2002 Industry Future Council Report

MORE JUICE FOR THE SQUEEZE

EQUIPMENT LEASING AND FINANCE FOUNDATION

4301 N. Fairfax Drive, Suite 550, Arlington, VA 22203
Phone: 703-527-8655 Fax: 703-465-7488 Website: www.leasefoundation.org

EQUIPMENT LEASING AND FINANCE FOUNDATION

The Resources You Need !

The Equipment Leasing and Finance Foundation is a nonprofit organization whose mission is to promote the growth and effectiveness of equipment leasing and finance companies through programs that identify, study and report on critical issues affecting equipment leasing and finance. The Foundation works to develop the body of knowledge of equipment leasing and finance for use by the industry, academic, and policy communities. The Foundation provides the following FREE resources to you:

Research Grant Program

The Foundation awards grants funds to academics to study topics of interest to the equipment leasing and finance industry. Proposals are accepted three times each year. Average grant is $10,000.

Authorship Honorariums

The *Journal of Equipment Lease Financing*, the official Journal of the Foundation, is published twice annually. Authorship honorariums are available to academics and industry professionals that contribute in-depth articles on topics of interest to those working in and/or researching this industry.

Academic Internships

The Foundation works closely with university students and industry leaders to place students in academic internships within the lease financing industry.

Industry Reports and Analysis

Annually, the Equipment Leasing and Finance Foundation produces numerous reports and research papers on trends, industry analysis, forecasting and the state of the industry. These Research reports and studies are available to you FREE of charge.

Website Resources

The websites of both the Equipment Leasing and Finance Foundation and the Equipment Leasing Association (ELA) contain myriad research, statistical material, and industry related information for your use and exploration. Site addresses: www.leasefoundation.org and www.elaonline.com.

Case Studies and Teaching Modules

The Foundation has worked with industry and academic leaders to develop cutting edge classroom teaching material including real-life case studies and teaching modules available to academics through the Foundation website.

All of this and so much more is available through the Equipment Leasing and Finance Foundation, and its ***all free***. Why? Because the Foundation's mission is to enhance the body of knowledge within the equipment lease financing industry. We are happy to provide this information to all academics and professionals interested in the industry.

The Foundation is supported entirely by corporate and individual contributions. Please make a contribution today!

4301 N. Fairfax Drive, Suite 550, Arlington, VA 22203; Lisa A. Levine, Executive Director
Phone: 703-527-8655 **Fax:** 703-465-7488 **Website:** www.leasefoundation.org

The Equipment Leasing and Finance Foundation wishes to express appreciation to the following company for providing partial sponsorship to support this report:

McCue Systems

Business Solutions
for the Leasing Enterprise

EQUIPMENT LEASING AND FINANCE FOUNDATION

2002

Industry Future Council Report

MORE JUICE FOR THE SQUEEZE

TABLE OF CONTENTS

MORE JUICE FOR THE SQUEEZE
2002 INDUSTRY FUTURE COUNCIL REPORT

INTRODUCTION

The 2002 Industry Future Council (IFC) met in Leesburg, VA, January 29 - 30, 2002. The 21st annual meeting was chaired by the Equipment Leasing and Finance Foundation Chairman (Foundation), and consisted of senior management from leading equipment leasing companies and Chairmen of the five ELA Business Council Steering Committees.

The IFC is sponsored by the Foundation each year, and its meeting results in the annual Industry Future Council Report released in the spring. The IFC meeting is an opportunity for industry leaders to discuss and examine external forces that will affect the future of the equipment leasing and finance industry, and assess how successful companies are dealing with these forces.

Over many years of IFC deliberations beginning in 1982, Industry Future Councils have looked at forces and drivers and have very accurately predicted the industry's future, envisioning options for new products, opportunities for new markets, rapid acceleration in some newly deregulated business, new technology deployment, or a major legal or regulatory change that would enable innovation. The dominant themes of many IFC reports have been product innovation, specialization, diversification and growth.

Prior to this year's IFC meeting, the Foundation distributed a survey on critical forces and issues to 60 members of the Business Council Steering Committees and a number of individual Foundation members. It then used the results of this "homework" to structure the IFC meeting.

The survey identified a number of key forces as most critical to the future of the leasing industry and individual companies, including the economy, capital availability, technology, and productivity/human resources. In addition, IFC members examined thirty trends now at work in the world and identified twelve as being particularly significant for equipment leasing and finance. At the meeting, participants discussed these issues in the context of both the immediate future and the longer term.

The bottom line: IMPLEMENTATION not INNOVATION is on executives' agenda for success in the foreseeable future, as is reflected in the phrase de jour, *More Juice for the Squeeze*. In a consolidating, mature industry, productivity is the key to successful competition. Given this environment, IFC members see future opportunities in lowering costs, deploying technology and accessing reasonably priced funding. Viewed in a historical context, equipment leasing and finance companies still have great opportunities, but narrower options.

The 2002 IFC sees a mixed but fundamentally strong economy. With the exception of healthcare, no market looks to have high growth potential for lessors. Such traditionally good markets for lessors as transportation and telecom are at over-capacity. Information technology and the Internet are temporarily flat.

PRODUCTS

As for products, most of the "innovation" attention is focused on delivery and customer relations management systems that utilize technology. These systems carry big implementation challenges and risks, but companies definitely are moving in this direction.

In some companies, the strategy is to do more for the customer, attempting to get more of existing customers' pocket book by adding services to the package. While some IFC members wondered about the implications of the future mix of revenues from financing and services, nobody offered any numbers. It was clear from the meeting, however, that forces are at work to increase the revenue from service (fees) relative to revenue from pure financing.

Not one member of the IFC described product initiatives in terms of managing more risk. The dominant drivers, the economy and capital markets, are forcing residual assumptions down and putting a bigger premium on credit underwriting, portfolio management and asset recovery activities.

