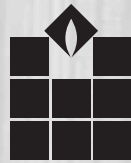


2006 *State of the Industry Report*



Equipment Leasing &
Finance Foundation

Your Eye On The Future



Equipment Leasing & Finance Foundation

Your Eye On The Future

The *premier* provider of industry research.

The Equipment Leasing and Finance Foundation is the only non-profit organization dedicated to providing future oriented research about the equipment lease and financing industry.

The Foundation accomplishes its mission through development of studies and reports identifying critical issues impacting the industry.

All products developed by the Foundation are donor supported. Contributions to the Foundation are tax deductible. Corporate and individual contributions are encouraged.

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*The Equipment Leasing and Finance Foundation
wishes to express appreciation to the following company
for providing the sponsorship to support development
of the
2006 State of the Industry Report:*





State of the Industry Report ²⁰⁰⁶

Prepared by:

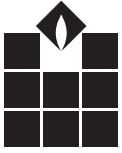
FINANCIAL INSTITUTIONS CONSULTING, INC.

October 2006

State of the Industry Report

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Equipment Leasing & Finance Foundation

Your Eye On The Future

October, 2006

Dear Equipment Lease Finance Experts,

I am pleased to provide you with this copy of the Equipment Leasing & Finance Foundation's 2006 State of the Industry Report. I'm certain you'll agree that this future-focused Report is an invaluable strategic planning tool.

The Report is the product of an exhaustive review and analysis of leasing industry information sources, including ELA's 2006 Survey of Industry Activity, government data, independent research and interviews with key executives in all the major industry segments. It provides a comprehensive portrait of the leasing and finance industry in the near term.

The Report paints a picture of a changing industry, with many strengths and weaknesses. Lessors have strengthened their risk management practices and credit is good, but profit margins are flat or eroding. The lease continues to be an excellent product, even as companies increasingly view themselves as "solution providers" offering a variety of financing alternatives.

In short, our industry is faced with myriad opportunities and challenges. That's why the Equipment Leasing & Finance Foundation and its future-oriented research are so important. All the Foundation's reports, along with the semi-annual *Journal of Equipment Lease Finance* are designed to help you navigate through uncertain times, to be able to anticipate the direction of the industry's markets, products and processes.

And nothing the Foundation does would be possible without your generous support. The Foundation is funded entirely by individuals and companies within the leasing and finance industry, those who—like you—understand that their donations are an investment in the industry and in their own businesses.

As you read and use this Report, I hope you'll keep in mind that your contribution helped to create it, and that your continued generosity will help the Foundation provide you with a glimpse into the future, long into the future. Please visit the Foundation's website at www.leasefoundation.org for more information on our products and mission.

Sincerely,

Joseph C. Lane
Chairman, Equipment Leasing & Finance Foundation

PREFACE

The Equipment Leasing and Finance Foundation (the Foundation) selected Financial Institutions Consulting, Inc. (FIC) to prepare its State of the Industry Report. The mission of the Foundation centers on evaluating future trends and their impact on the leasing industry. The Foundation and FIC have designed this report to analyze and interpret the performance of the industry based on responses to the Equipment Leasing Association's (ELA) 2006 Survey of Industry Activity (the Survey). Using this and other information, we project and discuss future implications for the industry.

Founded in 1995, FIC is a management consulting firm that focuses on developing fact-based strategic and tactical solutions for its bank and non-bank financial services clients. Much of FIC's work centers on issues related to increasing growth and productivity. Beyond commercial finance and leasing, FIC's areas of segment expertise include the middle market, small business segments, and wealth management. While FIC is U.S. based and focused, it has completed projects in close to 20 other countries, indicative of the competitiveness of the industry worldwide.

The FIC methodology for this analysis incorporates statistical data, past client experience, and in-depth personal interviews. The Survey reflects fiscal year-end 2005 performance and, therefore, does not present a fully accurate picture of the industry today. In addition, as discussed later in this monograph, the distinction between leasing (specifically) and equipment finance (generally) continues to diminish. Of the new business that Survey respondents generated in 2005, over half was booked through non-leasing products (conditional sales agreements and term loans). As a result, throughout this Report, the terms leasing and lessor typically refer more broadly to equipment finance and its providers.

Interviewees

In preparing this report, both FIC and the Foundation wanted to take advantage of the industry's valuable human capital. Therefore, in addition to presenting data from the Survey, the report includes the insights and perspectives of industry executives. FIC conducted in-depth interviews with 14 senior man-

agers, representing a cross-section of lessor types, ticket sizes, and industry vendors.

These interviews focused less on current performance and more on obtaining the experts qualitative assessments of key issues facing the industry as well as on identifying trends and issues that may challenge the industry going forward. The insiders who shared their insights include:

Kent Adams – *Caterpillar Financial Services Corporation*

John Barry – *US Bancorp Equipment Finance, Inc.*

Doug Bowers – *Bank of America*

Crit DeMent – *LEAF Financial Corporation*

Curt Glenn – *GATX Corporation*

John Heist – *CCA Financial, Inc.*

Mike Humphreys – *Microsoft Capital*

Paul Larkins – *Key Equipment Finance*

Jim McGrane – *US Express Leasing, Inc.*

John McQueen – *Wells Fargo Equipment Finance, Inc.*

Paul Menzel – *Pacific Capital Bank*

Debbie Monosson – *Boston Financial and Equity Corporation*

Ken Pell – *CNH Capital, Inc.*

Paul Uszток – *Great American Leasing Corporation*

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.

Lessor and Segment Types

The lessor types analyzed in this report fall into three categories: Banks (either separately-operating subsidiary or integrated), Captives, and Independent, Financial Services lessors.

We think it is important to clarify the definitions of these various lessor types:

Bank lessors often combine leasing activities with other bank functions. They use internal funding sources and operate under the jurisdiction of the Comptroller of the Currency and/or the FDIC. They may be integrated with the bank or organized as a

separate entity within the bank holding company.

Captive lessors operate as subsidiaries of dealers or manufacturing companies. At least 60 percent of the lease portfolio consists of products produced by its parent and/or affiliates. They may also finance other companies' products.

Independent, Financial Services lessors are usually finance companies offering leases directly to businesses and are not affiliated with any particular manufacturer or dealer. Alternatively, an Independent may also operate as 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.

The Survey captures four leasing market segments: micro-ticket (\$0-\$25,000), small-ticket (\$25,000-\$250,000), middle-ticket (\$250,000-\$5 million), and large-ticket (over \$5 million). New this year, the Survey also presents data by business model, based on each respondent's primary origination channel, defined as the channel through which the respondent generated at least 60 percent of its business. The four business models presented are: Direct, Vendor or Captive, Third-Party, and Mixed. Lessors operating with a Mixed business model generate volume through a variety of channels, no one of which represents greater than 60 percent of its total volume. While no identifiable trends emerge from the first year of this data, next year's Report will incorporate an analysis of trends by business model.

State of the Industry Report: Primary Focus and Sidebars

We begin this report with an overview of the leasing industry, including an estimate of the size of the equipment leasing market and an analysis of the dynamics impacting industry drivers and related implications.

Following the industry overview, we present an analysis of the Survey of Industry Activity. This discussion highlights a number of important areas, including: new business origination, profitability and funding, credit quality, and operations. In addition, our analysis discusses current performance, ongoing

challenges, and potential opportunities by lessor type and market segment.

In this year's Report, we present sidebar analyses of some of the critical issues impacting the industry and offer our perspective on potential opportunities arising from these issues. We title these sidebars:

Beyond Stealing Share – Many lessors report growth goals that are often double or even triple the growth rate of the industry. We asked lessors if there are opportunities for growth that go beyond the seemingly self-destructive battle for market share

Can Small Lessors Compete in a Global Economy? – This year's Industry Future Council (IFC) Report focused on the rapidly increasing globalization of the U.S. economy and discussed the importance of lessors being able to satisfy the offshore equipment finance needs of their existing U.S.-based customers. In this sidebar, we assess the importance of developing international capabilities as well as the practical issues involved in doing so. This capability may be important to lessors small and large

Accessing the Customer: The Increasing Importance of Vendor Finance – In 2005, over a quarter of all new business was generated through vendor programs. Lessors are increasingly focusing on developing financing programs with vendors and smaller manufacturers, filling a market need, and gaining an advantage over competitors

As strategy consultants to the leaders in the financial services industry, throughout this Report we offer our perspective on how the critical issues identified will impact the leasing industry. Where possible, we provide insights into how best practice players are reacting and what lessors can do to create opportunities in the market today.

Financial Institutions Consulting

Charles B. Wendel, President

Matthew L. Harvey, Senior Engagement Manager

EXECUTIVE SUMMARY

The most recent full year numbers for the leasing industry were highly positive with higher volumes expected to carry over into 2006 and beyond. However, a number of fundamental challenges exist as the industry continues its transition to providing more complete equipment finance solutions rather than lease product sales and the competitive environment further intensifies.

