturers are selling broader packages of products to customers, going beyond the manufacturer's specific products. Aggressive captive lessors are taking advantage of this to increase wallet share of a customer's business. The economic slowdown challenges captives on at least two fronts. Manufacturing utilization rates are at the lowest level in over 20 years, meaning that demand for products and equipment has dropped precipitously in the last year. To bolster sales, the manufacturing arm often demands "suicide pricing" from the finance arm. Not only is the captive lessor required to transact money-losing deals, but also the manufacturing parent may now be in less of a position to supplement potential losses and in some cases may demand that the finance subsidiary contribute more to the overall bottom line.

Banks

Banks have become major players in the leasing industry. Until the last few years, industry leaders often commented on the frequency with which bankers would enter and then exit the leasing market. While in the past, real commitment to the industry may have been rare, that is no longer the case. Banks, no matter their size, now view leasing as a natural and profitable

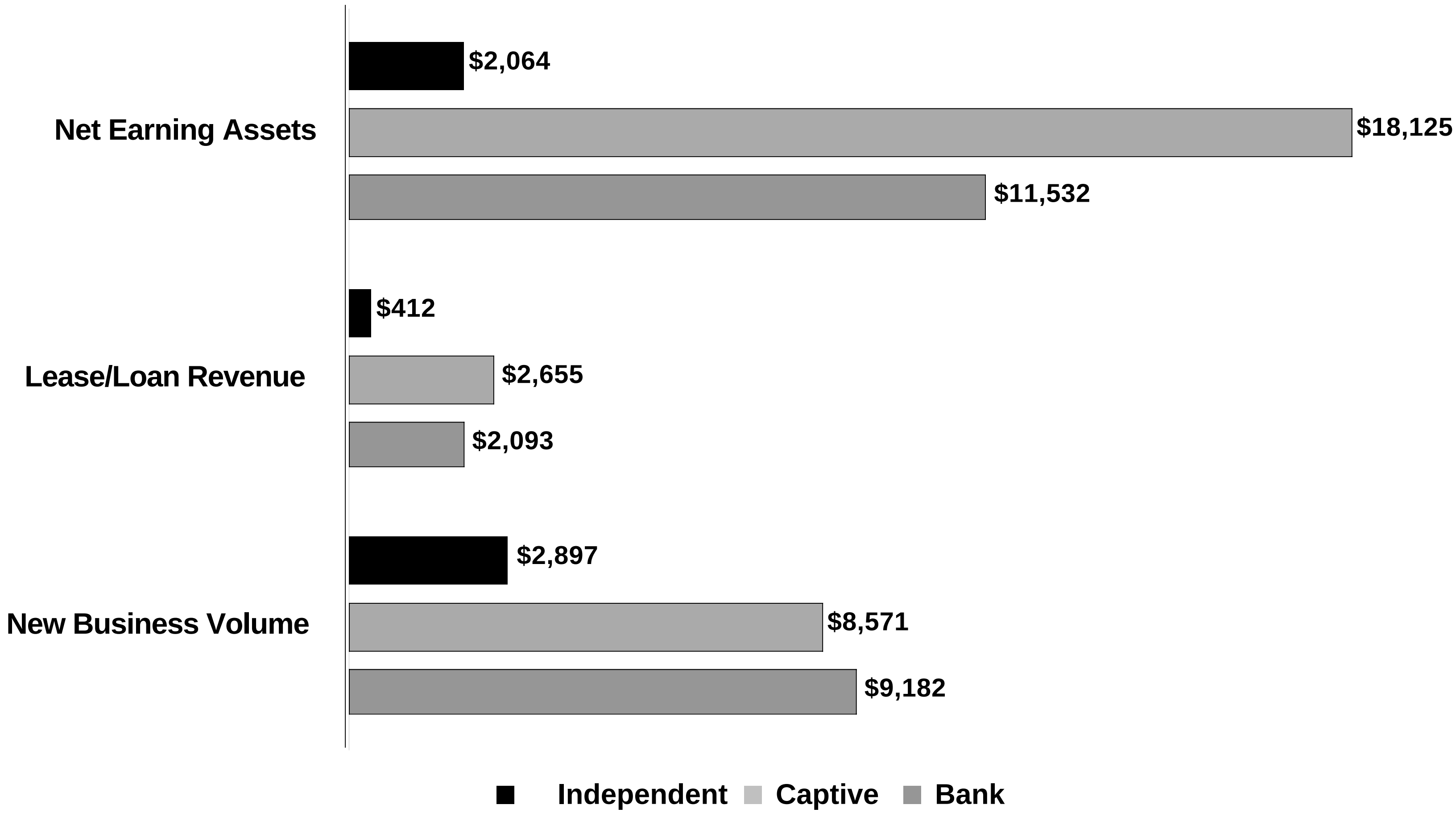
2000 Average Pre-tax Yield



Source: 2001 ELA Survey of Industry Activity Report

Figure 18

2000 Productivity per Employee* (000's) by Lessor Type

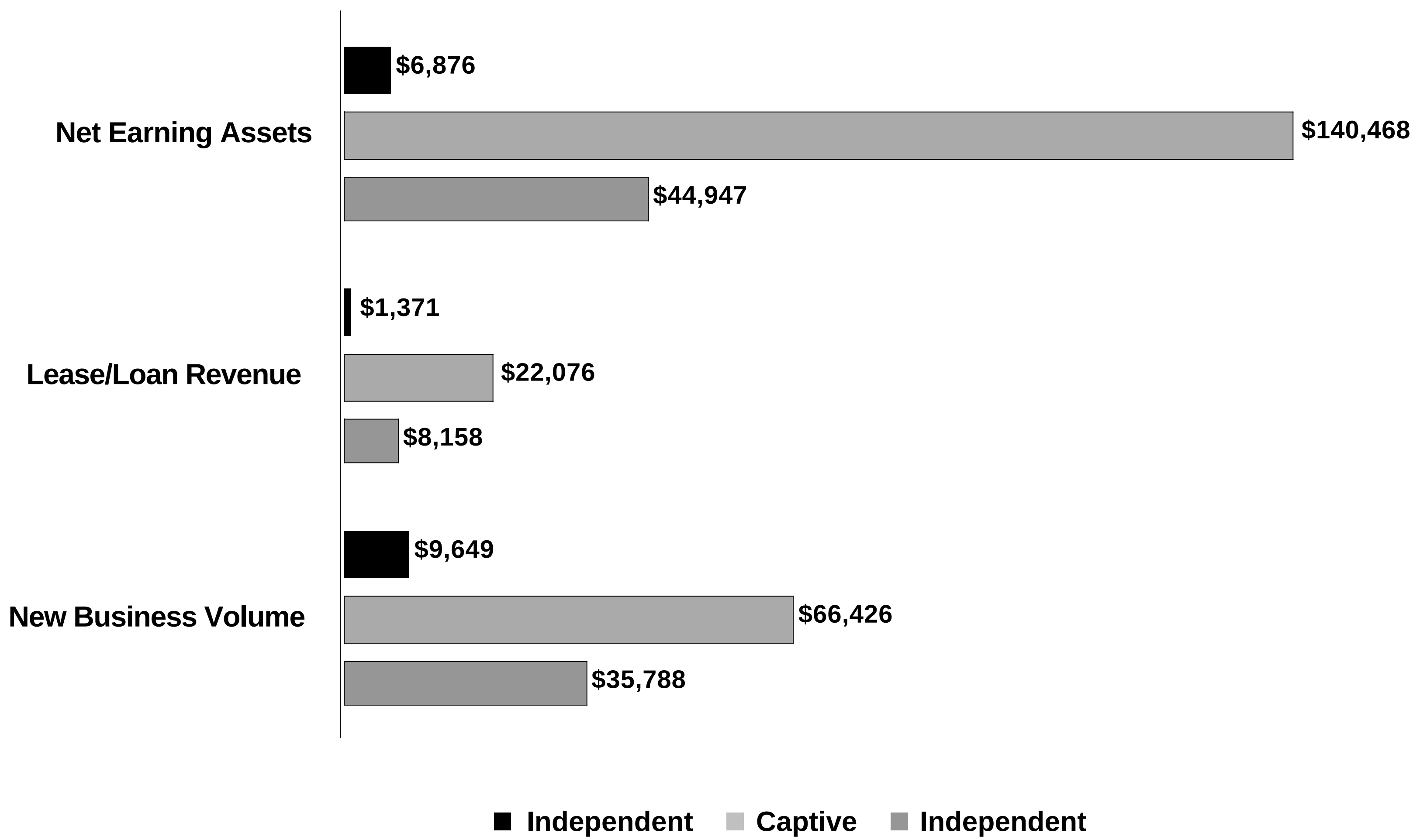


* Mean total employees

Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

Figure 19

2000 Productivity per Sales Employee* (000's) by Lessor Type

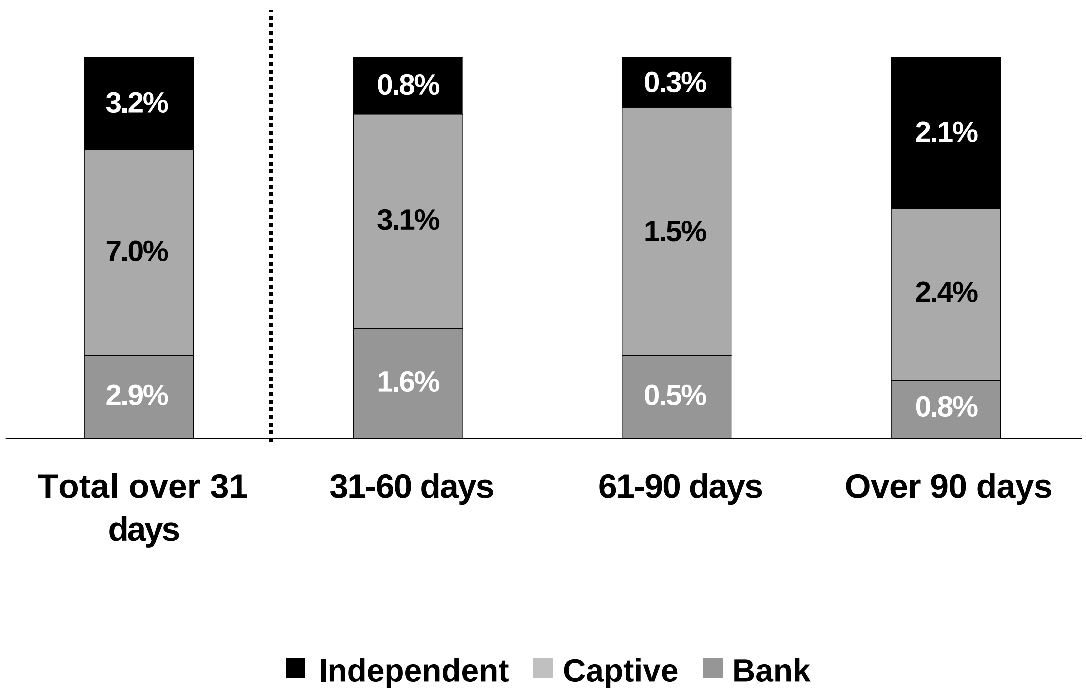


* Sales employees include mean inside and outside sales

Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

Figure 20

2000 Delinquency of Receivables by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 21

extension of their core business. And, with leasing providing a substantial cross-sell opportunity to commercial customers, generating good growth and providing substantially higher profit margins than traditional lending, many bank players will likely increase their interest in leasing.

SIA bank respondents reported generating 39% of 2000 new business volume, the highest of any lessor type. However, banks also reported the lowest new business growth rate, most likely driven by governance and risk management issues brought about by industry consolidation and an overall decline in credit quality. Profitability in terms of net operating margin and ROE remained strong. Banks generate the highest pre-tax yield at 10.4 percent, counter to the theory that "bank prices should be lower, since they service only the best credits" (See Figure 18).