FUNDING

Capital is scarce, but is available for the good companies. A risk averse atmosphere exists after the capital excesses of the mid 90's and the Internet / Telecom euphoria of the late 90's. Everyone is wiser now.

IFC members recognize an irony in the current environment—the great crest of the wave of liquidity a few years ago drove equipment leasing and finance companies to do a lot of business at rates that would be unthinkable today. However, the current trough in the wave cycle of liquidity can result in missing opportunities for good returns.

PEOPLE

Strategy clearly is dictated by a company's parentage and expertise. Some companies are and will be driven by the parent relationships to a customer base. Others are driven by a manufacturer parent or vendor desire to move equipment. But a common feature in all strategies is increasing productivity through either technology or quality personnel.

TOUGH TIMES CREATE OPPORTUNITIES AND ELIMINATE MARGINAL COMPANIES.

IFC members describe an interesting personnel by-product of industry consolidation: it has allowed consolidating companies to keep the best people in most cases as they eliminate redundancy. Still, many good people have been put in the labor market, easing the difficulty in finding experienced people. The IFC stressed, however, that in all cases companies must pay attention to the integration of new people and invest in general training to increase productivity. Workers in equipment leasing and finance companies are becoming increasingly seen as knowledge workers.

Working smarter also involves the use of technology at all stages of the origination, underwriting, approval, booking, funding, administration and termination / renewal process.

COMPETITIVE LANDSCAPE

The defining competitive trend of the equipment leasing and finance industry, the traditional *Whale and Minnow* concept, has itself been further defined. The phrase *Whale and Minnow* is being replaced with *Bi-modalism*, and the shift is more than words. Bi-modal is more than the poles of big and small. In the view of the IFC members it is *institutional versus entrepreneurial*. There is room for each type to be successful. Size does not guarantee success and the lack of it does not predict a struggle. Equipment leasing and finance will remain a fragmented business.

The market cap of public equipment leasing and finance companies is now below $5 Billion. The dramatic reduction in the number of independent companies that tend to be smaller probably portends an industry in which well managed companies with good reputations and access to capital can succeed in niches. The large institutional company leads from power and economy of scale. The smaller entrepreneurial company leads by quickness, flexibility and individual customer focus. Entrepreneurial firms will have success even as institutional companies do most of the volume.

STRATEGIC TRENDS

Historically, IFC reports have used a framework of three basic marketing strategies to categorize where equipment leasing and finance companies see themselves. Product innovation, operational excellence and customer intimacy are the three general strategies. Based on the IFC deliberations and information used by the IFC, the current trend in strategies seems to be:

- Product Innovation - Receding
- Operational excellence - Stable, particularly in deal flow, low touch businesses
- Customer Intimacy - Ascending. Customer Relationship Management (CRM) and high touch

It is important to remember that the equipment leasing industry is extremely diverse and fragmented. Its participants serve a wide variety of markets, follow highly individual business plans, and cope with conditions that often are unique to their particular environment and niche. Yet, by necessity, the IFC examines this industry from a macroeconomic viewpoint. Therefore, although most of the observations that follow will apply to a majority of equipment leasing and finance companies, individual comments and statements within it may not fit the unique circumstances and experience of a specific firm.

MAJOR DRIVERS IN THE EQUIPMENT LEASING INDUSTRY

THE ECONOMY AS A 5000-POUND GORILLA

It's not only "the economy, stupid," but-perhaps unsurprisingly-participants singled out this one driver as being by far the most important in the future success of their business. This was true for companies of all sizes and in all major market segments. Few participants felt themselves immune to its effects. Those with some sense of immunity were captive lessors, well funded by large parent companies and specializing in products with stable demand. .

Some of the respondents to the pre-IFC survey were relatively calm about the current recession. One large-company executive observed:

"The economy is slowing equipment purchases;offsetting this,the interest rate cuts are encouraging the choice of fixed rate financing (leasing),and well capitalized companies have access to funding and are doing well."

THE TOP DOZEN TRENDS: THE FUTURE ISN'T WHAT IT USED TO BE

IFC members were asked to read the report,30 Trends Now Affecting the Leasing Industry, select the trends they found most important,and comment on their significance. In the pre-meeting survey, the following trends were chosen most often.These are trends that will influence the direction of markets and companies.

• The economy of the developed world will continue to grow for at least the next five years. (15 responses)

"The interruptions are only a temporary set-back," one participant advised in the pre-IFC survey. "Look to take advantage of resurgence in various fields;i.e., real estate and transportation."

"A steady and increasing volume of equipment to finance is a must," noted another executive.

A representative from the Small Ticket Business Council made it unanimous. "First of all we need a healthy world wide economy," he said. "There needs to be a confidence that the developing and developed countries will all play a part.New markets opening up, like China,will have a great impact.The U.S. needs new markets to sell its products."

Continued...

At the IFC meeting itself,participants were more focused on the recent recession than on the underlying trend toward growth. Many felt that it had contributed new institutional memories,the first experience of a downturn for new-generation personnel,and thus would bring more prudence to future transactions.However, one skeptic forecas that "The old excesses will be back in two to three years,as new capital chases deals."

At least one also feared that the nascent recovery might never materialize. "All it would take is one more attack like September 11 to put us into a deep and lasting recession," he worried."I don't think we have paid nearly enough attention to the threat of ter rorism."

This was one concern the facilitators could address,as Forecasting International (FI) has carried out se veral major studies of ter rorism,including a ground-breaking Pentagon report called Terror 2000,which in 1994 predicted the attacks on the World Trade Center and the Pentagon."I am really not worried about that," said FI President Marvin Cetron."There will be more terrorist attacks,but probably not on that scale.We will absorb the shocks and carry on."

Yet others were more concerned. One small-to-mid-market specialist reported that business is down 15 percent since last year. Others said that sales are down, new applicant credit quality has declined, asset resale values have slipped, and delinquency and charge-offs have risen. Two observed that their market share has actually increased during the recession because of consolidation among their competitors.