New business volume improved significantly in 2005. New business volume improved across all lessor types and transaction segments. Survey respondents reported a 10.3 percent increase in new business volume in 2005. Our interviews with leasing executives as well as our review of available quarterly data indicate that volume continued to improve through the second quarter of 2006. Further, most economists anticipate continued growth in capital expenditures through 2007.

The industry is continuing its transition from leasing to equipment finance. In this year's Survey, respondents reported booking nearly two-thirds of new volume through non-lease financial products. This is a continuation of a paradigm shift away from leasing as a standalone product and toward the reality that lessors can reposition themselves as full-service equipment finance providers.

Capital appears plentiful. As we saw last year, the industry benefits from an abundance of low-cost capital resulting from financing by venture and private equity firms, combined with a renewed expansion of the capital markets and an increase in banks' willingness to lend to the industry. However, many lessors now believe that too much capital is chasing too few deals. In turn, this excess of capital is contributing to the industry's pricing pressures.

Margin compression worsened. Due to intense competition and an overabundance of capital in the market, lessors have been unable to increase pricing enough

to compensate for their increased cost of funds. As a result, pre-tax spreads declined sharply and, although both net income and ROE improved, 2005's increase in net profit was significantly less than in previous years.

Niche focus emphasized. Some lessors continue to occupy niche markets that allow them to increase pricing and improve profitability. While the types of niches vary (equipment type, end-user industry segment, customer credit grade, etc.), the message from these players was similar: employ a targeted approach, develop an expertise, and be ready to move if the market changes.

Banks command a competitive advantage. Despite losing their cost of funds advantage, largely due to Basel II requirements, Banks commanded the largest share of the market again this year. As we discuss throughout this Report, Banks are in an excellent position to take advantage of the industry's transition from leasing to equipment finance. In addition, Banks are increasingly leveraging internal referrals from their commercial banking divisions.

In the coming year, economic growth and the expansion of the industry's focus to include all types of equipment finance will present lessors with tremendous opportunities for profitable growth. That said, individual companies will continue to face challenges as they strive to improve margins and differentiate themselves from the competition. Increasingly, across financial services, competitors must institutionalize their ability to identify and adapt to market shifts. Virtually all industry analysts and observers expect the pace of change to intensify in the next few years. The best performers will exploit their ability to anticipate and adapt to these changes quickly.

LEASING INDUSTRY OVERVIEW

Driven by an increase in Business Fixed Investment in equipment (BFI), the leasing industry grew for the second consecutive year. And, based on second quarter 2006 Gross Domestic Product (GDP) results and economic forecasts for 2007, growth should continue through next year. However, despite promising economic forecasts, the industry faces a number of challenges in the near-term, including accounting and regulatory changes, an intensely competitive environment, and a bruised public image.

Economic Conditions

Economic growth in general and growth in BFI specifically drive the demand for equipment finance. In its May 2006 Outlook, the National Association for Business Economics (NABE) projects that BFI will grow by 8.3 percent through 2006 and 6.5 percent in 2007¹, indicating continuing growth for the industry. In addition, the NABE and other sources project that both stable interest rates and core inflation will exist as the likely scenario through the end of 2007.

In its second quarter 2006 CEO Economic Outlook Survey, the Business Roundtable, an association of 160 chief executive officers of many of the country's largest corporations, reports that 48 percent of the chief executives expect to increase capital spending over the next six months and an additional 48 percent expect capital spending to remain at present levels. Only three percent expect to reduce capital spending².

Additional economic forecasts that may impact the industry include:

- *Declining dollar* – Economists expect that the U.S., as measured by the Federal Reserve's trade-weighted broad dollar index, will weaken through the remainder of this year (from 98.3 to 97.4) as well as through 2007 (to 94.9 by year-end 2007)³. This may result in an increased demand from abroad for U.S. produced goods and an increase in investment in manufacturing equipment

- *Falling housing starts* – As of July 2006, housing starts fell by 5.1 percent year-to-date and by 13.3 percent over the same period last year⁴. Most economists anticipate that residential investment will continue to decline in 2007, though estimates vary widely. The decline in residential construction will impact demand for certain types of construction equipment and, given that the construction and real estate industries employ nearly 7 percent of the U.S. workforce⁵, will likely have implications for the overall economy

- *Stabilizing oil prices* – Most economists expect oil prices to stabilize or decline through the end of the year. Nearly half of the economists the NABE surveyed anticipate that oil will trade between \$60-80 per barrel (for West Texas Intermediate) by year-end, compared to \$73 per barrel at the end of August. About twenty percent of the economists forecast oil to fall below \$60 per barrel by year-end. Most of the economists participating in the NABE survey agreed that rising oil prices will slow economic growth, but will not trigger a recession unless prices exceed \$100 per barrel

Market Size

In last year's State of the Industry Report, we estimated that leasing (true leases and lease-like instruments) funded 27-28 percent of the total dollars invested in equipment. While interest rates, increased in 2005 and through the first half of 2006, industry experts do not believe that rates rose significantly enough to impact the demand for leasing as a financing product. As a result of this factor as well as customers' increased demand for simple, transparent products, we estimate that leasing penetration, the percentage of dollars invested in equipment funded by leasing products, remained largely unchanged in 2006.

As shown in Figure 1, revised BFI (excluding software) in 2005 was \$733 billion and the estimated

¹National Association for Business Economics: NABE Outlook, May 2006

²Business Roundtable: Second Quarter 2006 CEO Economic Outlook Survey, June 2006

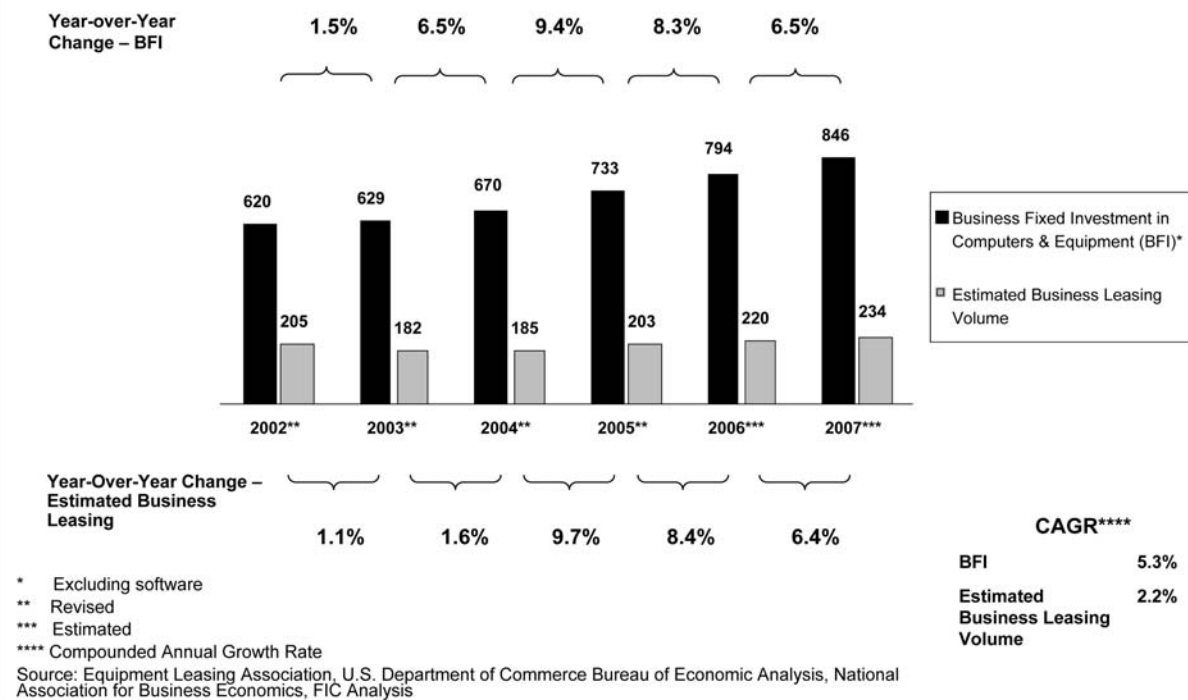
³National Association for Business Economics: NABE Outlook, May 2006

⁴U.S. Department of Housing and Urban Development

⁵U.S. Department of Labor, Bureau of Labor Statistics

Figure 1

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



total leasing volume reached \$203 billion. In 2006, based on economic forecasts, BFI (excluding software) will increase to \$794 billion and total estimated leasing volume will reach \$220 billion. We project 2007 leasing volume to reach approximately \$234 billion, based on projections for BFI. Our estimates assume no change in the percentage of equipment financed by leasing products.

However, as Figure 2 indicates, performance by sector will vary. Based on second quarter 2006 GDP data, investment in non-computer IT equipment (including medical, communications, and office equipment) will increase by nearly 11 percent over 2005 and investment in industrial equipment and computers will increase by 8.8 percent and 8.0 percent, respectively. Investment in transportation and construction equipment as well as in furniture and fixtures will also grow, but at a much slower rate. Only agricultural equipment is expected to show a decline in investment in 2006.