Banks generate the lowest revenue to assets of any lessor type (Figure 22) translating into an ROA of just 0.9 percent. Reported data indicates that only 30 percent of the total assets of bank owned leasing companies are earning assets, comparing with about 90 percent for both captive and independent lessors. Seventy percent of bank-related assets are classified as "other assets" (including plant and equipment) that do not directly generate income. Recalculating ROA to include only earning assets (including off balance sheet securitized managed assets), banks produce the highest return (Figure 23), indicating the best overall profitability.

At 17.8%, banks generate the highest ROE across lessor types, not surprising, as banks also report the highest leverage. Operating expenses hit 35.9 percent of total revenue, compared with 17.9 percent for captives and 41.7 percent for independents (Figure 24). A closer look at those numbers reveals a very small percentage of total expense (0.2 percent of total revenue) attributable to corporate overhead and expense, compared to 7.6 percent for captives and 12.4 percent for independents. This indicates that if bank lessors (and for that matter captives) absorbed all overhead costs, the impact on profitability would be severe.

Banks have a unique opportunity to leverage their existing "trust" factor to compete effectively in leasing. Many businesses view themselves as having a relationship with their bank, and are willing, to some degree, to trust them with their financial lives. Banks have the opportunity to leverage this trust, their existing client relationships, and their stable access to funding to gain an even larger share of the leasing market. Banks face two main challenges, however, one regulatory, the other cultural.

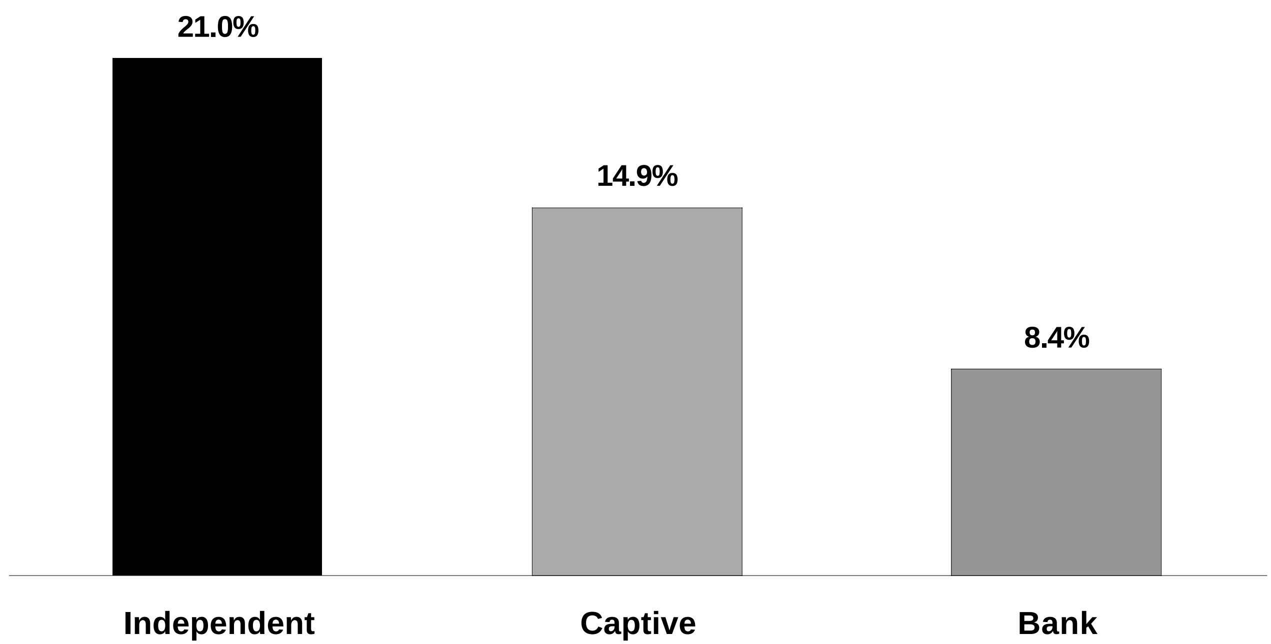
Banks may need to be even more diligent than independents and captives concerning risk management. Bank regulations dictate the amount and types of exposure a bank leasing company can maintain. For this reason, and because of their unique relationship with customers, banks are often seen as choosing only the best customers with the best credit, leaving non-bank competitors to scramble for what they turn down.

Many banks also operate with cultural barriers to leasing success. Banks primarily think of themselves as lending institutions, and for some, leasing does not fit within that definition.

Tale of Two Banks

Bank-owned leasing companies operate on a continuum with two distinctly different business models at the extremes. In the relationship model, a bank can use its leasing subsidiary to

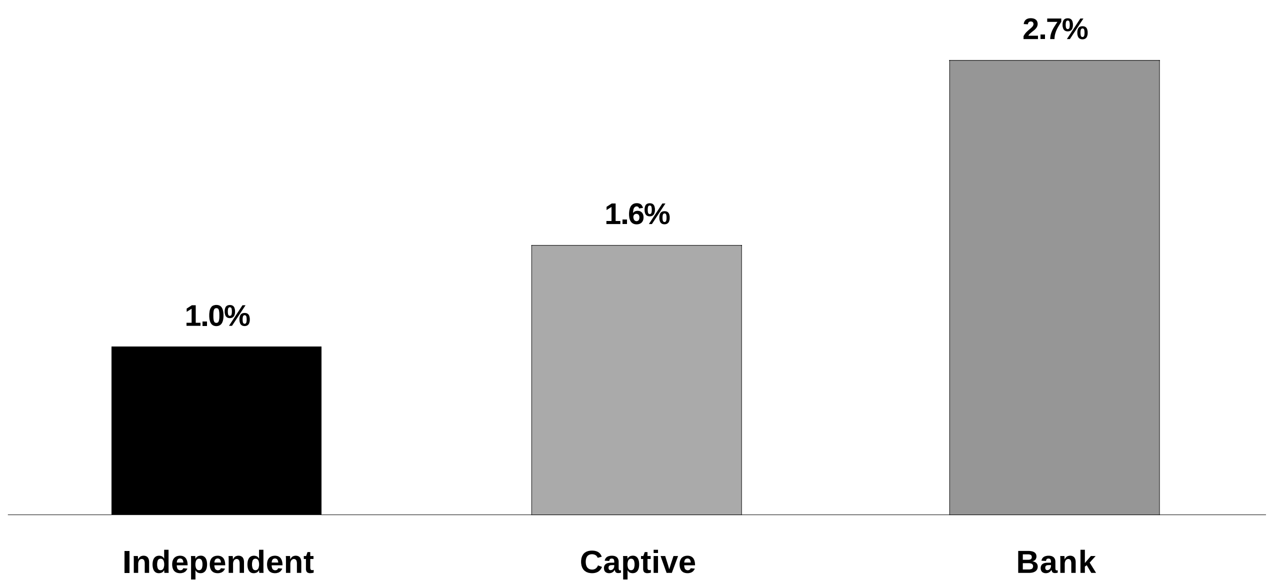
2000 Lease Revenue as a Percentage of Total Assets by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 22

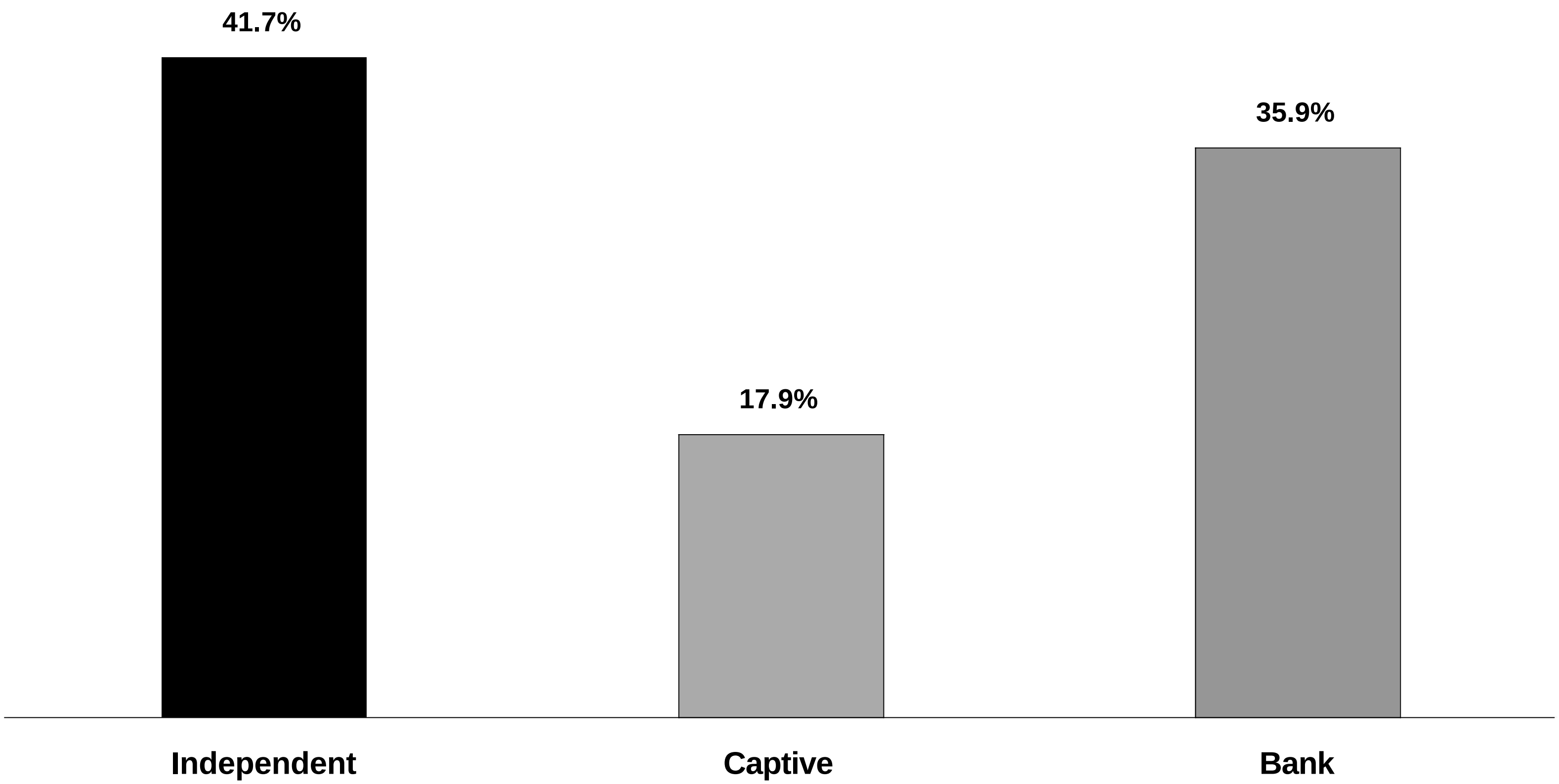
2000 Return on Earning Assets by Lessor Type (including off balance sheet securitized managed assets)



Source: 2001 ELA Survey of Industry Activity Report

Figure 23

2000 Operating Expenses* as a Percentage of Total Revenue by Lessor Type



* Operating expenses include 2001 SIA income statement categories: Sales and Marketing, Operating, and Other

Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

Figure 24

solidify relationships with its existing customers. In the separate business line model, the leasing subsidiary pursues business on its own, outside existing relationships. We interviewed banks using each model and found they have different strategies, cultures, and sources of income.

One large bank we interviewed states that they follow the philosophy that the leasing subsidiary exists to enhance and solidify existing customer relationships. They do not accept any brokered business, relying totally on cross-selling their existing middle market and large corporate customer bases. They believe they have successfully broken the barriers that often exist between the leasing and lending groups; they work in concert with the core bank relationship executives to bring to the customer the best possible financing option. They claim that staff compensation issues have been mitigated and that the only real issue left is that of internal "shelf space", i.e. too many products competing for the bankers' sales attention.