With these concerns in mind, the IFC members spent considerable time examining the state and probable course of the economy. The consensus is that the bottom of the recession has been passed and the real question is when will we emerge from it. Throughout the last year, consumer spending has been the life preserver that kept the economy from sinking even farther than it did. No matter what else went wrong, that 70 percent of the American economy refused to give in. And as of December, consumer confidence was at its highest level since before September 11. Orders for capital goods were up as well.

This expectation was supported by other economic data. According to the Purchasing Managers Index, new orders for capital goods last August were making a strong recovery from their January 2001 low. Then the terrorist attacks threw business expectations into turmoil. By October, new orders had collapsed from an index high of about 53-a level not seen since Spring of 2000-nearly to their previous lows well under 40. But by December, durable goods orders had leaped to new highs for the year. Non-defense capital goods, sliding since last April, had begun to recover. Overall business activity had recovered as well. These are strong indications that corporate executives agree with consumers: The bad times are nearly over.

If fact, these optimistic portents were confirmed during the IFC, when the latest economic report came out. The data showed that the U.S. economy had actually grown during the last quarter of 2001, by about 0.2 percent. Though not the runaway expansion seen through much of the 1990s, this can only be seen as powerful evidence that the economy is much more resilient than some doubters had feared.

BY WORKING CLOSELY WITH CUSTOMERS, SMALLER LEASING FIRMS WILL BE ABLE TO INCREASE MARGINS IN SPITE OF HIGHER COSTS OF FUNDS BY ADDING VALUE BEYOND THE ACTUAL LEASE.

All this should come as little surprise. In previous recessions, interest-rate cuts have needed six months or more to set off a general economic recovery. If there is bad news in all this, it is that the economy will not recover to the heady levels of the late 1990s, when consumers grew their spending by 5 or 6 percent each year.

For specific industries, the outlook is mixed:

- Aerospace and defense faces diverse prospects. Thanks to the collapse of the airline industry, demand for civilian jets is expected to fall for the next two years, with production by industry giants Boeing and Airbus Industries falling from about 840 planes in 2001 to around 500 in 2003. However, at the end of January 2002, an unanticipated order for 100 Boeing 737s from a no-frills airline in Europe brightened the picture. In sum, this is not good news for lessors of new aircraft. But there may be longtime opportunities as airlines go through major fleet rationalizations.

- Airlines were hurting even before September 11 kicked the bottom out of their market. Since then, flights are down by at least 20 percent, and some 800 expensive airplanes have been mothballed. Not counting Washington's $5 billion bailout (with another $10 billion in loan guarantees yet to come), revenues were down by 15 percent in 2001. At worst, 2002 should not be that bad. Industry analysts say operating losses should be down to $2.4 billion this year, with actual profits finally returning in 2003. Output growth will be a scant 0.3 percent.

- Agribusiness is suffering a drought, as prices for most important farm products remain at all-time lows. Corn stocks are declining, but far from gone. China's entry into the World Trade Organization brings the prospect of new markets for corn, soybeans, wheat, poultry, and beef-someday. Genetically engineered foods could be a hot profit source for American biotech firms if Europe and Asia accept their safety, but it has not happened yet. As a result, net farm income will be down in 2002-this despite output growth of 2.1 percent-and revenues for the $10 billion farm equipment industry are expected to fall by as much as five percent, after sluggish sales last year. Leasing of farm equipment, and especially tractors, threshers, and harvesters, may have to wait until 2003.

- Auto industry prospects are limited for 2002, thanks in part to the sales programs that kept the car makers healthy during the lean times after September 11. Zero-percent financing back then moved vehicles in record numbers, but almost surely robbed sales from this quarter. Auto sales in 1Q02 are expected to be down by at least 12 percent from last December. At the same time, profitability is slipping as more players enter the once-lucrative market for SUVs and light trucks. In all, the automakers' output is likely to sag by 0.6 percent for the year.

- Banking firms have been hit doubly hard in recent years, first by the collapse of the high-tech and telecom boom in the late 1990s and again by the World Trade Center attack last year. Investment banks found that revenues from underwriting and M&A were off by 56 percent as of November. Analysts say that cheap funding, strict capital standards, cost cutting, and the first hint of economic recovery should raise banking profits by no less than 20 percent this year, on output growth of 1.6 percent. All this suggests that banks may have more money available, both to compete with the leasing industry and to fund small lessors.

- Computers, software, and chip makers all have left the boom years behind. With both corporate IT managers and consumers sitting on their wallets, computer hardware sales are expected to fall by 1.7 percent in 2002. (Not bad, considering the fall of 16.5 percent last year!) Chip manufacturers are looking to video games, cell phones, and brainy appliances to bail out their sales, which plummeted 31 percent in 2001, software firms anticipate flat-or-worse sales to companies, with only the market for security software showing strong growth. For this once-buoyant sector, output will be waterlogged in 2002, offering only limited opportunities for those in the IT leasing business.

- Construction companies rode out the lean months of 2001 in relative comfort. Low mortgage rates and the tight supply of starter homes kept new building at near record levels. However, the current recession has all but killed the commercial market for new office and factory space, and tight government budgets have public building on the ropes, save in Washington, D.C., where nothing ever slows the local economy. Overseas markets may offer better prospects for those lessors of building equipment who are comfortable abroad, and with the dollar far stronger than the yen, most leased hardware may be sourced from Japanese makers.