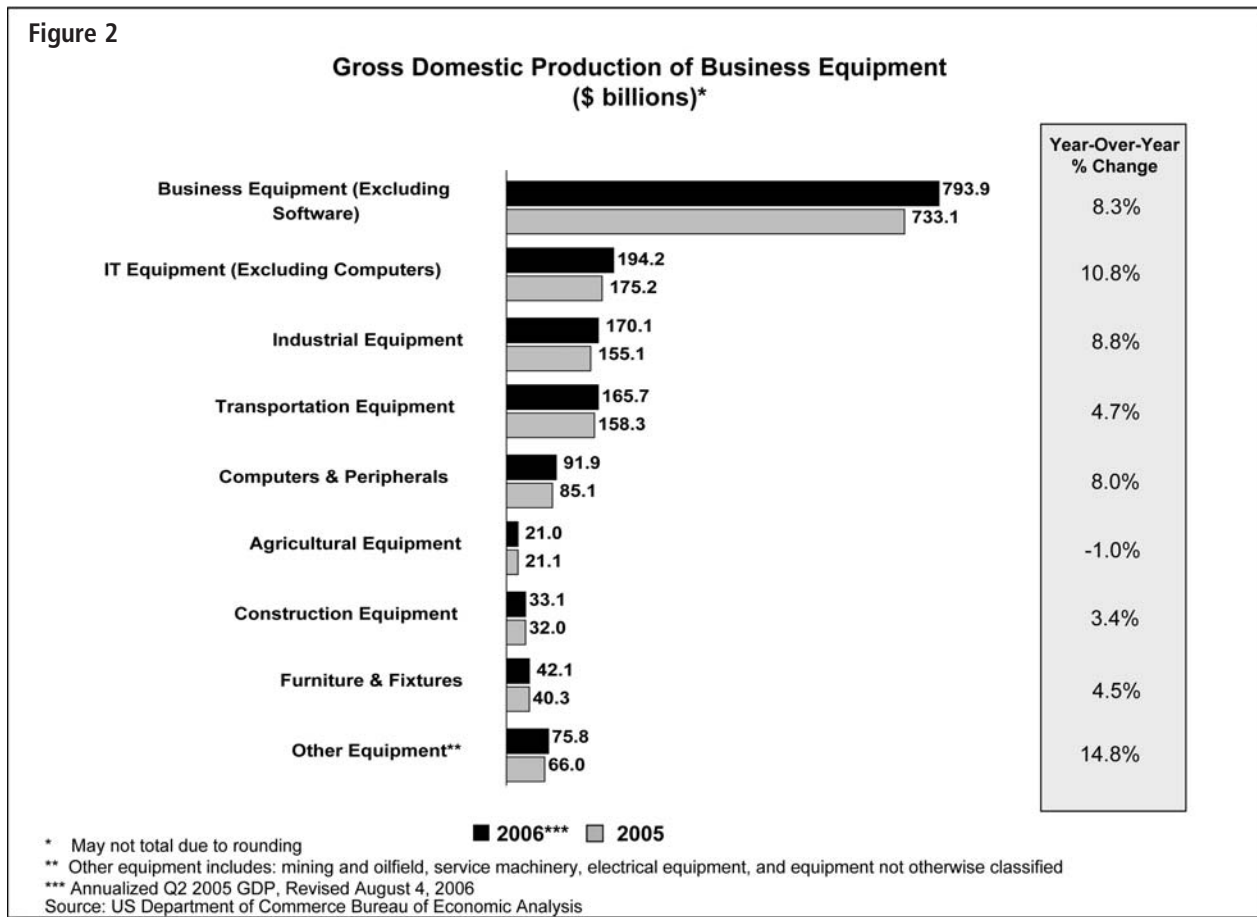
Beyond Stealing Share: Growing the Total Market

As we conducted our interviews with senior executives at some of the industry's leading companies, we asked them to discuss their views concerning how lessors could grow by increasing the total size of the market ("a larger pie") versus battling competitors for a larger share of the existing market ("a larger piece of the same pie"). In addition to expanding overseas, which we discuss below, executives shared their views on growing the market, including expanding the products and services that lessors offer and the types of assets they finance.

Expanding the Definition of the Market

A number of leasing executives believe the "leasing" industry has already grown to include all types of equipment finance. As several managers point out, most "lessors" currently offer a broad array of financial services products beyond leases and generate significant volume through non-leasing product (discussed later in this Report).

Figure 2



A number of managers proposed opportunities to offer products and services that go beyond traditional financial services offers. In their view, an opportunity exists to exploit niche expertise to offer a vertically integrated suite of products. In one disguised example, an executive discussed the potential opportunities resulting from a focus on dental equipment. In this instance, this entails financing both personal as well as commercial financing needs and expanding into areas requiring value added advice such as a focus on mergers and acquisitions and related valuation analysis and financing.

“Because of our current focus on financing dental equipment, we have developed an expertise in assessing the cash flows peculiar to this industry to determine whether the practice generates enough revenue to pay for the equipment. The next logical step is that we also provide financing for the dentist personally, a car loan, credit cards, etc. When a dentist wants to purchase a practice, we are able to provide acquisition

finance. Again, we have the expertise to analyze the practice and evaluate the likelihood that it will generate the required cash to pay the debt.”

“Given that we already evaluate practices to determine if they can support their purchase price, it is reasonable that we should also provide practice valuation services for dentists trying to sell. To further expand on our expertise in dental practices, we are also in a position to provide M&A services for practice acquisition as well as practice management services and consulting.”

Financing Non-Traditional Assets⁶

A handful of interviewees expressed the view that financing non-traditional assets, such as software or other intellectual property, offers a viable opportunity to grow the market. Conversely, however, most interviewees and other experts expressed skepticism of any transaction in which they could not see, touch, and hold the underlying asset.

⁶For more on leasing intellectual property, refer to the 2002 Foundation study “*Intellectual Property Leasing and Its Implications for the Leasing Industry 2002*” available at www.leasefoundation.org/store

Figure 3



*Estimated – based on six-month figures
Source: Asset-Backed Alert

Those who believe in the potential of financing intangibles, including those that are currently engaged in the business, point out that the need to finance these assets may become inevitable. As one executive noted, “Increasingly, the most important products produced in the U.S. are intellectual properties. We cannot just cut ourselves off from a huge chunk of the country’s domestic product.”

Even currently active players in this sphere admit a number of issues must be resolved related to financing intangibles, including:

- How does the lessor determine the value of the collateral?
- What does it repossess in the event of default and what, if anything is the remarket value?
- What is the legal standing of a lien on some types of intellectual property?

One of the more difficult issues to resolve, however, may have more to do with tradition and mindset than with liens and collateral valuation. Banks, investors, and hedge funds, among others, have been profitably financing intellectual property and other non-tradi-

tional assets for decades. It seems unlikely that the equipment finance industry cannot do so as well.

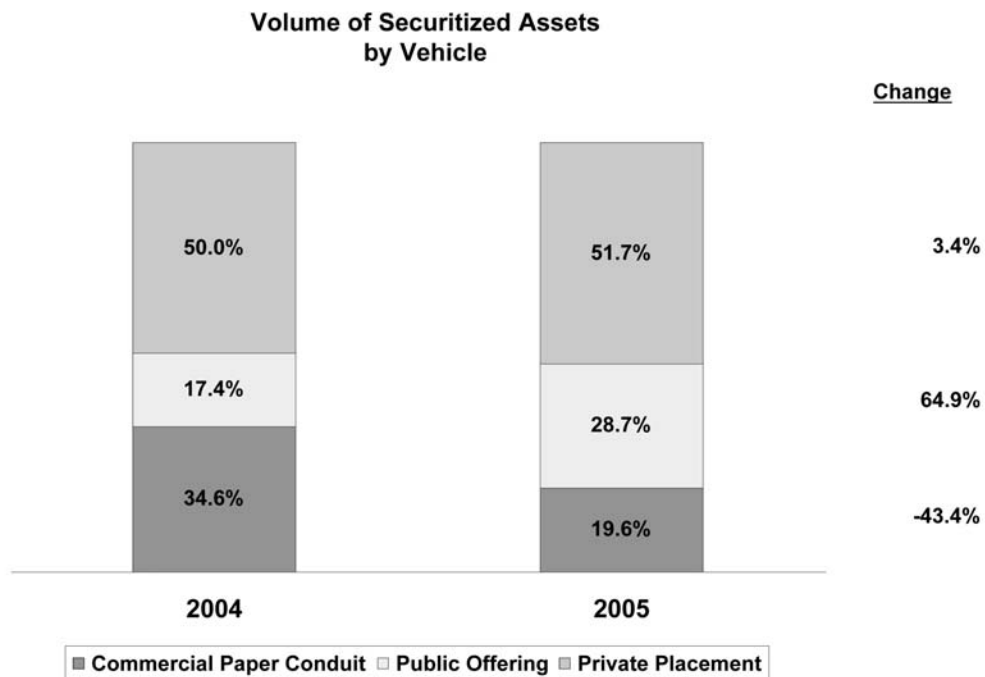
FIC’s Perspective

The 2006 Industry Future Council Report discusses Council members’ concern that leasing may become indistinguishable from other types of equipment finance. However, results from the Survey as well as interviewees’ comments suggest that this transition may have already occurred. As we discuss in more detail later in this Report, successful players already understand that they must be far more than just “lessors” and have adjusted their business models accordingly.