Oftentimes, one of the biggest obstacles to integrating leasing into the overall banking relationship results from the barrier that exists between the lending officers and the leasing group. Frequently, the compensation structure encourages the relationship manager to sell loans instead of leases, even though a lease may be in the best interest of the customer. One challenge for banks involves changing the compensation structure so that relationship managers are "indifferent" to which products they sell commercial customers, focusing on providing the product that best suits the customer's needs, rather than the product that best enhances their own income.

As noted above, bank leasing management states that the biggest issue they face centers on "shelf space". The bank relationship manager has many different products available to fill customer needs. While hardly a new product, we have found that leasing is not a product with which most relationship managers (RM) are familiar. RMs are typically lenders, used to selling traditional loan products. The intricacies of leasing, and the many lease structures available, are generally foreign. As such, RMs typically default to selling the product with which they are most familiar.

This bank addressed this challenge by launching a comprehensive training and information-building program, leveraging its Intranet and other resources to educate relationship managers about the benefits of leasing. They have also assigned internal salespeople to work with RMs to promote the leasing product.

One of the most important contributors to this bank lessor's success involves the strong support of senior management. Organizationally, the leasing group reports to the middle market group, giving it a natural link to that group's customers. After solidifying its position with the middle market group, the leasing subsidiary has achieved initial success at targeting larger corporate clients. As for small ticket transactions, they, along with a number of other banks, outsource these deals to a third party specialist firm, realizing that this type of activity requires a different set of competencies.

Over 80 percent of originations come from within the bank's existing customers, and any new business originated outside the bank's current customer base centers on forming an overall banking relationship. The bank lessor states that despite the focus on overall relationship building, they use risk-based pricing on every deal and rarely, if ever, resort to "relationship pricing."

Another bank we interviewed demonstrates an antithetical approach; in effect, they refuse to depend on a relationship-based approach. While they certainly will not turn down internally generated new business, they do not actively seek it. Instead, they focus outward to generate new business and do not actively pursue turning that business into a multi-product banking relationship.

While it might be ideal for the various parts of the bank to work together, this bank's leasing management recognizes the barriers that exist between the leasing and lending groups and believes that they will not be able to overcome them. They have therefore chosen the path of least resistance and operate almost as an independent leasing company, leveraging the bank's name and resources but not its customers.

As often occurs in banks, the compensation structure of RMs seems counterproductive to the overall best interest of the banking customer and the bank itself. Given the choice between selling a product for which they will be compensated (a loan), and selling one for which they will either not be compensated or compensated at a reduced amount (a lease), the rational choice (from the RM's perspective) is to sell the product that will add to compensation. Without intervention from senior management to change the compensation structure and the culture, attempts to get RMs to promote leasing may be futile. Understanding this, the second bank lessor focuses externally to sell business.

The separate business line approach has been very successful for this bank. They have an aggressive broker-based program and also act as a partner to other banks wishing to outsource their small-ticket business. The banks discussed above illustrate that successful bank lessors understand the culture and capabilities of the bank. They align their leasing strategy with the bank's overall strategy and choose the business model that creates the best synergy with the parent's overall business goals.

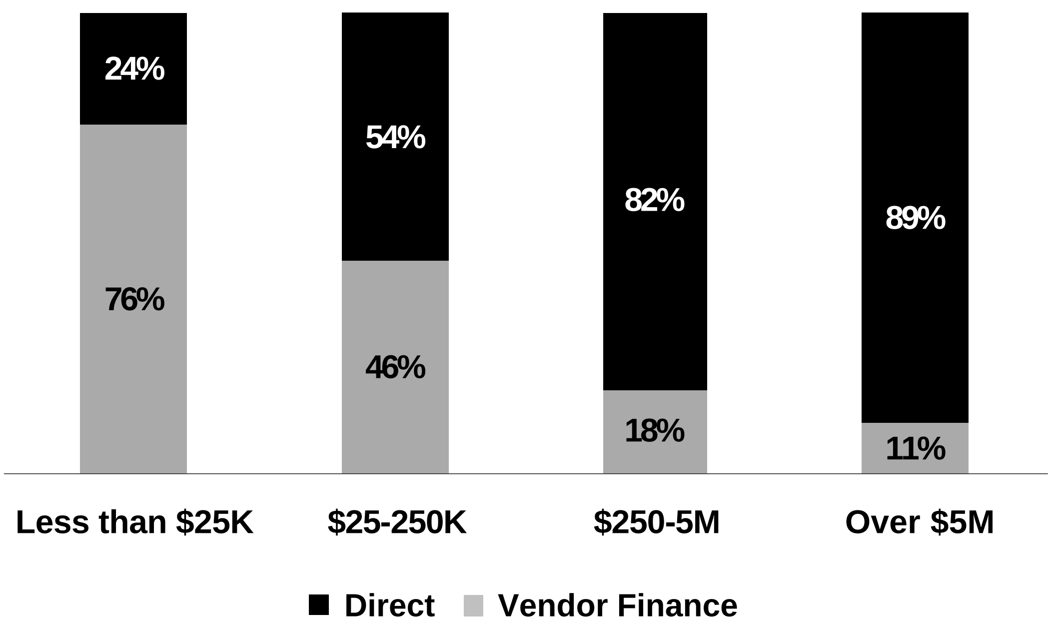
Vendor Finance

Vendor finance has become an increasingly important part of the leasing industry, particularly in the small ticket arena. The vendor channel generates three quarters of the transactions under $25,000 and nearly half of the volume of transactions from $25,000 to $250,000 (Figure 25). The importance of the vendor channel drops significantly for higher dollar transactions.

In 2000, respondents reported over 5,000 vendor programs, generating over $7.1 billion in volume. Seventy percent of those programs were non-exclusive (open to more than one lessor), and 85 percent were non-recourse.

Since most of the volume originated through the vendor channel is small ticket, price is seldom a differentiating program factor. Lessors offering vendor programs must be able to drive down costs through effective use of technology while at the same time providing value-added service to the vendor/manufacturer. Vendor/manufacturers expect programs to facilitate the effectiveness of their sales force, improve sales, and improve customer retention. As the economy continues to soften, we believe that vendor/manufacturers will continue to place greater

2000 New Business Volume by Market Segment



Source: 2001 ELA Survey of Industry Activity Report

Figure 25

demands on their vendor finance partners, demanding they accept a greater range of credit at lower prices in order to improve sales.

Market Segment Profitability

To determine the potential profitability of leasing, we need to examine ticket size as well as lessor type. The large ticket segment generates the most attractive profits (Figure 26). Even though the pre-tax spread for large ticket transactions averages less than that of small ticket transactions (3.6 percent vs. 4.3 percent), the large ticket segments generate higher operating margins, indicating a more efficient cost structure. While the middle market segment generates the highest ROA, when recalculated to include off balance sheet securitized managed assets, ROA drops significantly, indicating the dependence on asset securitization of lessors in the middle market segment. Defining characteristics of each market segment include:

- Large ticket: This segment enjoys lower origination costs and depreciation costs. Charge-offs for large ticket-related bad debt is also the lowest of the three segments, making the cost structure of large ticket leasing the most efficient.

- Middle market: High origination and depreciation costs, combined with the lowest gross profit margin, create a difficult profit environment for this segment.

- Small ticket: This segment commands the highest gross profit (pre-tax spread) but also has a relatively high cost structure hampering net operating margins. Success requires investment in technology to drive high volumes at low cost.

Large Ticket

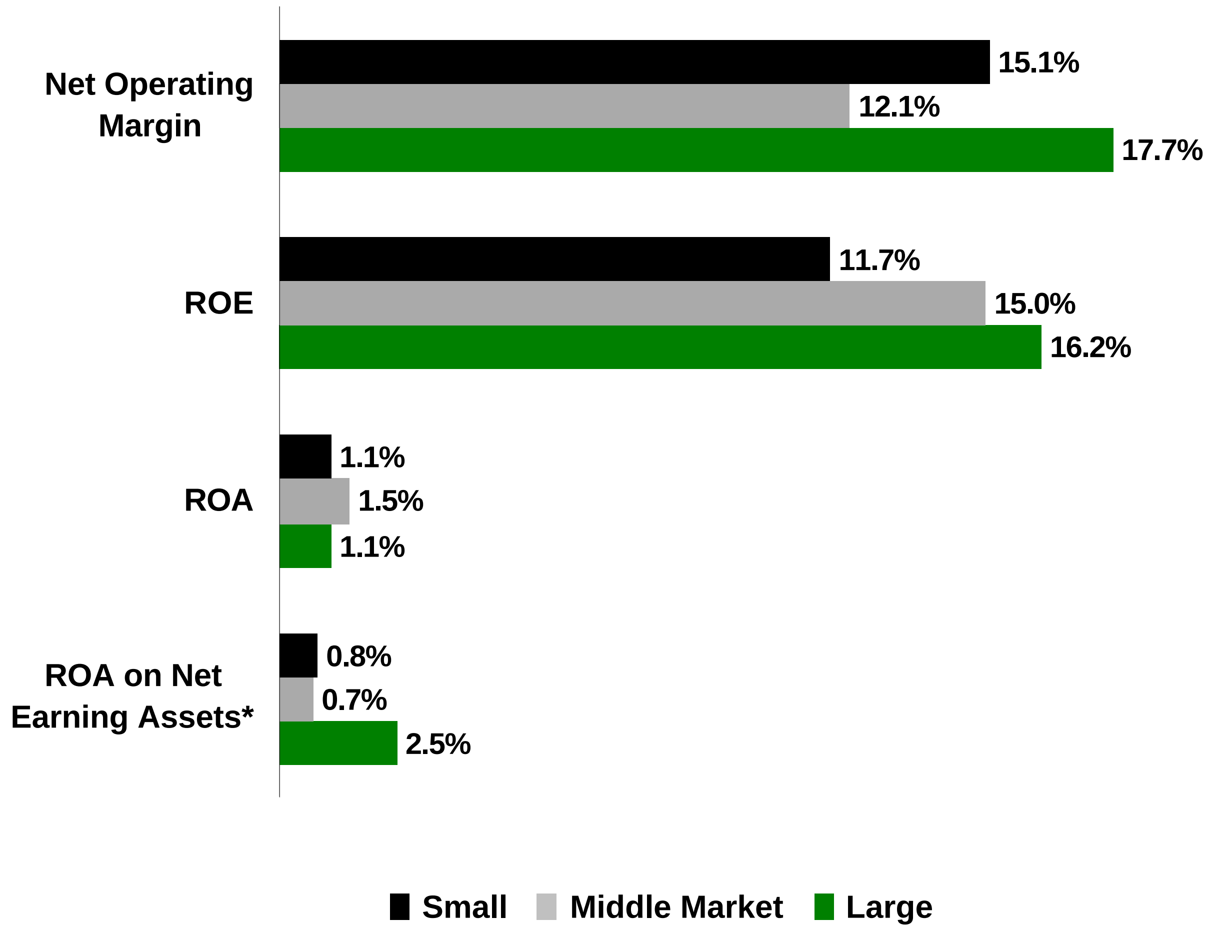
From a profit perspective, large ticket is the most attractive leasing segment. Relative to revenue generated, total large ticket costs are the lowest of all segments (Figure 27). Barriers to entry are quite high in large ticket, in equity requirements, funding ability, and specialized expertise. Online origination capabilities are not important to success, but increasingly, customers want online access to service.

The large ticket segment generated 44 percent of new leasing volume in 2000. Airlines and railroads are the dominant large ticket end-user lessees, with 32 percent of total large ticket volume (Figure 28).

The cost structure of large ticket transactions drives the profitability of the segment. Origination costs are less than 0.1 percent of revenues and depreciation costs are only 6.7 percent. The nature of large ticket lessees (typically large, well-capitalized entities) means that bad debt charge-offs are nominal at 0.8 percent.