- Health-care spending is skyrocketing again, thanks to costly new drugs, surgical procedures, and technology, and an aging population that needs more of them every year. America's health budget will be about $1.37 trillion in 2002, up more than 13 percent over 2001. However, that does not signal a boom for the nation's hospitals and nursing homes. A sharp rise in labor costs, stagnant reimbursement levels from Medicare and insurers, and other factors have them struggling to stay out of the red. Instead, the money is going to drug companies, whose sales were up by 16 percent in 2001 and will grow by another 14 percent this year; and to insurers, which simply boost premiums when feeling pinched. Biotechnology is likely to send drug costs up still further in the next few years: FDA approved no fewer than 130 drugs in the five years ending in 2000, and 300 more are nearing the market. Over all, health care's output should grow by about 0.3 percent in 2002. While this may offer relatively little benefit for lessors in the short run, over time it means a growing market for the financing of biotech production hardware, CAT and NMR scanners, and other medical equipment.

- Telecom companies binged on capital spending in the 1990s, and the results have not been pretty. Equipment sales were down by over 20 percent in 2001, and capital spending is expected to decline by at least 15 percent, and perhaps as much as 30 percent, this year. On the bright side, mobile wireless carriers are still expanding rapidly, and broadband subscribers should double to nearly 20 million users in 2002. In all, output for this industry will be up about 1.1 percent this year.

All this represents mixed news for the equipment leasing and finance industry. Three large and lucrative markets for leasing-airlines, agribusiness, and computers-are still in decline, though probably bottoming out. Banks faced with tight profits in traditional activities such as consumer loans and M&A could focus more of their attention on equipment financing, and compete directly with lessors. Yet a mild economic recovery is a recovery still, and a rising tide lifts all boats. And the expanding biotechnology industry seems poised to need an infusion of financing for new production equipment. If 2002 will not be a boom year for equipment leasing, it now seems that the end of the bad times is only six or seven months away.

With this background in mind, IFC participants focused on changes in the leasing market.

"Five years ago, the most competitive segments were aircraft and rail," said one executive from a small leasing operation. "Now aircraft deals are not worth doing, but we are doing more rail transactions than at any time in the last thirty years. We also are doing many Asian deals, thanks to one person. Our niche is based on relationships."

Another participant noted:

"There is a lack of lenders in transport. Everyone got burned in that field. So banks are picking off the deals that are flying around. The credit is weak, but the equipment is valuable."

Said a third:

"Trucks were big for us, but the opportunities today are in medical equipment, transportation, IT, and construction."

One participant wondered whether the leasing business has really changed.

"Are there any really new opportunities, or is it all the macro-economy? I think macro dominates."

A mid-market specialist suggested:

"In 1998 and '99, the prime driver was growth and transformation. Now it's cost savings and efficiency."

Said another participant:

"We have a huge investment in security."

One executive from a company specializing in the middle market wondered:

"What about energy investment? Will there be a leasing market in power back-up equipment? What about capacity issues?"

Dr. Cetron, the IFC meeting facilitator, advised that that business will be limited by the low cost of energy. Another participant noted the many new projects emphasizing stand-alone power generation that could offer some opportunities.

The future depends on the economy, as one middle-market specialist summed it up:

"Strong growth means more capital expenditures. A downturn means credit problems. Losing sectors don't lease."

Capital Availability: The Haves vs. the Have-Nots

Even though the economy is by far the greatest concern for most lessors, capital availability is a close number two on their list of worries. For many companies going forward, it may decide whether they prosper or die.

In the 2001 IFC report, it was noted that "the top 25 leasing firms currently account for approximately 75 percent of the business" in the leasing arena. Since then, as consolidation has continued to absorb the middle tier, the largest players have even more clearly dominated. It is an unambiguous demonstration of the 80-20 rule, as roughly 80 percent of the total volume is handled by no more than 20 percent of the industry. As the big get bigger, they benefit from economies of scale (e.g. transaction-based.) The small become niche players with personalized customer service, or they are forced to leave the business.

Throughout 2002 and on into 2003, the leasing industry will continue to manage business and capital cycles that are declining in tandem with the downturn of the economy. "The limited availability of capital and the economic uncertainty are the problems of the day," as one participant observed. As in 2001, the impacts will vary across the industry along two axes-company size (e.g. whale vs. minnow) and business model (e.g. independent as a core-business vs. a line of business within a bigger organization or captive of a bigger organization.) "Capital availability is determined by independent versus self-funded (e.g. bank captive)."

The survey found that two groups were less concerned with this issue than others. The first is the large, investment grade companies that either are self-funded or command easy access to the capital needed to grow and expand. The second group is comprised of companies whose operations are integral to larger firms. Both groups reported that capital availability was not a major issue for them. "We have no capital constraints," commented a leading executive at one large captive leasing operation.

As in other industries, many mid-sized lessors are struggling to sell themselves as the best of all possible worlds.

Nonetheless, this easy access to capital has come at a price: Bank capital is still accessible to established, well-managed companies. "However, banks are highly focused on credit concerns and returns on capital and will not be an easy source of lease financing," one executive commented. "The uncertainty in the capital markets has helped us, because fringe lessors are being weeded out," said another executive whose parent company supplies all the capital his operation requires. Several respondents in similar positions echoed this comment. Tough times create opportunities and eliminate marginal companies.

During the deliberations, the IFC identified, but did not analyze a significant developing issue: What impact will the toughening risk-weighted capital standards for regulated institutions have on funding in general, and bank lessors specifically.. This issue will need more attention to fully understand how capital availability will drive the industry and the competitive marketplace. The standards clearly will alter the risk/return analysis on capital deployment and will create winners and losers among companies in the equipment leasing and finance business.

For the smaller players, capital availability depends heavily on the firm's current track record and demonstrated ROE. "Capital access for independents and captives is affected by portfolio performance," said a participant from one such operation. With tighter credit standards, fewer funding sources, dropping residuals, and lowered transaction volumes due to the poor economy, smaller players are working hard to get as much "bang for the buck" as possible. Instead of moving towards a low-margin, high-volume, transaction-oriented model, they are embracing the kind of customer-centric strategies that can command higher margins. Many simply lack the resources of capital, technology, and people succeed except as specialists focused on specific areas and niches.