Capital Availability

Capital continued to be readily available in 2005; overly available in the view of many of the executives we interviewed who believe that it continues to exert downward pressure on pricing, preventing yields from increasing as rapidly as the cost of funds. Executives state that bank credit remains an easily obtainable

Figure 4



Source: 2006 ELA Survey of Industry Activity

source of funding and that venture and private equity firms are a growing source of capital for the industry.

As Figure 3 shows, the volume of lease securitizations in 2005 grew by 53 percent over the previous year to \$9.6 billion. Based on the first six months of 2006, securitization volume appears to remain at 2005 levels. This may indicate that the market for lease-backed assets has completely recovered from the 2001-2002 meltdown, when volume dropped by over 55 percent.

Figure 4 shows that, in 2005, Survey respondents continued to rely on private placement of assets, generating over 50 percent of securitization volume through this structure. However, respondents reported a marked shift away from commercial paper conduits to public offerings of securitization deals. Commercial paper conduit volume declined by 43 percent in 2005 over 2004, and the volume of deals placed through public offering increased by 64 percent over the same period.

Overall, given the expected economic growth, increased investment in machinery and equipment, and the continued availability of funding, and absent

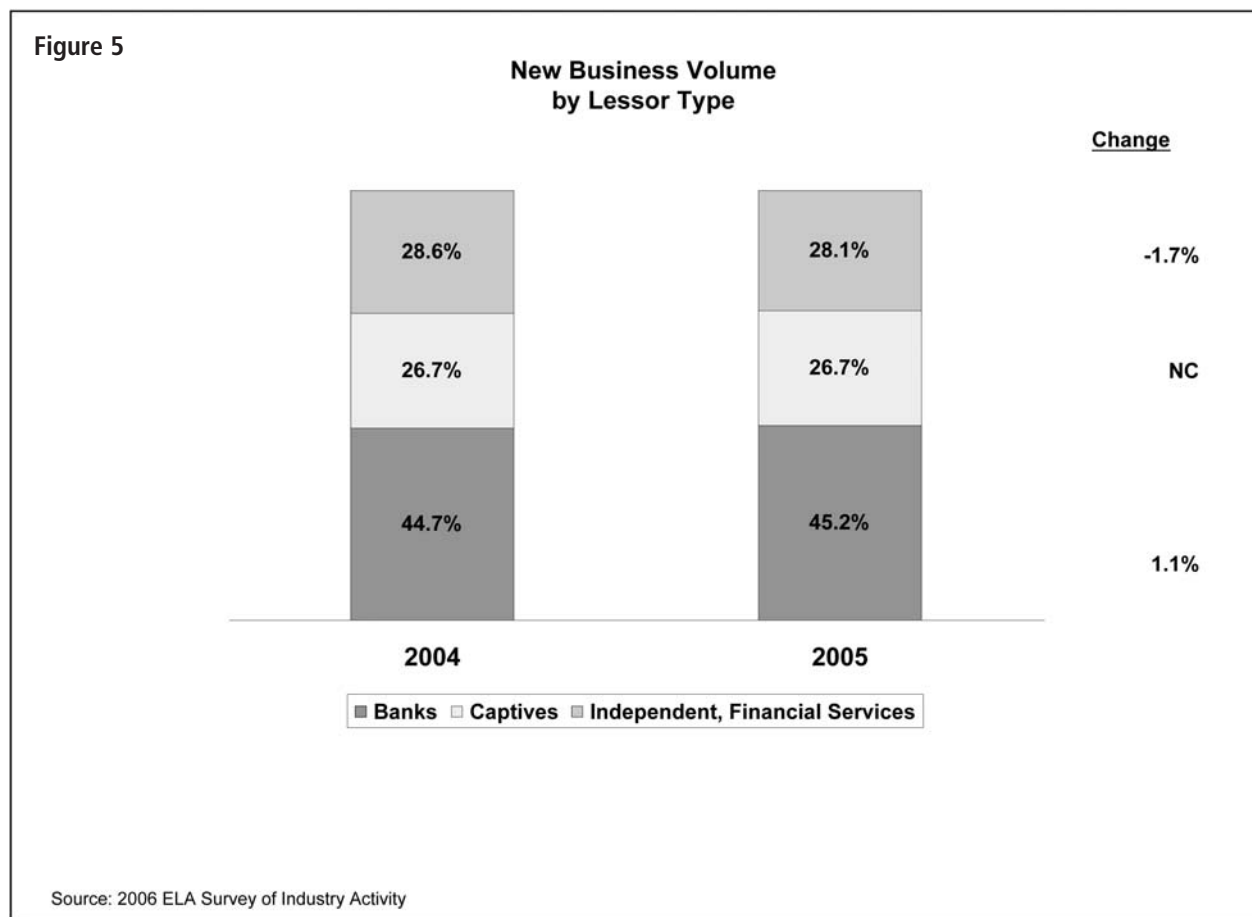
any significant external shocks, solid growth in the equipment finance industry should continue through 2007.

Accounting and Regulatory Issues

As we discussed in last year's Report, beginning in the 2004-2005 time frame, a number of regulatory and accounting changes impacted the industry. Among the changes:

- Provisions in Sarbanes-Oxley mandated that public companies increase the transparency with which they report lease obligations, essentially requiring that leases be reported as debt
- Changes in the U.S. tax code sharply reduced or eliminated the economic attractiveness of many types of cross-border and lease-back transactions
- Implementation of Basel II reduced the economic viability of many large-ticket leveraged deals by requiring that as banks calculate the amount of risk-adjusted capital they must hold, they include their potential loss if the lessee defaults

This year, interviewees discussed the impact of



Sarbanes-Oxley in terms of the economic cost of compliance. In the words of one Captive executive, “The cost to purchase, integrate, and test the reporting system alone cost us millions. That does not even include the cost of the additional people we hired to ensure compliance or the time we spent rewriting all of our processes and procedures so that they meet SOX requirements.”

Although industry executives see no major new accounting, regulatory, or legislative issues on the horizon, a number of managers believe that one perennially discussed issue may become an imminent factor: changes in the lease accounting standard.

Currently, the Financial Accounting Standards Board (FASB) is engaged in a multi-year project converging U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS). The issue worrying some leasing executives relates to the FASB and IASB defining leases as either operating or capital based on the substance, or intent, of the transaction rather than on its form; as is GAAP’s approach. Under a proposed change in the current standard, many of the transactions that lessors current-

ly are able to book as operating leases will be required to be recognized as capital leases. Lessees will no longer be able to deduct lease payments as rent but will instead be required to record the asset and corresponding lease on the balance sheet and the current year deduction will be limited to the effective interest expense and the appropriate depreciation based on the expected life of the asset.

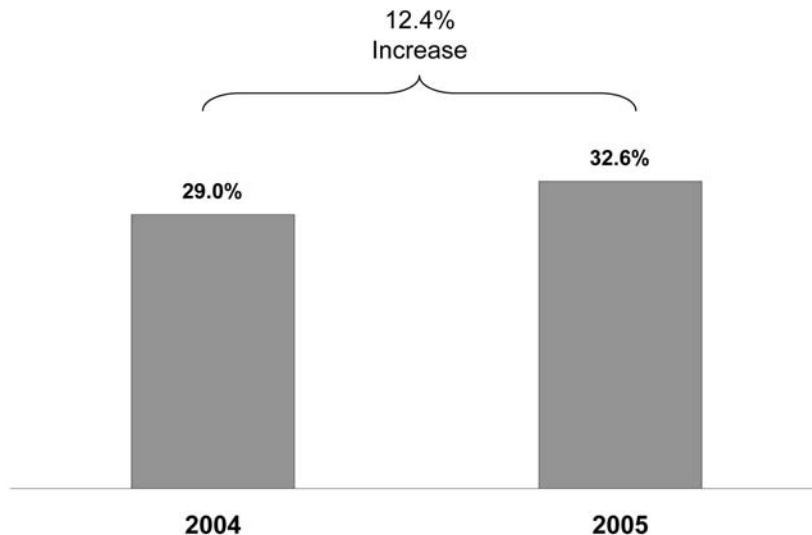
Some interviewees believe that these changes will have a significant negative impact on their business. Other executives disagree, pointing out that a significant amount of their current activity is already booked as loans and on-balance sheet leases.