In overall performance in the large ticket arena, banks and independents tie for top performer. Banks benefit from better pricing (Figure 29), but, even though their overall cost structure is the highest in the industry, independents appear to control costs more effectively in this segment, giving them an edge in net operating margin. Because of higher leverage, banks command a higher ROE, but independents generate nearly double the banks' ROA, prior to adjusting that

2000 Profitability Ratios by Ticket Segment

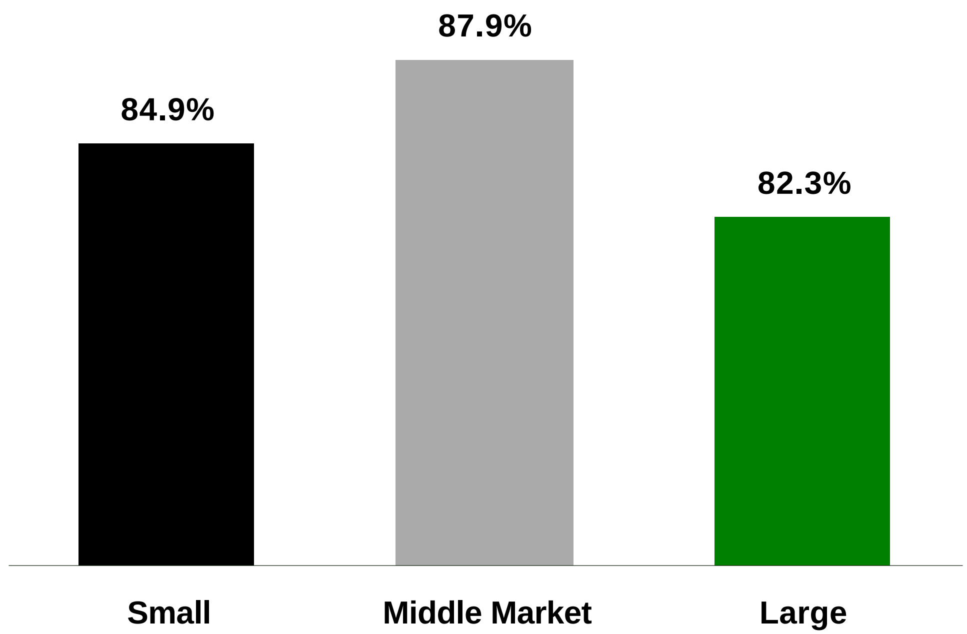


* Including off balance sheet securitized managed assets

Source: 2001 ELA Survey of Industry Activity Report

Figure 26

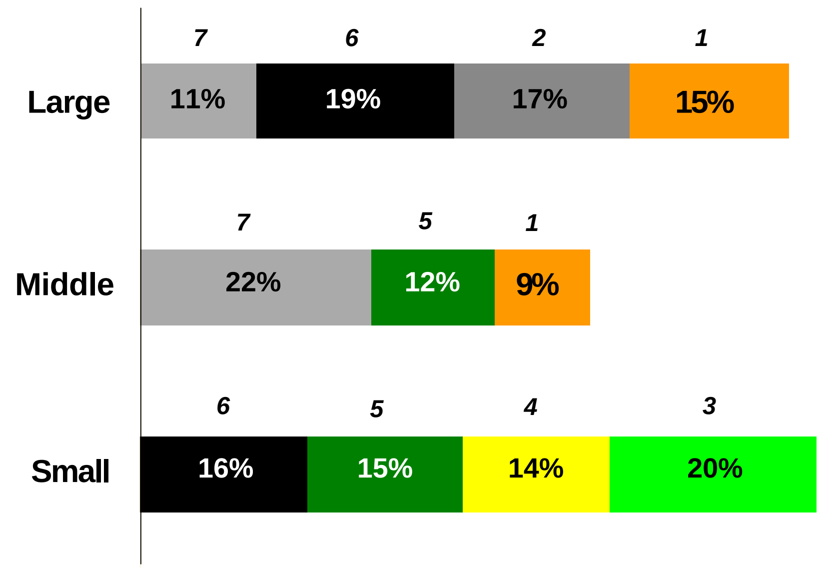
2000 Total Expenses Relative to Total Revenue by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report

Figure 27

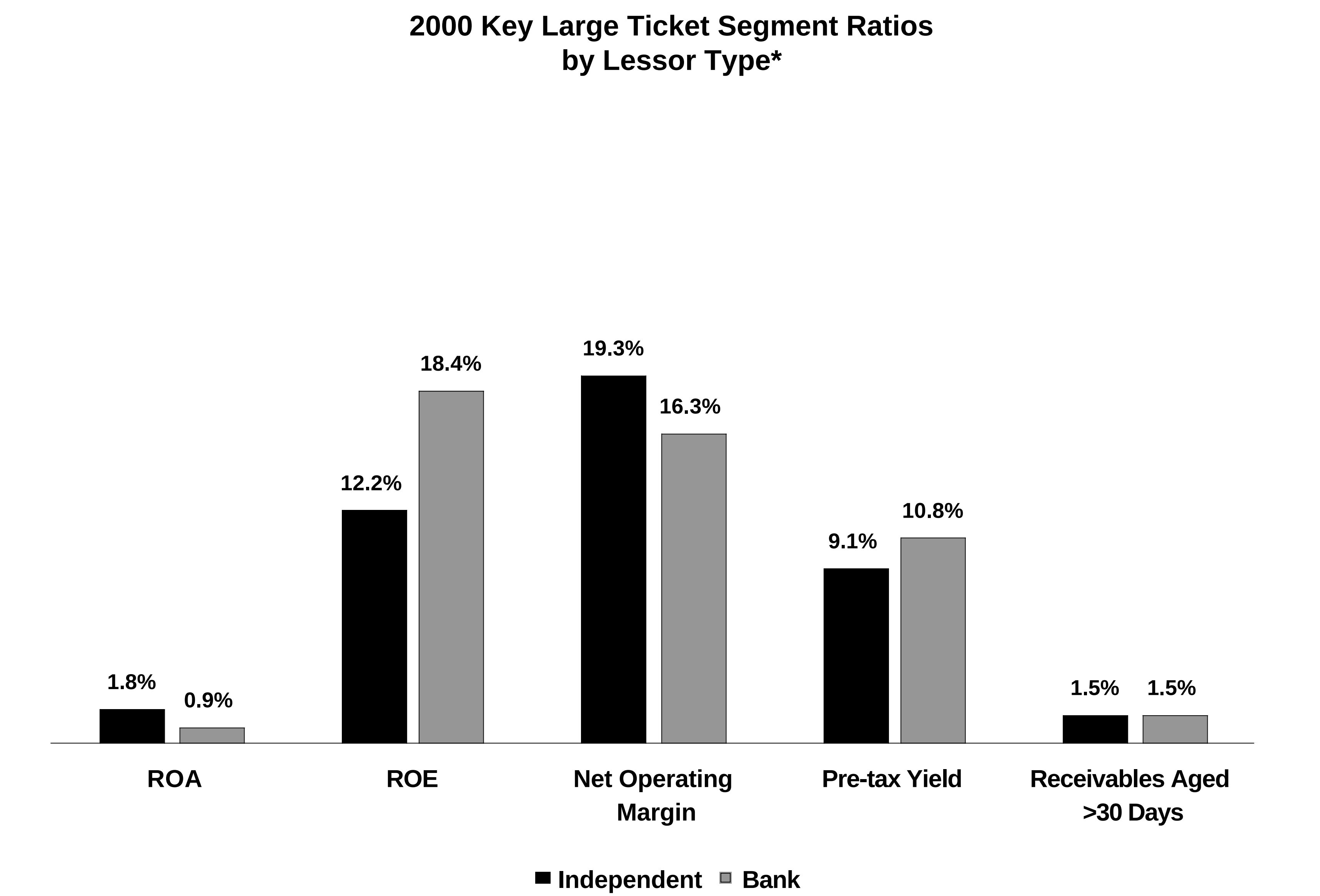
Top Four End-User Industries by Ticket Segment
2000



No.		Small	Middle	Large
1	Railroad		9.00%	15.00%
2	Air Transportation			17.00%
3	Wholesale/Retail	20.00%		
4	Truck Transportation	14.00%		
5	Services (excluding health)	15.00%	12.00%	
6	Other	16.00%		19.00%
7	Industrial/Manufacturing		22.00%	11.00%

Source: 2001 ELA Survey of Industry Activity Report

Figure 28



* Data for Captive not available

Source: 2001 ELA Survey of Industry Activity Report

Figure 29

calculation to include only net earning assets. Both lessor types control delinquencies equally well.

Large ticket transactions are second nature to large commercial banks. In addition to having access to the large corporate customers typically involved in these types of deals, banks have access to the capital to fund them. One advantage of independent lessors in this market segment has traditionally been their expertise in structuring complicated deals; however, as banks continue to play in this market, they may either grow this expertise or buy it, in some cases relegating independents to the role of accepting leftovers.

Middle Market

The middle market segment generated 35 percent of new business volume in 2000. Survey results show that this is the least profitable segment and faces the greatest threats and challenges. As one executive stated, "You have all the worst aspects of both large and small ticket—customized deals and commodity pricing."

Relative to the other ticket segments, the middle market does not perform well. It captures the lowest pricing and operates with the highest cost structure. While not as highly leveraged as large ticket, an average liability to net worth ratio of 9.3 is sufficient to drive ROE up to a respectable 15 percent. When calculated to include off balance sheet securitized managed assets, ROA falls from 1.5 percent to less than one percent.

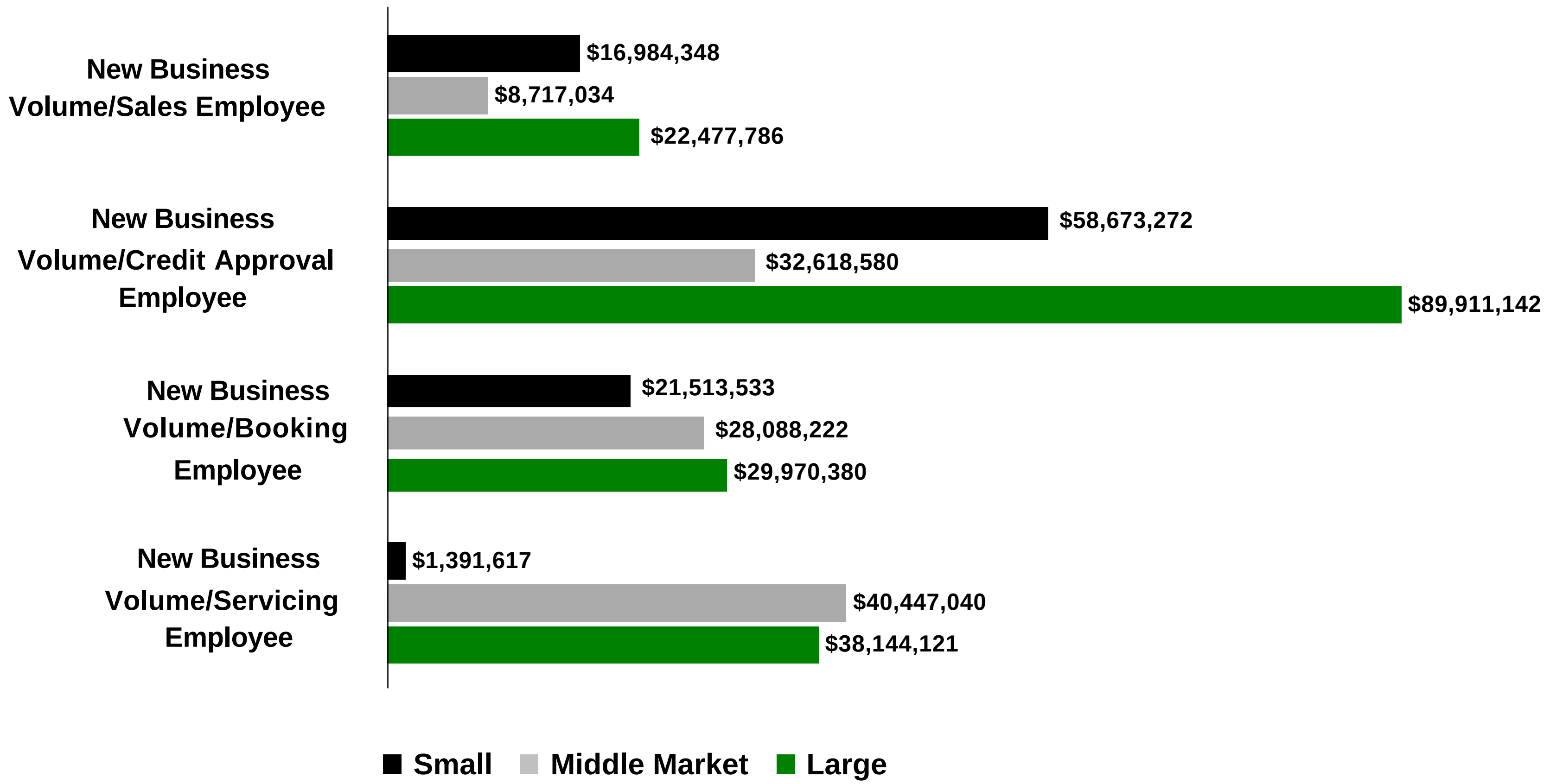
The cost to acquire new business demonstrates the difficulty of playing in the middle market. The average middle market salesperson generates just under $9 million in new volume per year (Figure 30). The cost to approve a transaction in this segment is also relatively high, while booking and servicing costs are comparable to those in large ticket. The number of independent lessors playing in this segment may explain the high cost of credit approval. Independents are less likely than banks to have a prior relationship with the lessee and more likely to consider lower quality business, requiring more research into the creditworthiness of the customer.