How will business models emerge from this new reality of scarce capital? Business models have split along a division between capital "haves" and "have-nots." As companies grow, they can become capital "haves" and exploit their size by moving toward a high volume, transaction-oriented business model. "In large ticket, the market has been transaction oriented," one participant observed. "Competitive pricing is still key and most often trumps relationship." This phenomenon seems independent of the industry sector supported. Combined with low interest rates, one executive from small ticket operation said, "...leasing has become a true commodity." However, because industry and company concentrations in the portfolios of many equity participants limits their ability to do new business, *new* equity sources will be in a powerful position.

For their part, capital "have-nots" compete by attacking the blind spots of bigger players. "There will be a market void created by the lack of flexibility and entrepreneurship that will be filled by new or smaller companies," explained a respondent from a smaller, less well-funded lessor. The "have-nots" must deploy under a different strategy, a high touch/knowledge based strategy. "The largest leasing companies (getting larger through consolidation) are missing their customer satisfaction goals. Their cost of funds is an advantage, but the service levels supposedly achieved by scale have not materialized. This will give the smaller companies a chance to give a more personalized, relationship-based service. The larger companies do too many things...Companies that specialize in niches will be the best service providers." By working closely with the customer, these smaller leasing firms will be able to increase margins by demonstrating a value-added beyond the actual lease in spite of higher costs of funds.

If large companies will continue to enjoy economies of scale, and small ones will provide extreme flexibility, what will mid-sized operations have to do to sustain themselves? As in other industries, many mid-sized lessors are struggling to sell themselves as the best of all possible worlds. They try to offer as much customer service as the small, highly maneuverable firms while having all the technology, market power and sophistication of the largest players. It will be hard to make this proposition work. They are ignoring certain realities of bi-modalism. Any company that relies on a dual strategy but cannot live up to it should be ready to sell its portfolio.

Just as availability of low cost capital and scalability will drive the business model of many firms, so the business model will be driven by technological underpinnings. Where transaction volume and efficiency is paramount, "high-tech" solutions will be the IT investment of choice. Conversely, where "relationship is king," IT investments in "high-touch" systems are prevalent.

Technology: High-tech vs. High-touch Frameworks

It has been said that technology is non-partisan. While this is true, the impact and application of technology differs widely, depending upon business model. Most of the large equipment leasing and finance companies in small ticket markets have migrated to a high-volume, low-margin, deal flow oriented business model. This requires growing efficiencies to reduce overhead costs, greater process automation to reduce time-consuming "human intervention," and tighter

Trends

• Technology increasingly dominates both the economy and society. (14 responses)

Nearly all respondents named this trend as among the most significant,no matter what segment of the market they served.

"Technology will be a driving force for the long-term economy," said a small-ticket representative in the advance survey."At times it appears that we need to catch up with it.Delays in being able to use technology are sometimes disappointing,but we usually take advantage in the long run."

• The growth of the information industries is creating a knowledge-dependent global society. (14 responses)

Representatives of all market segments cited this trend.

"Many companies in the U.S.,our prime market,will be owned by worldwide companies," forecast a participant who specializes in large-ticket leasing."We need to know these customers."

Another saw "significant expansion opportunities into global companies" resulting from this trend.

Someone from the middle and large markets suggested,"Information industry growth will lead to quicker equipment obsolescence and a higher risk factor for the residual."

"This growth,along with its Web-savvy computer users,will bring knowledge about our finance products and about our company to many more users," another predicted in response to the pre-meeting poll.

At the IFC, participants noted another implication of this trend.The Internet particularly has given leasing customers access to information not previously available to them."There is much greater transparency," he said."They know much more about financing costs and the residual value of commodity products."

• The Internet is still growing logarithmically and globally. (13 responses)

As one executive stated the general view,"We could no longer do business without the Internet."

"One thing the Internet has not changed is the value of a brand," a participant at the IFC pointed out."Customers go to Amazon.com,not because it has the best prices,but because it has built a name for itself and earned their trust.The Internet gives us the same opportunity among our customers."

Yet one of the most interesting observations dealt with the process of arranging a lease."People's experience as consumers changes their commercial expectations," he observed."On the Internet,buying something is a self-guided,self-directed process.Our customers are going to expect that same kind of convenience in their leasing transactions."

• The pace of technological change accelerates with each new generation of discoveries and applications. (10 responses)

While this trend offers opportunities for new business,the challenges it brings seemed to concern participants more.

integration of front-end systems with back-end systems, as well as with trading partners.

These scalable systems will go a long way toward cutting the cost per transaction, but they will not come cheap. The IT investments needed to implement and maintain them make these systems appropriate only for the largest firms in the industry unless a service provider is able to introduce a system for smaller companies that does not require a huge initial investment and infrastructure. “The small ticket market will continue to require lessors to reduce costs through efficiency,” one executive summarized. “Technology will be the only means of delivering these cost savings.”

Most small firms have realized that they cannot compete in parallel with larger competitors, but must play from their own strengths. As one small-company executive pointed out, “Larger competitors have not always been better competitors, leaving them vulnerable to more agile, customer-focused companies who know the value of service, relationship and responsiveness.”

With this in mind, small leasing companies are moving to “customer-centric” business models. Many have adopted customer relationship management (CRM) systems to provide not only user-friendly interactions during the traditional “market-sell-close” process, but ongoing support of the customer relationship during the lease period. When carried out skillfully, this provides value-added services to the lessee and encourages repeat business from the customer. However, one participant suggested that relatively few companies are applying it in ways that can provide a competitive edge. “Competition has been quick to embrace technology,” he noted, “but it has been used without development of relationships.”

As another participant advised, “A key competitive factor in this area is customer relationship management. Effective and practical implementation will allow a lessor to maintain an existing loyal repeat customer base, the most cost effective means of maintaining volume in today’s market.”

Web-based customer interfaces are following this trend. The best are designed to provide a complete “customer experience” instead of relying on the streamlined “no-frills” approach used in transaction-oriented front-ends.