The Competitive Environment

The competitive environment continues to exhibit the traits of a maturing industry. Relatively little product differentiation exists and, given that the Internet affords customers near perfect information, players compete primarily on price and, to some degree, convenience. Players grow by stealing market share from competitors versus growing new markets. However, changes in market share appear to occur only between

Figure 6

Bank New Business Volume from Internal Referrals
Percent of Total



Source: 2006 ELA Survey of Industry Activity

competitors of the same lessor type. As Figure 5 shows, market share by type of lessor remained virtually unchanged from the previous year, indicating that players may be optimizing the competitive advantages inherent to each type of lessor.

Banks

Banks' competitive advantage in the equipment leasing and finance industry results primarily from their expertise in assessing risk and their ability to leverage the commercial bank for origination. As discussed later, at least in the past year, funding cost no longer provided a significant competitive advantage to banks.

Bank lessors typically operate much like a commercial bank, assessing deals primarily based on the borrower's (lessee) cash flow, that is, their ability to repay the loan, with little consideration of the underlying value of the equipment. Many banks take a very low residual position, typically less than 10 percent. As one bank executive stated, "The last thing we want is to take back the equipment. What are we going to do with it, put it in the parking lot?" Bank-owned lessors are, in affect, lending money. And, as one executive

noted, "No one has more experience lending money than banks. We have been doing it for hundreds of years."

Bank-owned lessors' second significant competitive advantage rests on their access to a pool of customers about which they have a great deal of information and who are already inclined to do business with the bank, namely the commercial bank's customers. As shown in Figure 6, Banks increased the percentage of new business volume they generated from internal bank clients by over 12 percent over the previous year. Small-ticket transactions comprised five percent and middle-ticket transactions comprised 75 percent of the total new business volume generated from internal clients. Given that few banks participate in the micro-ticket segment on a direct basis (less than one-half of one percent of Bank micro-ticket volume is originated directly), it is likely that large-ticket transactions comprise much of the remaining volume generated from bank clients.

Banks-owned lessors can optimize this advantage by linking closely with the commercial bank and including its products in the overall package of finance solu-

tions that banks offer their customers. Doing so will increase margins, decrease origination costs, and link the customer more tightly to the bank, improving the likelihood of increasing shareholder value. However, significant challenges often prevent the leasing organization from effectively working through the commercial bank. Commercial bankers often do not understand the leasing product, its value to the customer, or its profitability for the bank. Often, individual bankers view leasing as a product that eats up part of the customer's overall credit capacity and for which they receive little compensation or glory.

Some banks, such as Chase, have been successful in overcoming these challenges. Their profitability model allows bankers to understand the profitability of a lease versus a loan for any given deal. Since Chase compensates its bankers based on net growth in relationship profitability, bankers are incented to structure deals based both on what is best for the customer and what generates the most profit for the bank.

While outside observers may view the linkages between a bank-owned leasing company and its commercial banking group as a no-brainer, until recently linkages between the two groups have often been minimal. Most recently, however, bank management's increased focus on cross-sell, wallet share penetration, and relationship profitability has, in many cases, resulted in an institutional push that, in effect, demands internal cooperation. While some leasing executives still maintain an independent stance from their banks, more appreciate the origination opportunity and take advantage of the deal flow common ownership offers.

Captives

Captives continue to enjoy three advantages over other players: their ability to bundle the equipment and financing at point-of-sale, their knowledge of the equipment for calculating residuals, and their asset management capabilities. While most Captives concentrate on financing only their parent's products, a number of Captives have broadened the scope of their operations to include a variety of manufacturers, typically as part of a package to finance a specific project. Most Captives do not expand their scope to become general lessors and respondents to this year's Survey reported directly originating less than five percent of new business volume.

Captives' dominance of the point-of-sale channel

may be under assault by Independents. This year's Survey indicates that Independents generated nearly seven percent of the total volume originated through captive programs. A number of executives of smaller Independents have indicated that they are increasing their focus on creating captive programs for manufacturers that lack either the resources or desire to build in-house capabilities. In addition, manufacturers may be under increasing pressure from shareholders and Wall Street to focus on their core competencies and divest themselves of ancillary businesses, such as customer financing. Others, such as Ford Motors, may sell their finance units in order to raise cash.

In this year's Survey, as in the past, Captives report a much higher credit approval rate versus other lessor types, approving 89 percent of submitted applications (compared with 69 percent for both Banks and Independents). In the view of many leasing executives, Captives' equipment knowledge and asset management capabilities allow them to approve more marginal credits without significantly increasing their risk. As one executive noted, "If a lessee defaults, the Captive is in the best position to grab the equipment, refurbish it, and then sell it through their own network. In all likelihood, they will lose little if anything from that default."

One of the central challenges that Captives face requires them to balance their credit/risk responsibilities with their mission to support and facilitate the sale of their parents' product. To reduce conflicts, few, if any, Captives have any reporting responsibility to the sales organization. According to most executives, conflicts seldom exist and those that do arise are often resolved through internal recourse agreements or other arrangements that protect the Captive's portfolio quality. Another challenge for Captives is to fully integrate the financing with the equipment sale, creating an environment in which it becomes second nature for the equipment sales person to incorporate the financing into his/her quote. Captives that stand out in that regard include Dell and Caterpillar.

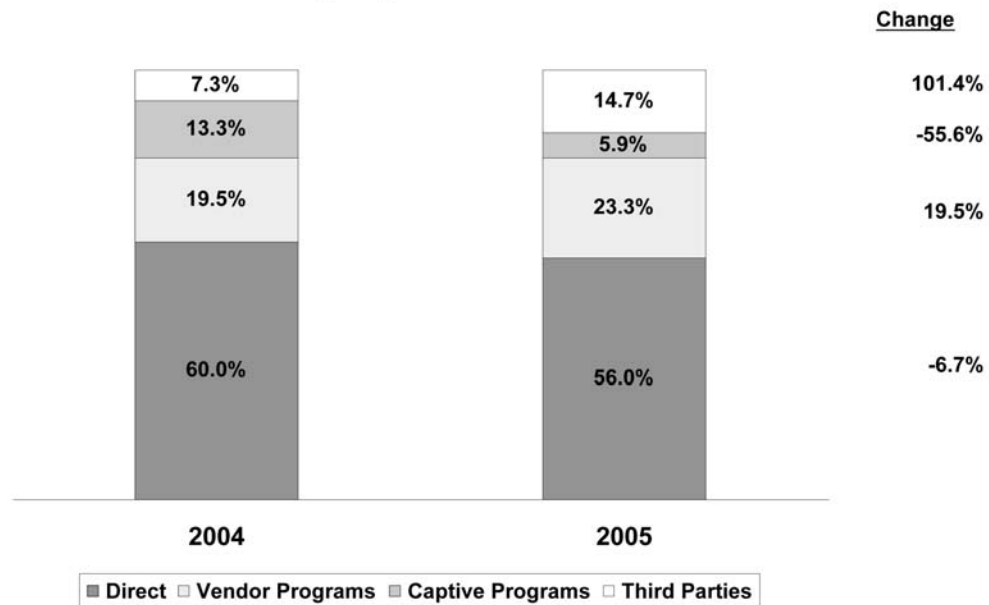
Independent, Financial Services

Independents' competitive advantage includes their flexibility and service. In addition, a number of executives cite their underwriting capabilities as an advantage over Captives and their asset management skills as an advantage over Banks.

Successful Independents understand their competi-

Figure 7

Independent, Financial Services New Business Volume by Origination Channel



Source: 2006 ELA Survey of Industry Activity

tive advantages and create targeted approaches to exploit them. Some compete effectively against Banks by focusing on equipment types and/or credits that Banks typically avoid. By avoiding direct competition with Banks, these Independents are able to earn above average returns while their underwriting and asset management capabilities help to reduce losses.

Independents are also increasingly competing in the point-of-sale channel, providing vendor and captive programs. As Figure 7 indicates, new business volume generated by Independents from vendor programs increased by nearly 20 percent over the previous year. The decline in volume from captive programs largely represents CIT's loss of the Dell program. A number of executives of small Independents indicated that they are increasingly targeting small manufacturers to establish captive or vendor programs. In their view, these manufacturers lack the scale and the capabilities to establish their own captive finance units and may be unattractive to large Independents because of their low volume potential. These executives believe that they can add value for the manufacturer by increasing

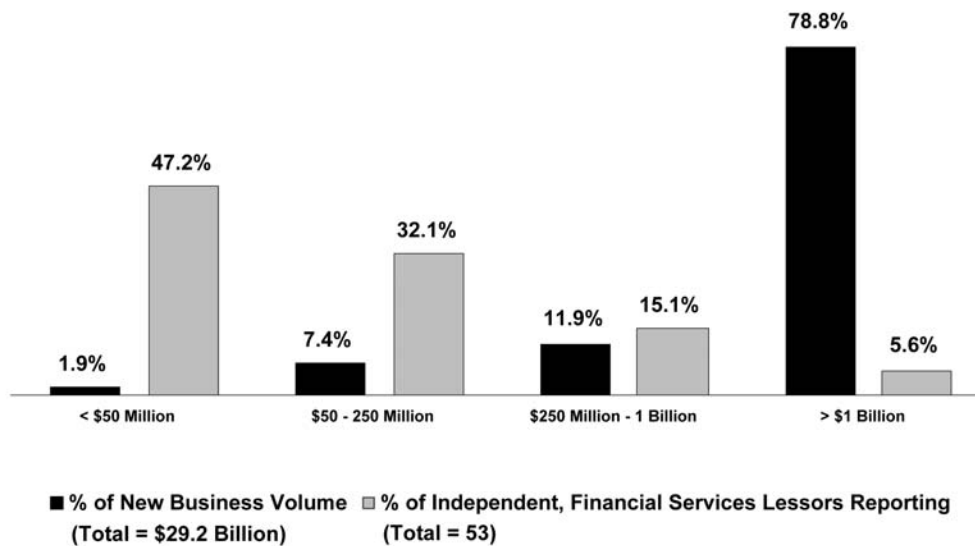
sales while generating an attractive return on their own investment.