Independents command the highest price for middle market deals, compensating them for their wider credit acceptance and higher cost structure; however, that cost structure prevents this pricing advantage from translating into high net operating margins (Figure 31). Independents achieve high leverage in their middle market transactions, translating an 11.2 percent net operating margin to a 17.2 percent ROE. Captives have the biggest problem with delinquencies in this segment, most likely due to their appetite for financing lower quality credits in order to close the product sale.

While significant challenges exist in the middle market (most importantly the erosion occurring at both the upper and lower ends of the market and the cost/pricing issues), significant opportunities also exist. The middle market represents is the second largest market segment, generating nearly $85 billion in new business volume in 2000.

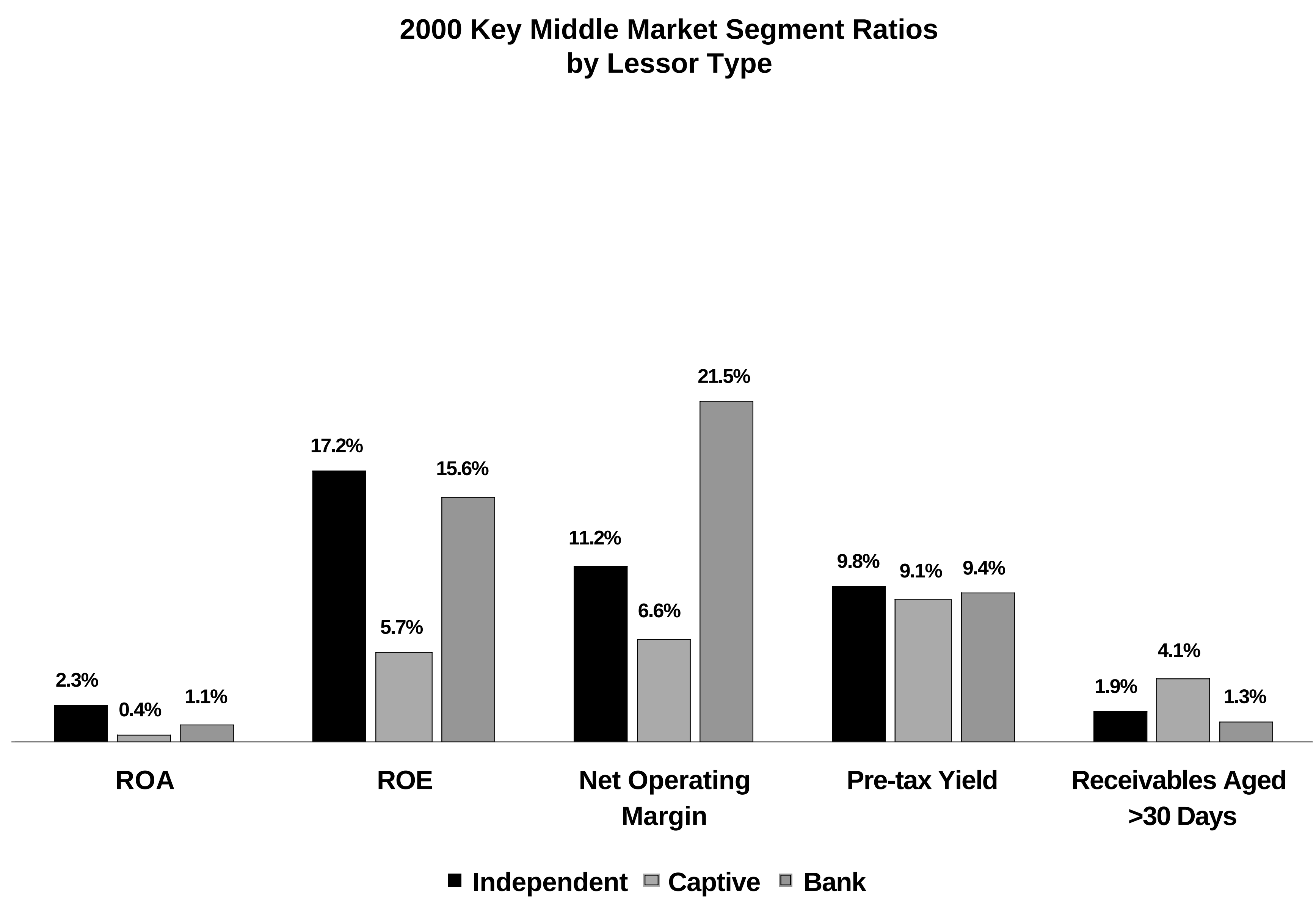
The player that can creatively use technology to drive down costs will have a real opportunity to succeed in this market. While it is unlikely that technology will create a significant origination channel, it is possible to use IT to manage down operational expenses such as application

Origination and Operational Efficiency by Ticket Size



Source: 2001 ELA Survey of Industry Activity Report

Figure 30



Source: 2001 ELA Survey of Industry Activity Report

Figure 31

processing, documentation, and risk management. Similarly, players with low-cost origination opportunities, either through existing relationships or partnerships, and those that can create and charge for value-added opportunities will also be able to profitably service this market.

Small Ticket

The small ticket segment generated 21 percent of total leasing volume in 2000. The segment is profitable for those players with the competencies to compete. Keys to success in this transaction segment include high volume throughput, technological expertise, strong vendor programs, and tight receivables, and cost control. As one leasing industry expert noted, “Small ticket is a whole different world, if you don’t have the technology in place and the low-cost origination channels, you’re dead.”

On atop line basis, small ticket leasing is very attractive. Small ticket lessors command the highest prices with an average pre-tax yield of 10.9 percent (Figure 32), and they also make the highest gross margins, 4.3%. Despite high gross margins, net operating profit comes in second to banks at 15.1 percent. The low leverage ratios on small ticket deals push ROE into last place at 11.7 percent.

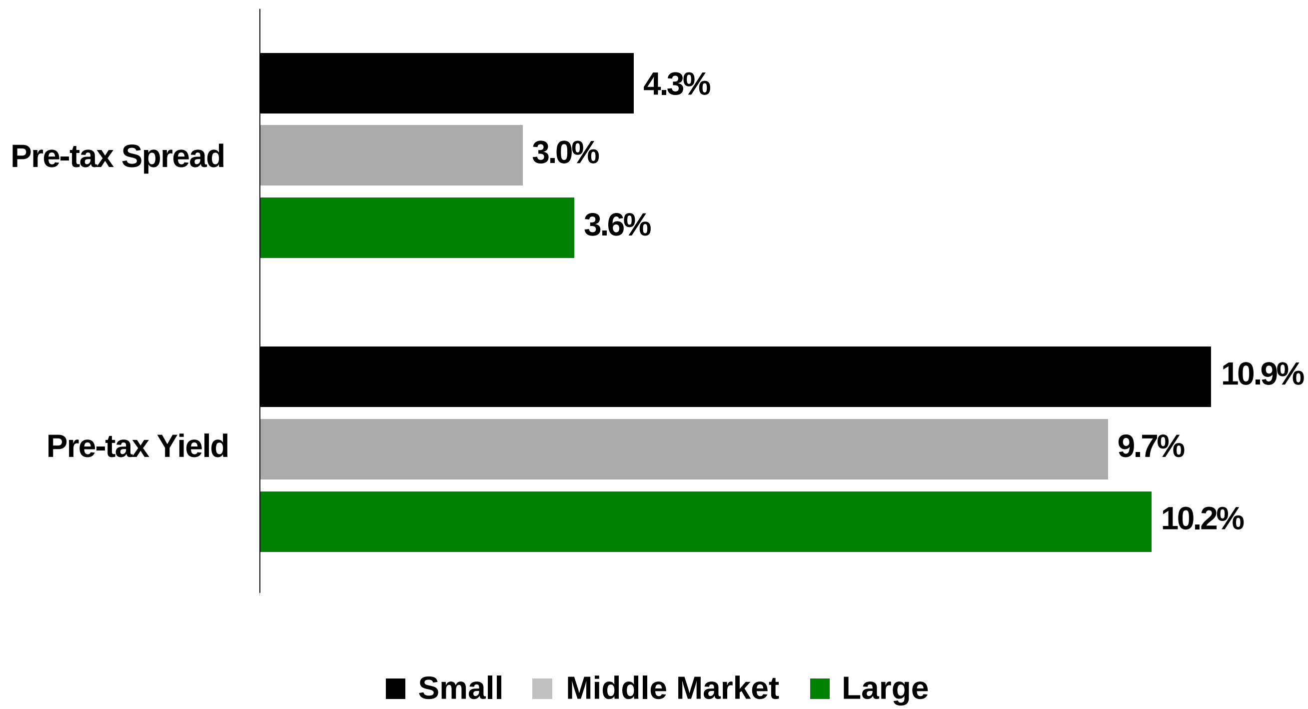
There are several keys to success in this market. As with most low-cost products, high volume is a necessity. With the average transaction size of just over $37,000, reliance on high tech/low touch processing seems the order of the day. Strong investment in automation technology, in both origination and back-end processing, needs to be considered as mandatory to play effectively in this segment. Nearly 50 percent of all originations in this segment come through vendor programs that reduce the need for lessors to maintain an expensive sales force.

Another area of critical focus for success involves tight receivables management and cost control. With the highest delinquencies of any ticket segment (Figure 33), bad debt expense is more than 300 percent that of the middle market segment and more than six times that of large ticket. Since over 60 percent (Figure 34) of small ticket transactions are auto-scored to some extent, the current economic downturn will serve as the acid test for this type of credit decisioning. If the auto-score model proves to be faulty, small ticket lessors will face serious losses as the slowdown continues. At this point the quality of the auto-scored decisions appears to be holding up.

Very few bank respondents play in the small ticket arena. Captive finance companies are the most successful in this segment. While independents command higher pricing than captives (likely because the captive’s parent subsidizes lower captive pricing in order to sell products), captives are best able to control costs in this market segment, yielding an impressive 17.9 percent net operating margin (Figure 35). ROE and ROA are also highest for captive players. SIA respondents reported lower delinquencies for captives than for independents in the small ticket segment.