In all markets, small companies and large are adopting new technologies such as automated decision-making and credit scoring. “The credit through servicing processes will be technology driven to lower cost, improve decisions and improve service,” said an observer. “Credit scoring will prevail at larger dollar transaction amounts.” As research and validation into credit models progresses, more and more transactions will become “hands-off,” with less human interaction in the process. “Consistent with the deployment of technology solutions, credit scoring will continue to grow and replace judgmental decisioning,” one participant forecast.

Data mining is another area where IT investments are growing rapidly. By identifying patterns in the current lessee portfolio, as well as similar patterns in the marketplace, firms can analyze and understand their customer base better. By identifying both high-value and high-risk customers, and by understanding the marketplace as a whole, marketing efforts can be precisely aimed at high-probability, high-value potential customers.

In the commodity small-ticket market, “Most functions between lessor and lessee will be completed online,” predicted one respondent. “Systems will automate many more functions. The need to cut costs for competitive reasons will be the driving force.”

This trend will make it increasingly necessary to implement large-scale systems that can provide for direct lessee input (possibly Web-based), automated credit scoring, back-end processing and, with e-signature capability, deal closing. As one participant observed, “The external technology-i.e., online applications, reporting, and credit scoring-are approaching parity in the market among the top lessors. The key to long-term competitive advantage, in our opinion, is to continue to expand internal technology to increase productivity and reduce costs.”

The middle market is becoming more like the small-ticket market, as the trend toward bimodal distribution continues, and the 80-20 rule takes effect here as well. Some companies will focus on the high-tech approach, while others will search out the “high-touch” market niches. “The impact of current technology changes, and the ability for companies to add or upgrade depends on the cost-benefit analysis,” said a proponent for one approach. “In our case, we believe the cost of technology is a cost of doing business.” Companies that cannot choose one of these strategies and pursue it effectively will be at a severe disadvantage.

Service providers tended to be more customer-centric overall. However the issues they face and solutions they choose proved to be much the same as in the rest of the industry. “Properly used, technology can do much to level the playing field for the sub-giants,” said an executive from one such firm. “But these companies cannot think of technology as a ‘magic pill.’ Incomplete integration of systems into the organization will not provide the synergy hoped for.”

Vendors too are buffeted by change. According to a member of the Vendors Business Council, “Some people who took the poll wrote of large projects that their company has undergone with little payback. Yet they still felt that it had been necessary to attempt these projects in order to compete. Communication access, process management, and basic accounting were cited as areas of focus... Stability of systems and customization for customer needs were cited as goals of their current technology efforts.”

In general, when it comes to technology, companies throughout the leasing industry have much in common. The respondents, as a rule, felt that their technology readiness was greater than that of their customers. Most believed that their competitors were still working to cope with many of the same challenges and issues they themselves faced.

Many companies have found that IT investments have not brought the ROI they once expected. Several respondents explained their failure in much the same terms. "Companies need to embrace technology change as a part of their culture," said one. "They need more than technology; they must understand how to use it to improve their effectiveness." Unfortunately, they hadn't.

HUMAN ASSETS: THE FOUNDATION OF THE FRAMEWORK

While technology is a strong enabler, ultimately it is people who make the difference between a successful company and a failure. People who can embrace the technology, understand the leasing business, and focus on the lessee will triumph over those who cannot. As one participant summarized it, "Technology will drive customer service. Customer service will drive growth. Employees who are good with technology and are customer-centric will be valued." Employees must be nurtured as a company's most important asset.

TRENDS

• Education and training are expanding throughout society. (12 responses)

According to IFC participants, the need for training brings new opportunities for ELA and the Foundation to serve its members. Several suggested that the Association could provide Web-based for-credit courses for members' employees. Graduates would receive accreditation or certification that could assure employers of their competence.

• Specialization is spreading throughout industry and the professions. (8 response)

"Small lessors will need to specialize and know the customers' businesses better than ever," a small-market participant said. "If employees aren't trained in these niches, the probability of survival is minimal."

A middle market executive noted, "Companies will be looking for additional sources of business as the generalist goes away."

• Young people place growing importance on economic success, which they have come to expect. (8 responses)

"This will affect your workforce," a large-ticket participant observed. "Quality of people and their drive for success should improve and help in hiring quality people."

However, an executive warned, "Gen Xers are hard to retain, and the cost of training is huge. As we are 'people intensive,' this is a major issue."

As the leasing market consolidates and becomes more competitive in the future, many IFC survey respondents believe that acquiring quality employees is priority. Several reported that there are more experienced workers available today than in the past, but some questioned whether mere time in the industry always mean quality additions. Companies must and will pay more attention to training employees. People do not become knowledge workers automatically. As a means of increasing productivity, spending $3,000 to $4,000 on average for development for each employee a year is a good investment.

As the need for lower overhead and greater efficiency cuts workforces, each employee must now fill multiple roles. The best candidates combine equal parts business savvy, technology literacy, leadership, and management skills.

"One of the key ingredients, for both technology and people, is the ability to change as customer needs and market conditions require," said one of the executives surveyed. "The best employees are people with broader skill sets who can handle diversified responsibilities."

This will be as true in back-end operations as it will be for sales personnel. "Lessors need an IT staff that understands their business and e-commerce," one respondent pointed out. "Lease operations managers must know how to convey their business needs to the IT staff, so they can develop realistic plans for new technology." Business knowledge is especially significant as many "old-timers" with extensive corporate memories retire and their experience is lost.

Most IFC members acknowledged the generational rollover occurring in the management ranks of the industry. Companies cannot ignore the need to develop new leaders as the graying continues.