Overall, Independents appear to be either minnows or whales. As Figure 8 shows, of the 53 distinct Independents reporting in this year's Survey, nearly half were small, (less than \$50 million in annual volume) and in total, they generated less than two percent of the new business volume reported by Independents. However, the three largest Independents, those generating over \$1 billion in new business volume, generated 79 percent of all new business volume reported by Independents. Most industry experts agree that it has become increasingly difficult for small Independents to become large. Many insiders believe that most of the Independent lessors formed within the past five years have incorporated into their overall strategy a plan to sell upon reaching a certain size.

Continued success for smaller Independents depends on their ability to identify and exploit market niches quickly, reduce origination costs, preserve credit quality, and retain access to funding.

Figure 8

**2005 Independent, Financial Service New Business Volume by Lessor Size
[by Annual Volume]
(\$ billions)**



Source: 2006 ELA Survey of Industry Activity

Can Small Lessors Compete in a Global Economy?

As discussed in this year's Industry Future Council (IFC) Report, one of the "hopes" for the industry requires U.S.-based leasing companies to adopt a global view and develop the capabilities required to meet existing customers' potential offshore equipment finance needs.

In our interviews, we focused on the extent to which lessors perceive the need to develop overseas capabilities and how small lessors, which comprise much of the industry, can operate overseas without a significant investment in brick and mortar.

According to the Department of Commerce's Bureau of Economic Analysis, U.S. companies invested \$27 billion in existing overseas operations in 2005 and an additional \$40 billion to acquire or create offshore subsidiaries⁷. Despite this significant overseas opportunity, most lessors we interviewed did not perceive the need to develop international capabilities.

However, because the opportunity is substantial and

because small companies in particular are at a disadvantage in pursuing this market, it is appropriate to focus on how small lessors can compete in a global economy. In its Report, the IFC suggests two ways that U.S.-based lessors can enter offshore markets: establish a *de novo* physical presence or, partner with an existing company and leverage its in-country capabilities.

Executives agreed that lessors are unlikely to be successful pursuing local business in countries where they do not have a brick and mortar presence. They also agreed that the cost to build a brick and mortar presence outside of the U.S., and perhaps Canada, is prohibitive for all but the largest lessors. As a result, our discussion centered on how small lessors can meet the overseas equipment finance needs of their existing customers and whether partnering with an existing company is a viable option.

Between 2000 and 2005, the Bureau of Economic Analysis reports that U.S. Direct Investment Abroad (USDIA) grew at a compound annual rate of 9.5 per-

⁷U.S. Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad: Country and Cost Detail, July 2006

cent, nearly double the growth rate of the overall economy. Given the rate at which U.S. companies are expanding abroad, an increasing number of lessors will receive inquiries from existing customers that are interested in financing equipment for their overseas operations.

Can small lessors partner with existing local companies and leverage their infrastructure and local expertise to finance offshore equipment for their existing U.S. customers? One Captive, albeit the captive of a very large company, is already doing so. This company's mandate is to finance its parent's product in each of the 170 countries in which the parent operates. To practically and cost efficiently do so, the Captive had to establish partnerships with existing local financial services firms. For each transaction, the Captive provides the funding and the local partner (for example GE Capital, a large multi-national bank, or a local player) provides processing capabilities, customer service, and billing, collections, and other operational functionality.

The executive overseeing global expansion for this Captive lessor acknowledges that there are risks involved, but accepts those risks because this is the only model that allows it to operate in so many countries without a massive investment in local infrastructure.

FIC's Perspective

Given the rate at which U.S. companies are investing overseas, even small lessors are eventually likely to face a customer's request to finance offshore equipment. As an alternative to referring business to competitors with international capabilities or investing directly in local infrastructure, lessors can consider partnering with a local player to provide the required local support. Among the issues to consider:

- Retaining ownership of the customer – The primary concern raised by small lessors we spoke with related to the potential loss of the customer to the larger lessor. As one executive noted, “There would be a tremendous temptation for the large lessor to approach the customer directly and take the entire relationship, including the U.S. business.” While potentially limited by non-compete agreements, some limited risk of losing a part or all of the relationship to the local partner does exist

- Ensuring service levels – Turning any customer-facing activity over to a third-party creates risk and discomfort the lessor. Lessors need to rely on detailed Service Level Agreements in order to ensure the proper level of customer experience

- Maintaining lessor profitability – It is unlikely that a lessor will be able to pass the additional internal costs associated with the overseas transaction through to the customer, particularly given the existence of players that can provide international capabilities at no additional cost to the lessee. Players need to evaluate each deal to determine if the overall relationship generates enough profit to warrant providing the overseas service

The Perception of the Leasing and Finance Industry

In this year's Industry Future Council Report, members discuss a number of issues, which, if unresolved, could have significant negative implications for the industry. In their view, the most pressing issue is the public's negative perception of the leasing industry. As we interviewed senior managers, we asked them to discuss their view on the genesis of the issue, what can be done to resolve it, and who should take the lead.

The Causes

Most interviewees agree that multiple events over a number of years have contributed to the unfortunate public perception that lessors and used-car salesmen are cut from the same cloth. However, several specific “events” stand out:

- Industry practices – When falling interest rates and increased competition cause margins to compress dramatically, many lessors turned to fees, end-of-lease rental, and other means to increase the financial return from each transaction. While all of the fees and additional charges may have been stated in the documentation, they were typically not made clear to the customer. As a result, the total cost of the transaction became significantly higher than the customer, typically a small business owner without benefit of a finance department and legal team to vet the deal, originally expected

- Enron – The fallout from the collapse of Enron included a regulatory focus on a number of the prac-

tices that the company used to inflate profits and hide losses from shareholders, including the use of off-balance sheet Special Purpose Entity (SPE), the entities used by large-ticket lessors in highly structured, and completely legitimate, lease transactions. However, as a result of the ensuing publicity and regulatory and legislative changes, public companies eschewed the use of SPes and any instrument that could be perceived as being other than totally transparent

- **NorVergence** – While the NorVergence scam was not perpetrated by a leasing company and, arguably lessors suffered the greatest economic loss from the scheme, poor public relations and crisis management caused the scandal to be inexorably linked to the industry. As details of the scandal emerged when Sprint began to cancel service to the small businesses that had leased the NorVergence device (the price of which customers were told included unlimited telecom service) lessors continued to demand payment for the now worthless devices. To customers who could no longer reach their NorVergence salesman, the lessor became the face of the fraud, a fact the lessors involved were slow to recognize

In addition to a number of well-publicized events, a nearly continuous flow of news related to scandal, fraud, and deception involving the leasing industry appears in the press. As one executive noted, “We can book 10,000 flawless transactions a day, but if one goes bad, that is the one that will end up on the front page. What we do right does not sell papers, what we do wrong does.”

Based on managers’ comments, the perception issue may impact smaller Independents far more than other lessor types. Bank-owned lessors enjoy the reputation of trust that a bank name typically invokes. As one executive noted, “In the customer’s mind, he/she is not doing business with XYZ Equipment Finance, they are doing business with Bank XYZ. And, people trust banks.” Similarly, for Captives, the reputation of their manufacturing parent overrides the reputation of the leasing industry

The Solution

Virtually everyone we interviewed agreed that, while the problem may be the result of the actions of a few rogue lessors, the solution is the responsibility of the entire industry. Executives discussed a number of

actions, which must be accomplished in concert in order to have a meaning impact. Among their recommendations:

- **Enact a strong Code of Ethics** – Interviewees agreed that the Equipment Leasing Association’s (ELA) Code of Ethics should form the basis of industry conduct. While some managers were aware of the ELA’s activities related to updating and revising its Code, many were not, indicating that industry leaders should place an increased emphasis on communicating the Code

- **Enforce the Code of Ethics** – Without the means or will for enforcement, the ELA’s Code of Ethics will carry little weight. However, most managers agreed that the Association is unlikely to take an aggressive role policing its members, and they further understand that there is little that it can do to regulate the activities of non-members

- **Create an ELA certification program** – One way for the ELA to regulate how its members do business and to mitigate its inability to influence non-members involves the creation of a certification program. Much as Underwriters Laboratories certifies consumer electronics that have met its specifications, the industry might certify lessors that conduct business according to its Code of Ethics and de-certify those that fail to meet its standards.