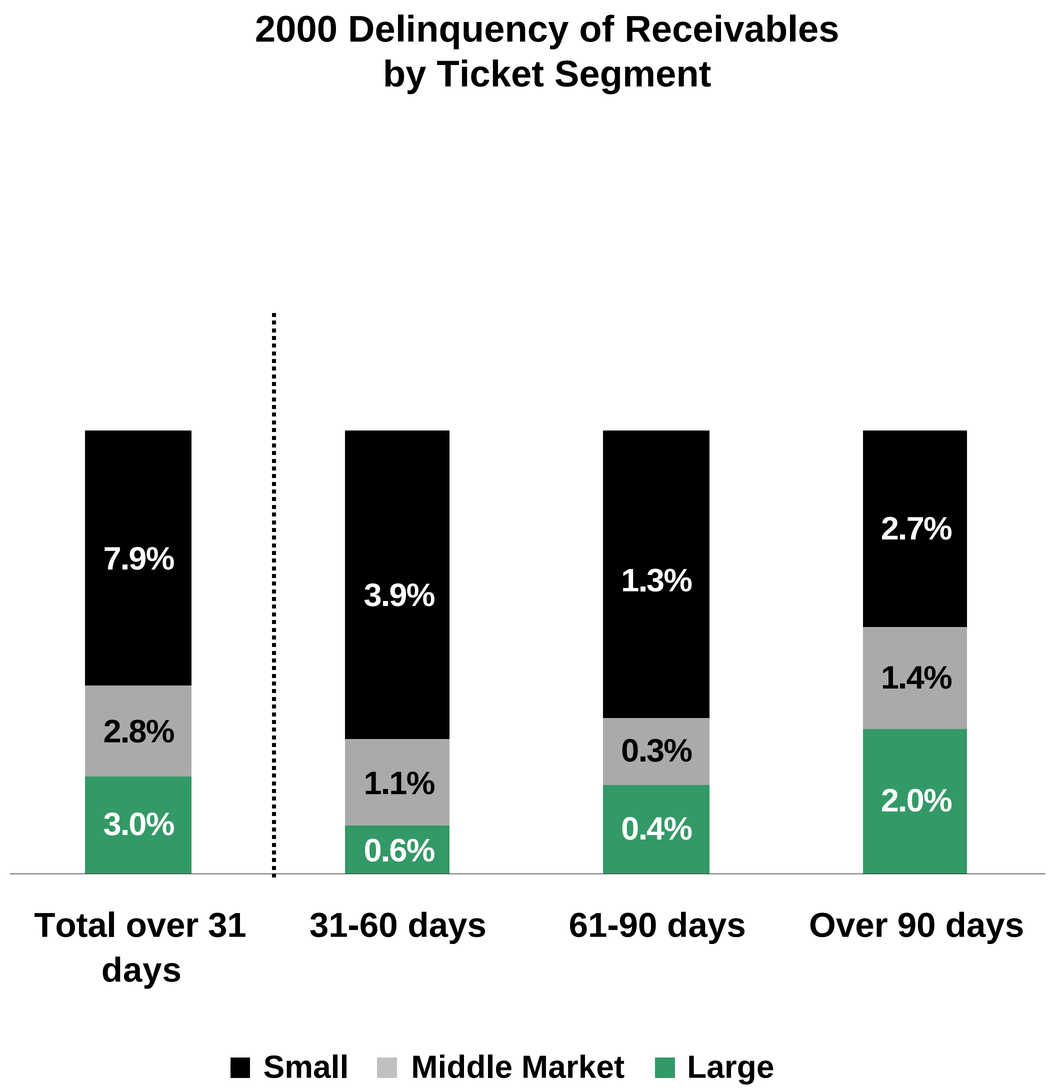
Small ticket is the one segment where Internet origination had been considered critical. However, as the impact of e-commerce fails to unfold as rapidly, or in the way many had forecasted, players in this segment must make critical decisions about deployment of resources in

2000 Average Pre-tax Yields and Spreads by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report

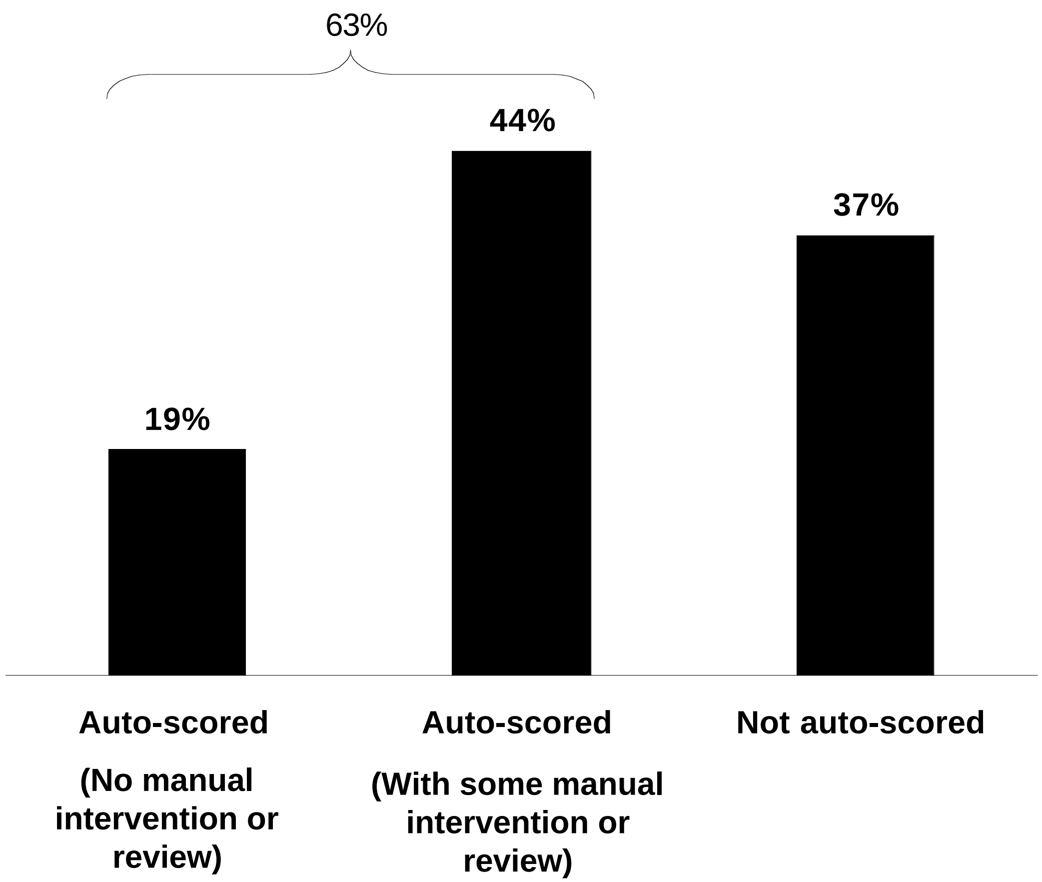
Figure 32



Source: 2001 ELA Survey of Industry Activity Report

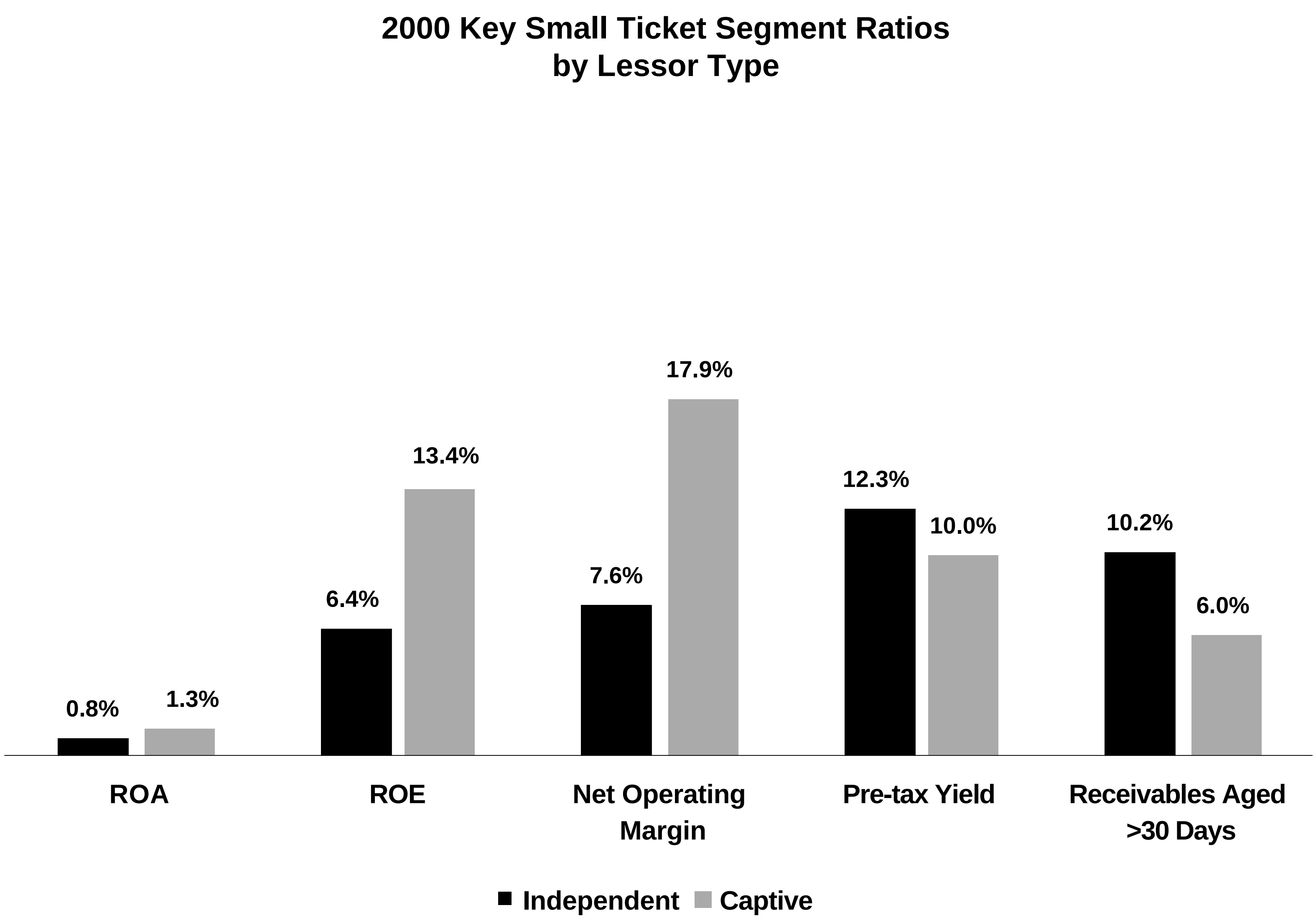
Figure 33

Small Ticket Credit Decision Method 2000



Source: 2001 ELA Survey of Industry Activity Report

Figure 34



Source: 2001 ELA Survey of Industry Activity Report

Figure 35

this area. Online may be critical to speeding up transaction approval, underwriting, and booking but of limited importance to the initial lease sale and closing process.

Industry Challenges

Although weaker than 1999, profits in 2000 remained strong. New business growth slowed from 1999, but still grew at more than six percent. However, the next two years may offer a less positive story. In addition to the ongoing issues faced by the leasing industry, macroeconomic causes may present further challenges to the growth and profitability of the industry.

The areas requiring immediate and ongoing focus include:

- *Economic challenges and declining volume*. Investment in business equipment appears likely to decline near term.
- *Access to funding.* Funding will continue to be an issue, as securitization volume declines and credit requirements become stricter.
- *Continuing consolidation.* Economic and funding issues will encourage further industry consolidation, hitting independents particularly hard.
- *Use of technology.* The Internet's promise as an effective sales channel has failed to materialize. However, e-business can deliver cost and service efficiencies.
- *Access to experienced labor*. Despite recent layoffs, the industry continues to face a shortage of experienced people.
- Changes *in accounting standards and regulation.* Adoption of new regulations and accounting standards could significantly alter the value of leasing as a product.

Economic Challenges

Analysts project investment in new business equipment to decline by two percent in 2001 and increase by one percent in 2002[3]. The rapid decline in growth experienced from the third quarter 2000 to the second quarter 2001 took some lessors by surprise. In the words of one executive, "It was as if the economy fell off a table." Many companies were building capabilities in the expectation of an expanding market when the economic landscape shifted; few were able to shift gears with the requisite speed. Profitability in 2001 will differ from 2000, as companies have been unable to pair costs to match volume declines. Operational efficiency and tight portfolio management, while always important, are mission critical for survival in today's climate.