But how will equipment leasing and finance companies attract, develop and retain qualified individuals? In a boom economy, workplace comfort was a big factor. "Give people room to grow," advised one participant. "Give them tools to plan their future. Foster a team atmosphere where people depend on each other to succeed and have access to challenges and intellectual stimulation. Provide a stable environment with good sharing of information, and make sure the team members feel they are valued and listened to." However, in a sagging economy, more individuals come to view a position as a job instead of a career. This short-term focus predominates until growth and opportunity returns.

On the other hand, such performance-based incentives as stock options, bonuses, trips, and awards have been remarkably successful in good times and bad. In a tough economy, these programs continue to be a major attraction. Virtually all IFC survey respondents offered stock options, bonus plans, or both, and had no interest in reducing or modifying them.

Profit sharing seems to be down currently, as the popularity of stock options and 401(k) plans has increased. However, in the wake of the the Enron collapse, many organizations may diversify the investment options in their incentive plans to reduce matching contributions in company stock.

Strategy, Growth and Management

This topic, while not covered in the pre-meeting IFC survey of Business Council members, emerged as a subject of major interest at the meeting itself. Participants were eager to glean insights into strategic and management approaches that might help them cope with today's difficult business environment. They found colleagues in a mood to share.

For most captive lessors, not much has changed since September 11. "Our strategy is constant unless our position within the company changes," said a representative whose parent company is a high-tech giant. "We reinforced our focus on credit quality," said another participant from a captive operation dealing with farm equipment, "but that has always been paramount for us."

However, both noted that of late, they are financing packages that include products from other companies. "We do whatever it takes to meet our customers' needs," said one. "That includes going to the competition when they need something not available in our own product line. About twenty percent of our portfolio is from other firms."

Another participant, whose leasing operation is owned by a manufacturer of medical equipment, reported much the same trend. "Less than fifty percent of our business is as a captive," he said.

For many other lessors, growth will remain a major issue. "We need to expand to a much larger base without falling prey to the problems of mid-sized companies," said a participant from one small leasing firm. "The consolidation is helping, because it lets us build our sales staff from the competition. We have to sell service, because our cost of capital is higher than others." Others observed that "There will be more opportunities for bundled transactions, thanks to market pressure. Customers want integrated service, not just the cheapest deal."

One participant had a specific question for his colleagues: "What are the biggest factors in determining your strategy?"

"Cost of capital," replied one company exec. "We want customers with high credit quality who are willing to pay more for service."

A small-ticket specialist offered, "The important thing is your core competencies and how you execute what you know."

"We got into leasing to serve the needs of customers who were going to others," said one participant that specializes in leasing to government agencies. "We've grown from $200 million to about $1.2 billion

Trends

• Information-based organizations are quickly displacing the old command-and-control model of management. (10 responses)

"Companies that can deliver real-time data management will be the winners," one participant who deals in the middle and large markets commented.

• The global economy is growing more integrated. (9 responses)

In the pre-IFC survey, participants from all segments of the industry cited this trend as being among the most important for leasing.

A small-ticket executive suggested, "Without the world participating, we will not have a good domestic economy. The opportunities for the large-ticket community are great. The small-ticket lessors will benefit when the trickle down occurs."

However, not everyone saw this trend as beneficial. "Equity being moved overseas will have a negative impact on our domestic-oriented equipment finance products," one middle-market specialist warned.

"A growing global economy will mean lessors will have to learn a whole new way of doing business," wrote another. "Foreign employee issues, foreign laws, and foreign accounting standards will create challenges."

At the IFC, participants expressed mixed views about this trend. "The U.S. is a big enough market for all of us," declared one. Another added that, "Many companies talk a good story when it comes to international leasing, but the reality falls short." A third was concerned that, "Data is scarce on foreign companies. We simply do not understand foreign markets."

However, participants from large companies were more interested in overseas leasing. "We already do business in dozens of countries," said a representative from a giant lessor.

A mid-market participant saw other implications: "Equipment is becoming standardized, particularly in the European Union, but in many other countries as well," he pointed out. "This brings new opportunities and a deeper resale market."

Another noted, "Pricing is now influenced strongly by the currency of manufacture. The weak yen has been good to many international lessors."

• Institutions are undergoing a bimodal distribution: The big get bigger, the small survive, and the mid-sized get squeezed out. (7 responses)

Virtually everyone mentioned this throughout their replies, and seven specifically cited it as being among the most important trends.

At the IFC itself, one participant gloomily noted, "There have been at least one-hundred roll-ups and bankruptcies in the last two years."

However, another saw some good in this trend. "This is creating new room for entrepreneurs," he said. "A few years from now, we may look back on this as a difficult but healthy change for the industry."

SCALABLE TECHNOLOGY SYSTEMS WILL GO A LONG WAY TOWARD CUTTING THE COST PER TRANSACTION, BUT THEY WILL NOT COME CHEAP.

in the last five years. We just want more of the same. We are expanding our small-ticket leasing, because that is what some of our customers need. We are aiming for growth of fifteen to twenty percent.

A small-ticket executive replied, "We are aiming for ten to twelve percent growth this year. We had been getting twenty percent."

At this point, all participants were asked to comment about their strategy and management practices. Their replies, edited for space, were as follows:

"We are looking for aggressive growth, consistent with good credit controls," said a representative from a captive "Our strategy is to find profitable niche markets."

Another large-company participant said, "We are projecting flat volume, but a better bottom line-around fifteen percent-due to better credit quality and more efficiency. We are looking at becoming specialists in some lines. We also are expanding our overseas vendor program." For larger companies, growth will remain an essential ingredient to maintaining profits.

A high-tech lessor replied, "We want to focus on the lower-end market as well as provide better service to our large customers. We are working hard at integrating new technology into our operations, while hiring and training better people."

Someone from a traditional captive lessor commented, "Growth is our parent's issue. Our big job will be to not jeopardize our parent company's profitability."

A mid-market executive said, "Last year, we worked hard on operational efficiencies, consolidation, and integration of our business. As a result, we were able to maintain our market share through the downturn. Now we want fifteen to twenty percent growth."