- **Build the ELA brand** – Lessors agreed that for an ELA certification program to successfully contribute to a positive change in the industry’s image, the Association must create strong brand awareness around itself and the program. A number of managers cited the National Realtor Association’s success at creating an image for its members as businesses of the highest ethical standard. Building and maintaining the brand will require a prolonged and consistent effort on the part of the ELA and its members

- **Promote the positive** – As a number of executives rightfully pointed out, “Bad news sells.” While the industry processes millions of transactions and funds billions of dollars worth of equipment without incident, much of what the public hears about the industry relates only to events that rarely occur. To date, the industry overall has done an insufficient job of getting its story heard in a way that impresses the public. Press releases related to the percentage of railcars or

inter-modal containers financed by the industry will likely be of far less interest to most than stories of how leasing makes the latest diagnostic equipment available to even small rural hospitals

Overall, interviewees agreed that while individual companies must examine their internal practices, it is a central group like the ELA that must take a leading role in the effort to change the industry's image.

The Issues

In some industry leader's views, the fact that the industry's negative image does not impact all lessors equally could be a major impediment to action. They question whether there will be the long-term commitment of time and resources that is required to address this issue given that the members that are footing the largest share of the cost are those that may be the least affected.

FIC's Perspective

Unless there is a strong, focused, and prominent effort by the industry to address the public's concerns,

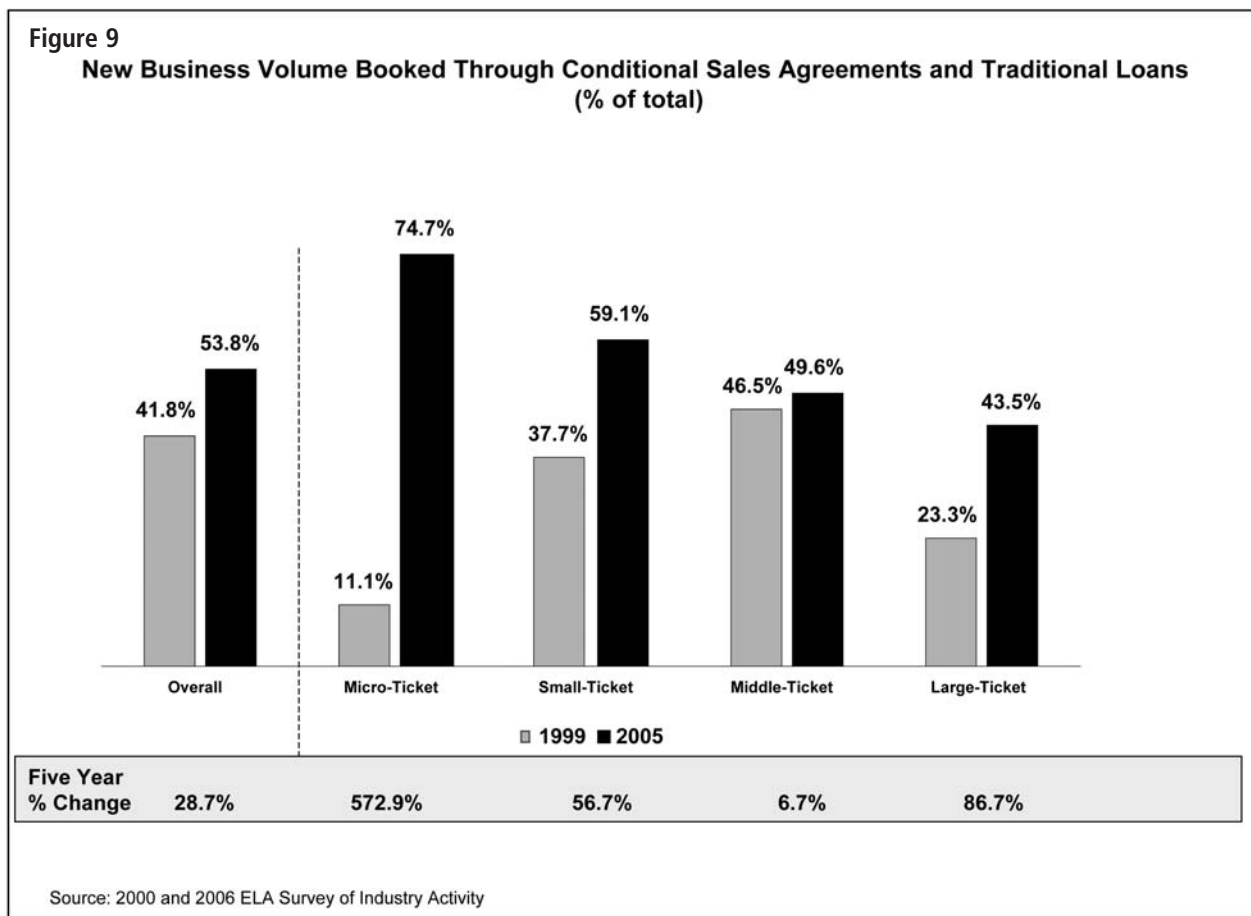
small business owners, fearful of being "taken", may increasingly turn to bank financing and politicians and regulators, seeing the industry as an easy mark with few allies, will attack it for political gain.

For an industry that is seeking to "reinvent" itself, grow its markets, and head off additional regulation, failure to commit fully to addressing its image problem is shortsighted and over the long term could have a devastating impact on the commercial finance industry.

Industry Trends

Over recent years, some of the major trends we have observed include the growth of Bank dominance, the bi-polarization of the Independents, and the increased use of automation. None has the potential to redefine the industry to the same extent as the continuing shift of traditional lessors to provide customers with multi-faceted equipment finance solutions rather than a standalone equipment lease product.

In 2000, Survey respondents reported booking just over 40 percent of total new business volume



through conditional sales agreements and traditional loans (See Figure 9). By 2005, the share of new business booked through these products reached nearly 55 percent, an increase of over 28 percent. By transaction size, the increased prevalence of “non-leasing” products becomes even more striking: a nearly six-fold increase in micro-ticket and an 87 percent increase in large-ticket.

Even as the ELA expands its mission to include both equipment leasing and finance, many lessors, in practice, have already done so. Implications of this continuing trend for the industry, include:

- A leasing specialization may no longer be viable – As customers increasingly expect a variety of product options, players may no longer be able to survive by offering only leasing. Those players lacking the capabilities to expand their product set face possible marginalization and eventual disappearance
- Banks will continue to grow in dominance – The industry’s trend toward equipment lending versus leasing plays to the Bank industry’s primary competitive advantage. As Banks become better at marshalling the financial products and services available from all areas of their organizations, they should dominate the industry. Our view, and the evidence supports this, is that banks are *finally* becoming better at this
- The available market is huge – The industry has limited its potential opportunity by defining its available market as the “leasing customer”. Over the years, our estimates have sized that market at approximately \$200 billion. By including all types of equipment finance, the available market becomes the equipment purchaser and its size jumps to well over \$800 billion

- Players must broaden their focus - Those players that already operate as equipment finance companies versus equipment leasing companies understand that their focus must center on creating a value proposition that differentiates their companies from the competition. They further understand that the competition includes all types of lenders, not just those in the “leasing industry”. In addition, their value proposition must also be strong enough to compel potential customers, even those that might otherwise choose to pay cash, to use that lessor to finance their equipment

To some extent, recognition of this paradigm shift changes little, given that most players have long operated as full-service equipment finance companies. However, accepting that this may indeed be the “new world order” may focus some players to direct their energy toward capturing an increased share of a much larger market than they believed existed.

ANALYSIS OF THE SURVEY OF INDUSTRY ACTIVITY

This year's ELA Survey includes 133 survey responses from 125 companies. Three companies provided separate surveys for their various lines of business.

Each year's Survey asks respondents for current and prior year data. Unless otherwise indicated, data charts comparing two years' data include only those respondents providing information for both years. Since the respondent set varies each year, it is not possible to compare absolute numbers between different years' Survey Reports. However, the Survey Administrator, PricewaterhouseCoopers, analyzed data representing a number of years and determined that the relative data (for example, percentage of new business volume generated by a specific lessor type or percentage of new business originated through a certain channel) is statistically accurate. Therefore, some of our analysis of the Survey relies on relative, not absolute, data.

We have organized our analysis of this year's Survey into the following major components:

- The Overall Industry
- Lessor Profitability
- Market Segment Profitability

The Overall Industry

Overall, Survey respondents reported a strong increase in new business volume in 2005. While pre-tax yields improved slightly, spreads declined sharply as the cost of funds increased more rapidly than pricing. Net income increased slightly over the previous year as did Return on Equity (ROE); Return on Assets (ROA) remained unchanged. Credit quality also improved as charge-offs declined sharply over the previous year. However, delinquencies increased slightly. Operational efficiency improved again this year, as lessors increased volume without increasing staffing.