Within the leasing industry, operational efficiency is receiving a great deal of attention. Nearly every executive interviewed noted the importance of driving costs out of back-office functions. They continue to note, however, the difference between working smarter and simply slashing costs. As one executive noted, "In the early 90s we were obsessed with slashing costs. What we did not realize, until too late, is that we were also slashing quality and service. It cost us customers and money."

[3] These projections were made before September 11

Achieving operational efficiency involves three areas:

- Regular process efficiency and technology reviews
- Frequent performance evaluations
- Periodic business line evaluations

Whatever its name (TQM, Six Sigma, reengineering), process streamlining encompasses the same basic principle: continually look at what you do and how you do it and find ways to improve it, reduce it, or eliminate it, oftentimes through the use of technology.

Performance evaluations are necessary to gauge the effectiveness and productivity of operations. Many of the best companies use both internal and external benchmarking to push improvements. Evaluating and adopting best practices both from inside and outside the company can eliminate operational inefficiencies without "reinventing the wheel". By comparing company operational metrics against others, managers can gain insight into opportunities to improve performance. One example: the American Productivity and Quality Center, a non-profit organization dedicated to improving quality and productivity, found in a recent survey that the median cost savings from benchmarking was $1.4 million. More impressive, the average savings was over $70 million.

In fact, some of the most effective best practices insights result from evaluating how companies in non-related industries perform similar functions. For example, when Tenneco wanted to improve its inter-company billing process, they adopted best practices from a credit card company that excelled at billing. Many companies, even those in dissimilar industries, have similar core processes, whether it is billing, document processing, or treasury functions. To determine true best practice players in many operational areas, lessors need to look outside the industry. However, a number of lessors we interviewed are benefiting from participation in active, but informal, share and compare networks with peer companies.

Our observation is that many managers have ignored the core competencies that made them successful to branch off into unrelated lines of business in pursuit of the goal growth. For example, in recent years several well-known leasing companies began dabbling in the venture capital/debt market, leasing equipment to start-ups and accepting stock options and warrants in payment. During the Internet boom, they enjoyed good growth and their management received accolades from Wall Street and some envy from their leasing colleagues. Today, those companies or divisions within them have joined the ranks of corporate "perfect storms" in the wake of the technology meltdown.

Focused businesses will regularly examine their activities in light of performance expectations. In the past year, Bank of America announced that is was exiting auto leasing as a result of a strategic review of all business lines. Similarly, Heller Financial exited the SBA loan business. Their review showed that these lines of business were not meeting profit expectations. Senior management made the tough, but correct, decision to close them down. We know of several lessors who are undertaking detailed strategic reviews of various business lines to determine if and how they should continue or curtail operations.

Access to Funding

Access to funding remains a critical issue, particularly for small independent leasing companies. Banks, captives, and large independents secure funding either through their parent company or through credit facilities and the capital markets, based on their own balance sheets. However, small independents with weaker balance sheets rely on the capital markets and lease asset securitization for liquidity. In response to the economic downturn, the capital markets have become more discriminating. At the same time, banks and other lenders have tightened credit requirements. These two events have served to choke many small lenders, forcing some to either exit the market or secure outside funding partners.

Commercial paper conduits remained the primary securitization vehicle in 2000, but their availability, if not their importance, dropped from 1999 (Figure 36). Public offerings also declined during the same period, while private placements increased by nearly 30 percent. This confirms that access to the capital markets has become more restrictive. Overall, securitization volume, which increased rapidly in the late 1990s, is declining; this serves as another indication of the unfriendly operating environment that small independents face (Figure 37).

For many of the top players, funding is not a day-to-day worry. They rely on their strong credit ratings to access bank lending or to float bonds. Many use securitization only as a means to reduce credit exposure to specific companies, industries, or equipment types.

Conversely, for some small independents, the funding situation has become so serious that in order to survive in this funding environment many have been forced to secure funding partners. Some have done this by seeking partners on specific deals, while others have actively marketed themselves for sale.

Continuing Consolidation

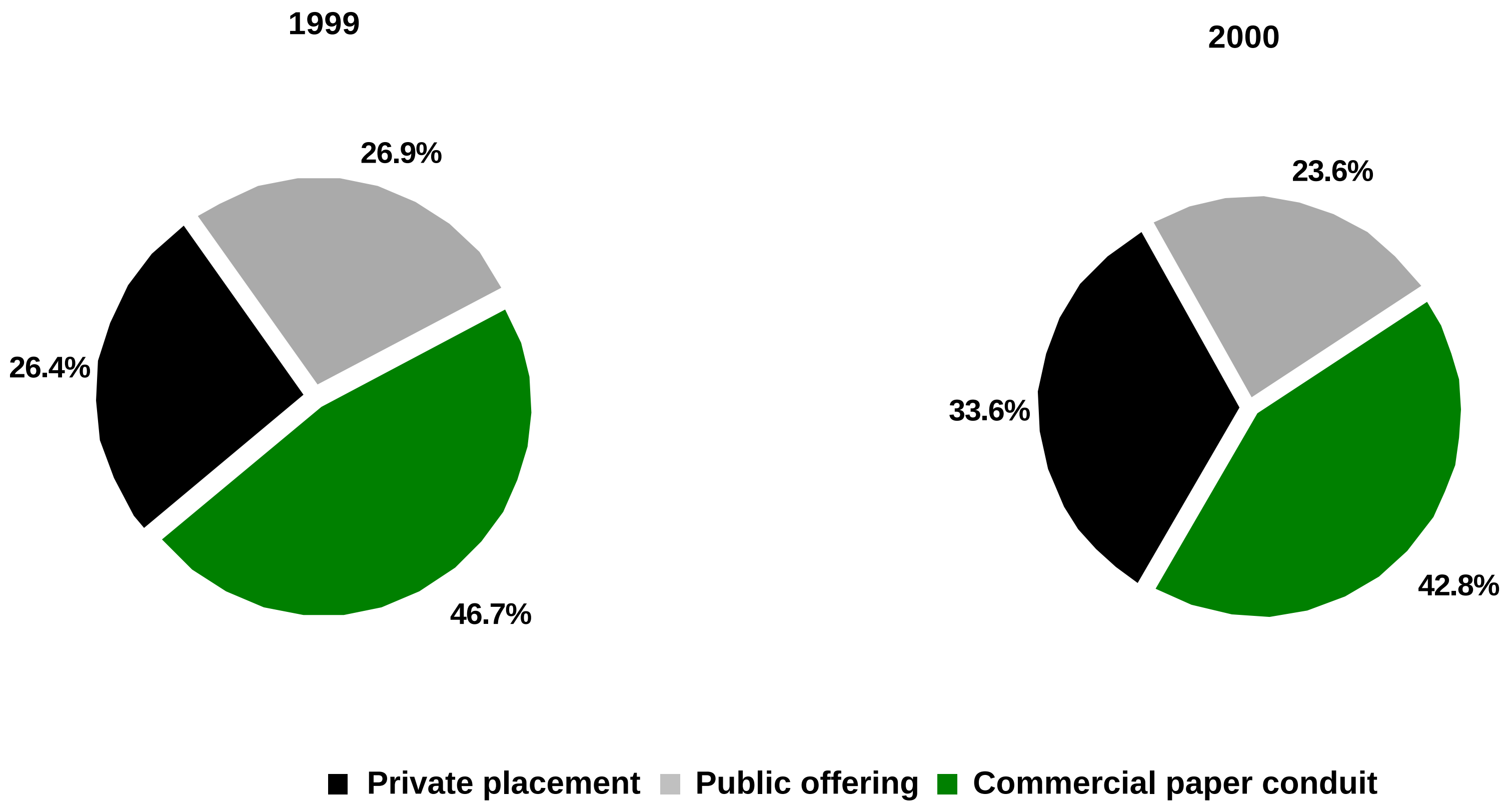
Consolidation activity increased in 2000 and continues apace in 2001. Several large deals, such as Citigroup's acquisition of Associates and GE's acquisition of Heller Financial, highlight recent consolidation activities. Growth, funding, and bargain hunting are among the reasons for the increase in consolidation activity. Bank industry consolidation also threatens the leasing industry, potentially reducing credit facilities available to lessors.

As the economic downturn slows new business volume growth, companies with a mandate to grow must supplement organic growth by acquisitions, enabling an individual company to record growth while the overall industry contracts.

Obviously, leasing companies facing a funding crunch are candidates for acquisition. In the near term, the industry leaders state that a buyer's market exists. Small independent lessors with limited access to loan facilities and those denied access to the capital markets are looking to acquisition as a means to secure stable and relatively inexpensive funding.

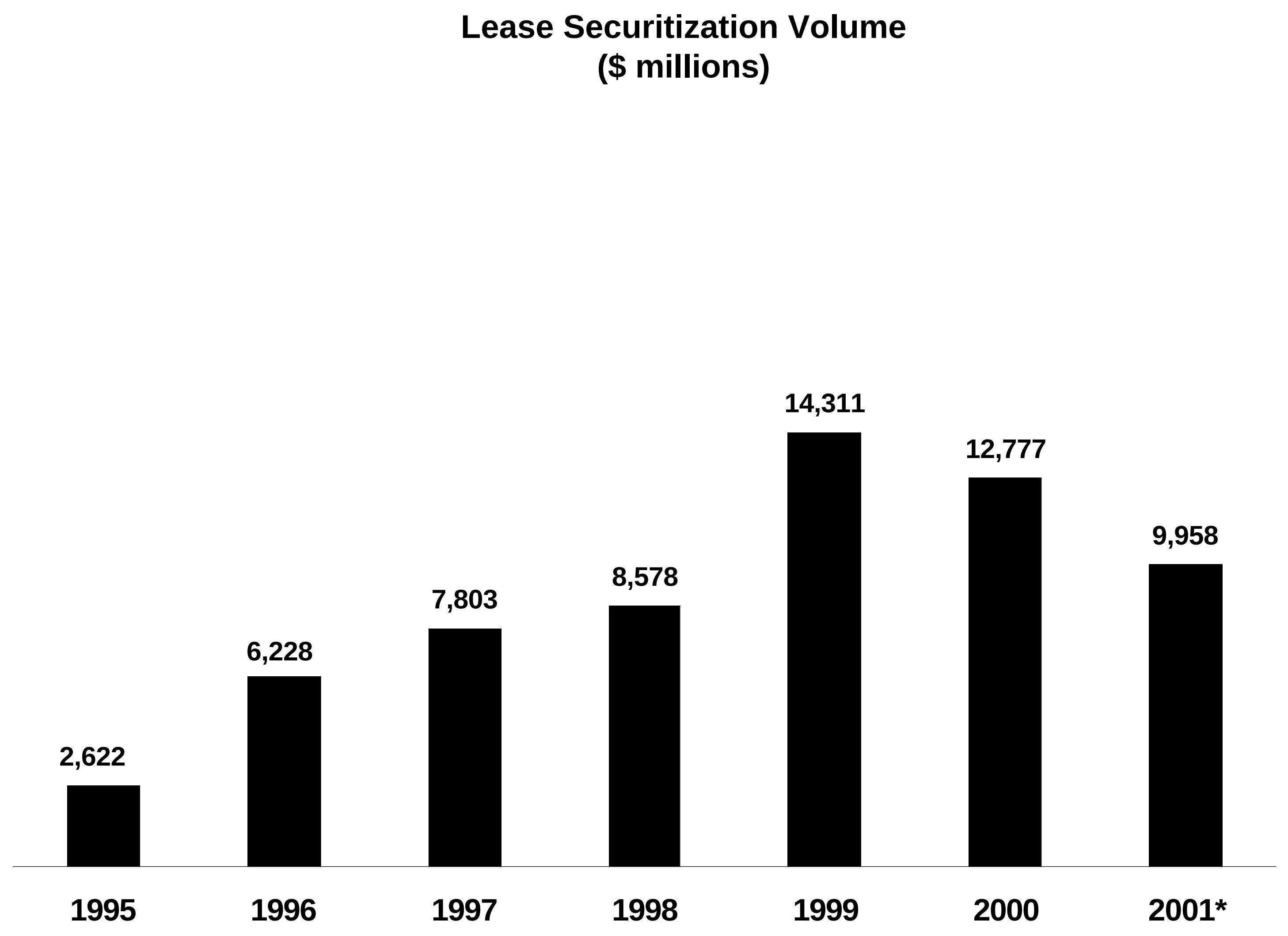
Banks and other companies with strong financial positions looking to enter the leasing market are finding willing candidates for takeover. Nonetheless, the nature of the post-acquisition management of the bank-owned leasing company often maintains the acquisition's operational

Total Dollar Volume of Securitized Assets by Type



Source: 2001 ELA Survey of Industry Activity Report

Figure 36



* Estimated
Source: Asset-Backed Alert

Figure 37

integrity and independence. Bank acquirors often find it advantageous to allow the leasing organization to operate as a separate entity, rather than folding it into overall corporate operations.