One participant wondered whether his colleagues saw any trend in their willingness to buy business from brokers. The results varied. Several participants replied, "We avoid non-institutional business;" "We're out of it;" or "We never did it."

However, the head of a small leasing operation reported, "About twenty percent of our business comes from brokers. They apply to us, and we accept maybe one deal in ten. We charge them more money than our own customers, and they can take it or leave it. Sometimes we also become brokers for bank money if one of our customers goes over his limit with us, but this is invisible to the customer."

A small-ticket specialist noted, "We used to avoid brokers. Now we deal with them on a highly disciplined basis. We simply need it for growth."

LAWS, REGULATIONS AND STANDARDS

Laws, regulations and standards have been and will continue to be important to how equipment leasing and finance products are designed and how companies compete in the marketplace. Laws, regulations and standards set the boundaries and have slight imperfections that structures can utilize. IFC members and respondents to the IFC survey expressed concern about three issues going forward.

1. Financial accounting standards.

FASB and other national and international standard setters have made it clear that they do not like current accounting for leases because there is not enough capitalization. They intend to change standards to increase capitalization. The issue is not "if" but "when" and "what" will be capitalized. The "when" has been given greater impetus in the wake of the Enron collapse. However, standard setters and the equipment leasing industry have been wrestling with the framework for a new standard and capitalization measurement issue since 1996. ELA believes that a new standard will tighten capitalization requirements. However, in order for financial accounting to reflect the true economics of transactions, substantial risks and rewards will not be capitalized under a new standard.

2. Federal and state tax policy.

ELA has promoted the policy of a level playing field between lessors and owner/users of equipment. The level playing field is the driving policy in lobbying work by ELA. IFC members do not see a threat to that standard, particularly at the federal level, but all agree that it must be monitored constantly.

The threats however, are that in a political atmosphere characterized by opposition to tax provisions considered as corporate welfare or abusive, abilities to structure products could be limited. The second threat is the need for revenue as deficits begin to appear again. While it is unlikely that corporate rates would be increased, the ability to use incentives such as depreciation could be reduced. The latter could lessen the ability of lessors to play a tax intermediation role in their products.

3. Commercial law.

The loss of legal provisions that differentiate between leases and loans. Structuring and pricing different products based on different risks and rights are important to marketing. There is no apparent threat to the current differentiation between leases and loans continuing if constantly monitored, but it is a potential problem.

Other more specific issues within each business council such as issues related to consumerism, foreign trade and export, sales and use tax definitions and practices and the use of legal structures such as Special Purpose Entities. Advocacy by ELA is seen as critical to the future success of the industry.

CONCLUSION

More Juice from the Squeeze is a challenge to companies, but certainly an opportunity. In addition, *More Juice from the Squeeze* does not limit itself to a specific juice. Orange, apple, cranberry and more are not unlike the great differences among companies in the equipment leasing and finance business. The business may be mature, but it is diverse. There is nothing in the IFC deliberations of 2002 that suggests anything but opportunity in many segments.

Believers in free market capitalism-and people in the equipment leasing industry are nothing if not believers in free markets-understand waves and cycles. There are ups, such as the "irrational exuberance" spoken of by Chairman Greenspan. There are failures and retreats as described in the Foundation's *Perfect Storms* report. There is reduced liquidity as reflected in capital markets in recent years.

At the 2001 ELA Convention, ELA President Michael Fleming reminded attendees that from pain comes wisdom. Experience is a cruel teacher, but as every cycle turns up, leaders are better prepared to exploit the opportunities of the new expansion. Greater liquidity will return and demand for equipment will increase. There was no doubt expressed by IFC members or in the many business council steering committees that while the future will be different, it will be great.

For more information on the Equipment Leasing and Finance Foundation, visit the website, www.leasefoundation.org.

EQUIPMENT LEASING AND FINANCE FOUNDATION

2002 INDUSTRY FUTURE COUNCIL

Mr. John Bella
Director
FITCH,INC.

Mr. Edward A.Dahlka,Jr.
President

Mr. David D'Antonio
Managing Director
DIVERSITY CAPITAL LLC

Mr. Mike Fleming
President
EQUIPMENT LEASING ASSOCIATION

Mr. Eric Hanson
Managing Director
LAZARD FRERES & CO. LLC

Mr. David A.Jackson
SVP
FIFTH THIRD LEASING COMPANY

Mr. Joseph C. Lane
President
IBM GLOBAL FINANCING
ELA Chairman

Mr. Charles Lee
Director, Sales & Marketing
FLEET CAPITAL LEASING

Mr. Robert A.Lever
Managing Director, Financial Services
JLG INDUSTRIES,INC.

Mr. Allan Levine
EVP
MADISON CAPITAL,LLC dba HARBOR EQUIPMENT LEASING

Mr. Kenneth E.Lindholm
Managing Director, Capital Markets
GE CAPITAL MARKETS SERVICES, INC.

Mr. John McCue, III
President & Chairman of the Board
MCCUE SYSTEMS,INC.

Mr. Paul J. Menzel,CLP
SVP & General Manager, Leasing Division
SANTA BARBARA BANK & TRUST

Mr. Richard Remiker
President & COO
KEY EQUIPMENT FINANCE

Mr. Paul Sinsheimer
President,Chairman & CEO
FINANCIAL FEDERAL CORPORATION

Mr. Rich Tambor
SVP and General Manager
AMERICAN EXPRESS BUSINESS FINANCE CORPORATION

Mr. Lou Vigliotti
Executive Vice President
LENDX,INC.

Mr. Thomas C. Wajnert
Chairman
THE ALTA GROUP
Equipment Leasing and Finance Foundation Chairman

Mr. Robert Young
VP, Sr. Credit Officer
MOODY'S INVESTORS SERVICE

Mr. William Zadrozny
President & CEO
SIEMENS FINANCIAL SERVICES, INC.