While consolidation in the leasing industry threatens the pool of finance options available to lessees, consolidation in the banking industry threatens the pool of finance options available to lessors. As banks merge, regulatory requirements often necessitate reducing their combined risk exposure to specific companies, industries, or equipment types. For example, if a leasing company has a similar credit commitment from two banks and those banks merge, the new commitment from the merged bank is likely to be less than the total commitment previously enjoyed. When banks merge, the whole is often less than the sum of their parts.

Use of Technology

The changing e-commerce business model is forcing executives to rethink the role of technology in their business. In the past several years, multiple millions have been spent building a sales and delivery channel around the Internet. The past 12 months have shown that the so-called “new economy” is not materializing according to plan. Instead, what executives have found is that the Internet is proving most effective as a service channel rather than a sales channel.

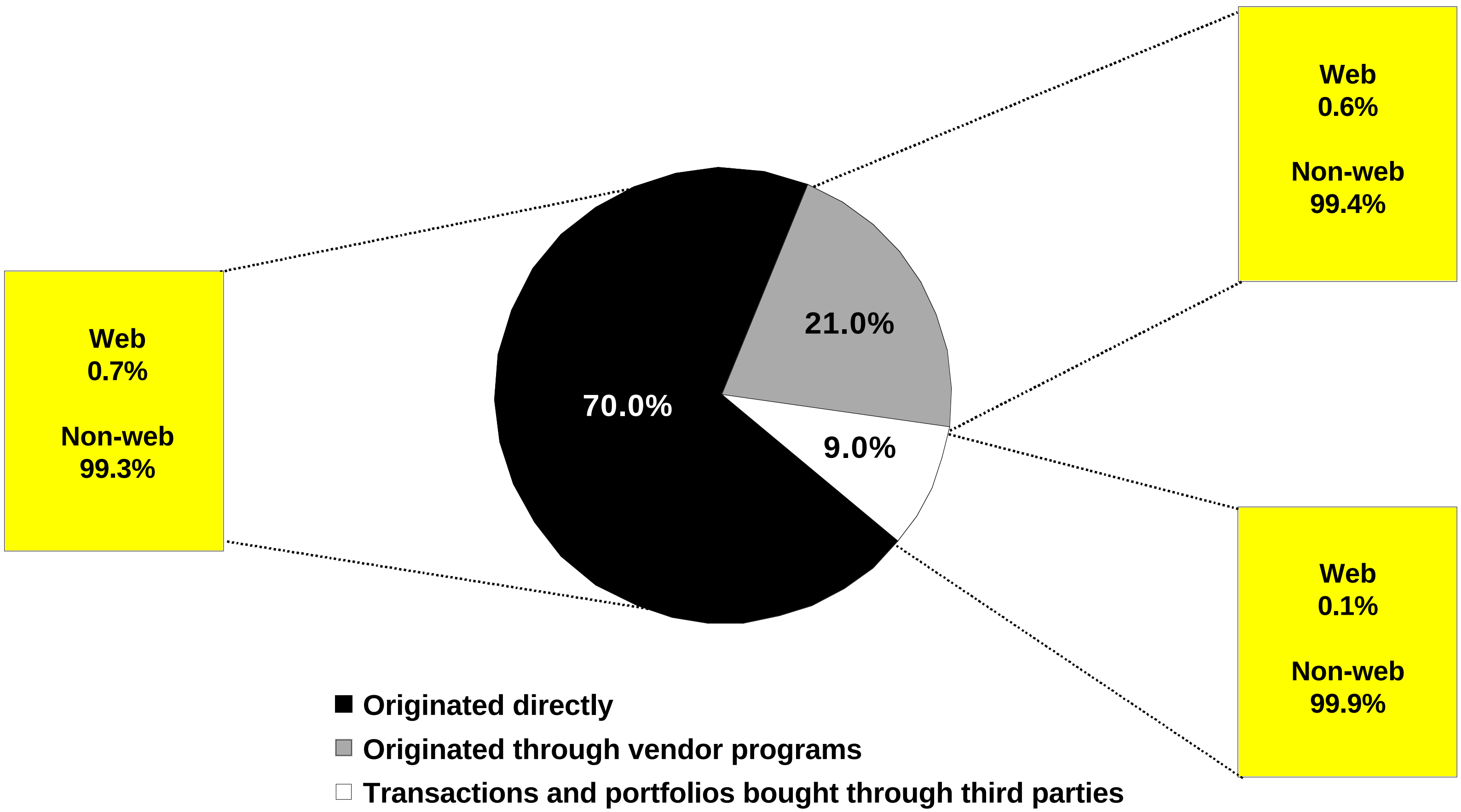
For the past five years, companies devoted major resources to building e-commerce capabilities, with the hope of tapping into a vast new revenue source. These projects were often reactionary “me too” initiatives with little analysis into their cost/benefit. Despite the billions of dollars spent, today, revenue generated through the Web amounts to a tiny fraction of total new business volume (Figure 38). Management cannot even be certain whether that volume represents new business or just cannibalization of existing business.

Many companies are now refining their technology strategy. While electronic origination may be practical for micro (under $25,000) and small ticket transactions, it is unlikely to be a significant source of sales for larger deals. Management has found that use of e-business (as opposed to e-commerce) is an extremely valuable tool for servicing the customer and providing back-end support. One executive told us, “We determined that the Internet would do nothing for us as a sales channel, however, we have found it very valuable as a customer service channel. We allow our customers to access their accounts via the Internet 24/7. This frees up service reps from the call center and lets us use them in a more value-added way. And the customers are very, very happy.”

However, before spending on the latest automation, top players thoroughly examine new technologies’ “all in cost”. Too often, management spends for the newest technology and then realizes that the expense does not justify the investment. One leasing company whose executive we interviewed spent significant dollars to develop an online sales/origination channel that generates only a small fraction of new sales.

Conversely, in a technology success story, another lessor invested in an Internet-based servicing platform, allowing customers to manage their own accounts without calling the telephone service center. The leasing company was able to move many of its customer service positions to sales,

2000 Business Origination by Channel



Source: 2001 ELA Survey of Industry Activity Report

Figure 38

generating more business. Clearly, an example where technology contained costs, improved customer service, and increased sales.

Currently, many lessors are evaluating the impact of past and projected IT-related expenses with increased skepticism. Careful technology planning based on a partnership between line and technology staff is critical. The top companies first define the goals of their technology initiatives and perform analysis into the probability of achieving those goals. And, their goals are more often improving back office efficiency and customer service rather than generating new revenues. As for the Internet, one industry leader summed it up well when he said, “The Internet will happen. But, whether its major impact will occur two years from now or five years from now and what that impact will be, no one knows.”

Access to Experienced Labor

The leasing industry continues to confront a shortage of experienced labor, even in light of a softening job market. Our interviewees believe this issue will continue to plague the industry and hamper future growth and innovation. One manager stated the problem simply: “Where is the next generation of leadership?”

One of the results of the restructuring programs of the early 1990s was the elimination of many internal training programs. Many in the leasing industry feel the effects of this “shortsighted” decision today. As one manager stated, “It takes a different kind of person or a different degree of expertise to really be proficient in the leasing industry.”

Another manager told us, “The problem is: leasing is not a glamorous industry. It is not highly paid like investment banking, and there is almost nothing taught about leasing in business schools today.” While people are no longer deserting the industry to go to dot.coms, its attractiveness has not been demonstrated to those entering the job market or considering a switch. This same manager went on to state his belief that the industry needs to do more to promote itself to attract talented people.

Regulatory Changes

There are few regulatory changes on the foreseeable horizon. Accounting standardization continues to be a concern and privacy regulations may potentially pose problems for the industry.

Operating, synthetic, and other off balance sheet leases represent an important source of volume for the industry. They also provide an important “marketing tool” for the lease product. The ability to acquire equipment without impacting the balance sheet is a critical differentiator.

In a push for standardization, the international accounting community is trying to tighten the definition of operating leases and force the inclusion of more assets and the corresponding lease liability onto the books of the lessee. The argument for this change is that it will result in the balance sheet more accurately reflecting the financial position of a company, particularly in outstanding liabilities. The proposed accounting changes would also affect the income statement of the lessee. Instead of deducting the lease payments as rental expense in the year paid, the value of the asset would be amortized over its life, as determined by the Internal Revenue Service.

Efforts by the ELA and others to slow implementation of the standardized accounting rules appear to be effective. However, some executives believe that it is only a matter of time until these rules are adopted, particularly in light of the increasing globalization of the leasing market.

Privacy is another topic of discussion among leasing executives. Although many of the initiatives being legislated apply only to individual consumers, there is some fear that these regulations may spill over onto commercial customers as well. One executive told us of some initiatives in California to apply consumer protections to commercial customers as well, "We do not need to pay as much attention on the Federal level; these types of attacks will come on the State level. States like California often act as a test case for state legislatures around the country."

Final Thoughts: Finding the way through the darkness

The short-term prognosis for the leasing industry looks mixed and portends greater volatility than in the recent past. The current business recession has caused volume to decline; funding issues will cause some players to exit the market; and, credit weakness in some important sectors will deliver losses even to strong players.

At the time of this writing, international issues make prediction of the immediate future of the leasing industry difficult. One example: an article in the Financial Times stated that recent acts of terrorism could have a devastating impact on the holders of over $250 billion in aircraft lease and loan debt, as airlines face an estimated $10 billion in losses in the next year alone.

While the near term appears uncertain, we believe the most successful lessors will continue to pursue some basic business practices that are often a struggle to execute: pricing appropriately, determining the optimal technology approach, and delivering on a well-crafted strategy.

Renew emphasis on risk-based pricing. Many lessors, both interviewees and clients, have admitted to lowering price to get business. Lessors need to institute a discipline to price deals based on the appropriate risk. Lenders and capital markets will no longer reward growth alone but will place greater emphasis on strong P&L and balance sheets. In a contracting market, respectable margins, disciplined credit management, and declining debt-to-equity ratios are looked on most favorably.

Determine your technology approach. Lessors must look at their businesses and determine the best fit for technology in their business strategy. They must create sound cost/benefit analysis before embarking on new initiatives and avoid the "me too" approach to building an e-infrastructure. The life cycle of the latest technology "fad" has shortened considerably. For example, several of the executives we interviewed bemoaned the amount they had spent on customer relationship management (CRM) technology, pointing out its lack of clear payoff.

Determine your strategy and execute on it. In order to compete, lessors must identify their core competencies and the key niches; an initiative easier said than done. As leasing becomes increasingly commoditized, the best lessors will create additional value for their customers based upon their distinctive strengths, whether that be deal structuring, niche knowledge, or price.

Clearly, the short-term presents a challenging environment for the leasing industry. Those companies with the strength and discipline to withstand the hardships of the next several quarters will be well positioned to take full advantage of the rebound in equipment leasing.