Our analysis of the overall industry focuses on the following areas:

- New Business Origination
- Profitability and Funding

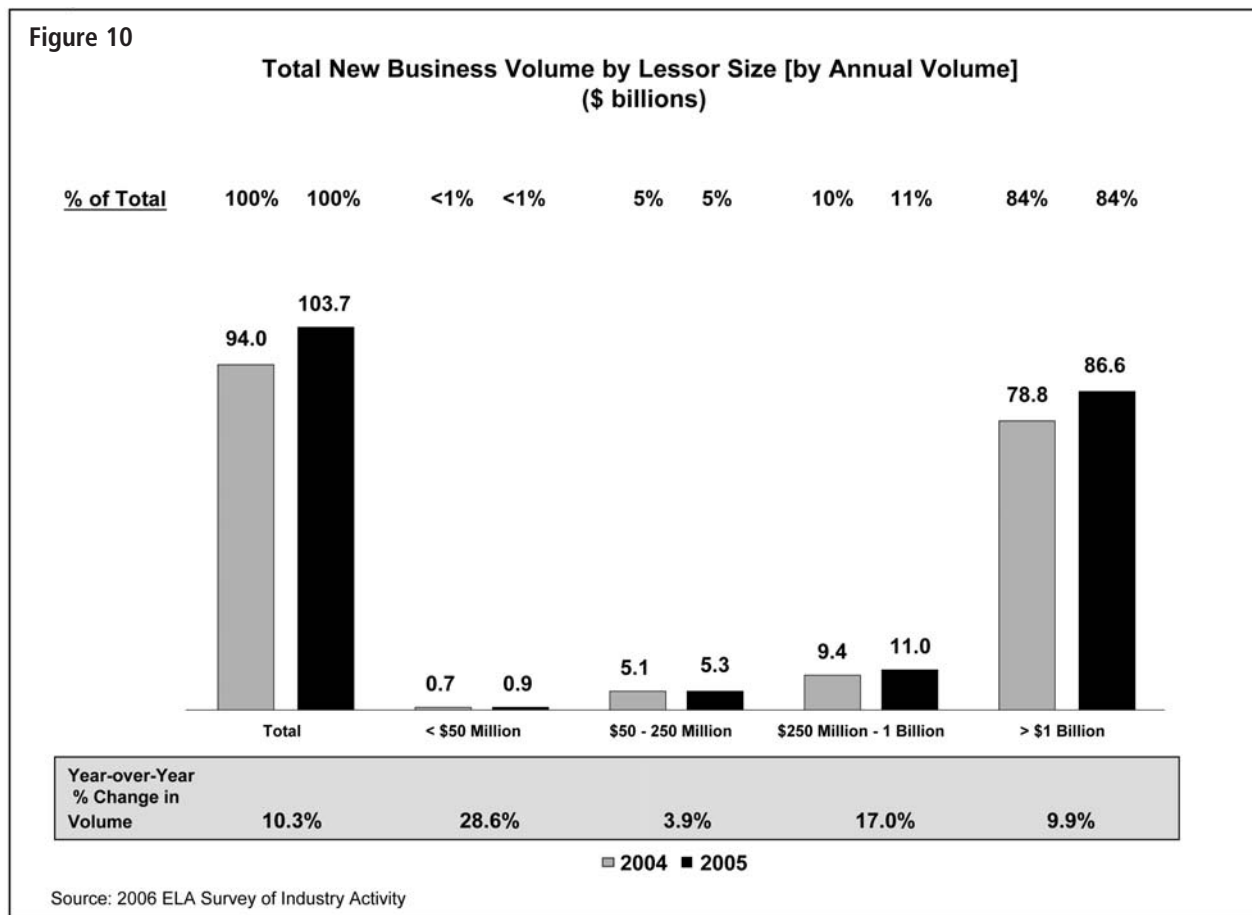
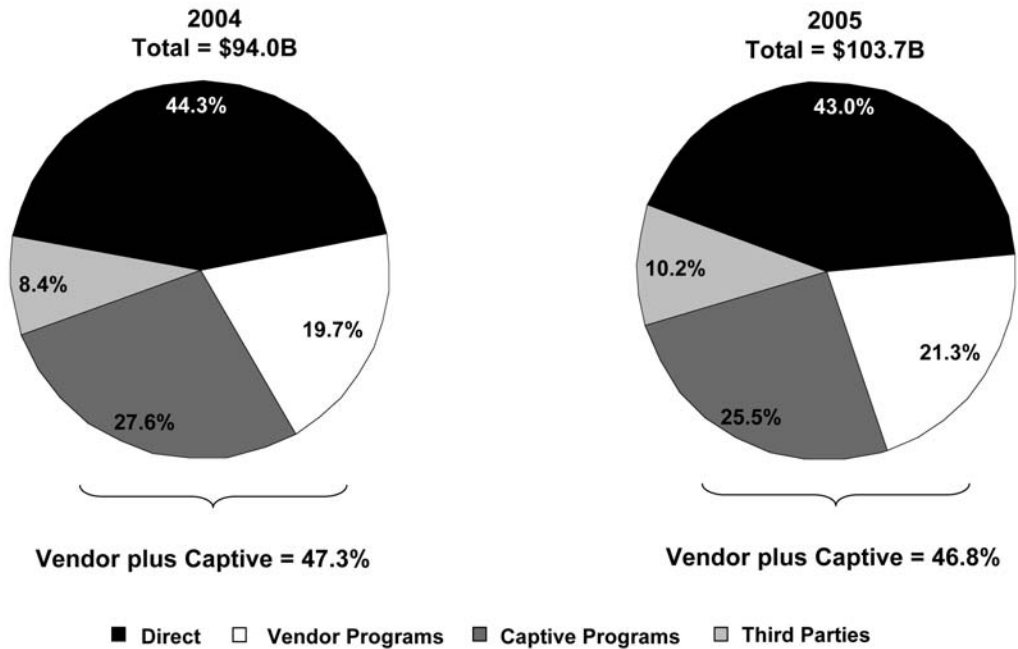


Figure 11

New Business Volume by Origination Channel

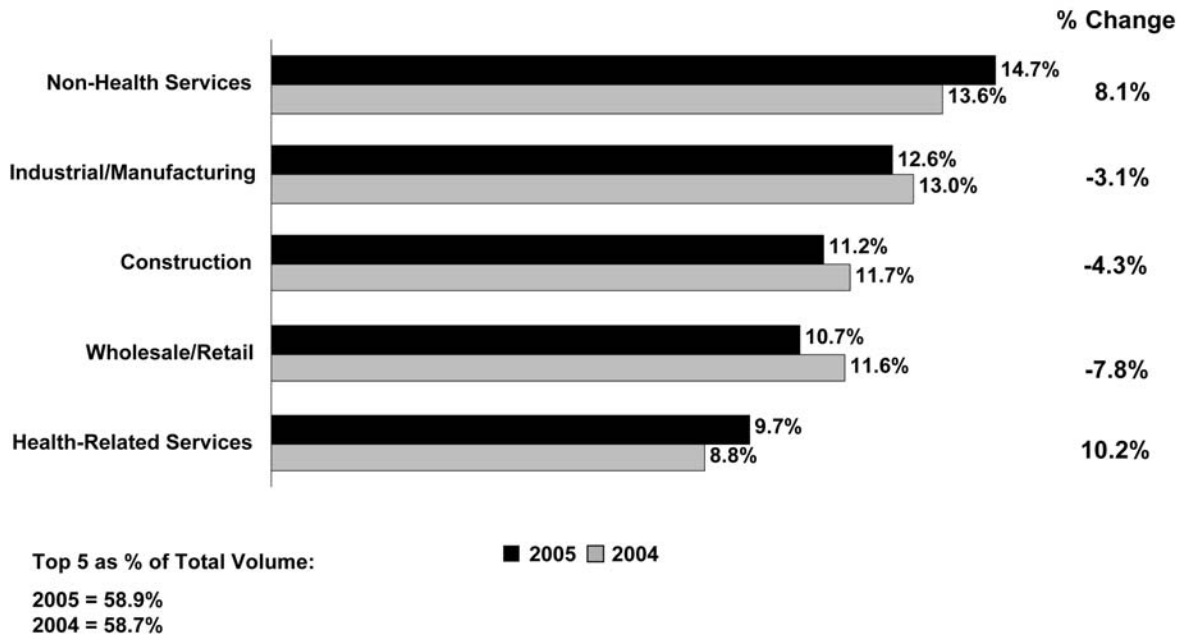


Source: 2006 ELA Survey of Industry Activity

Figure 12

**New Business Volume by End-User Industry
(% distribution over 2 years)**

Top 5 End-User Industries by % of Volume



Note: Trend data is provided only for respondents who reported both years of data
 Source: 2006 ELA Survey of Industry Activity

- Portfolio/Credit Quality
- Operations

New Business Origination

For the second year, respondents reported strong growth in new business volume. As Figure 10 shows, overall volume increased by over 10 percent and the distribution of volume by size of lessor remained unchanged. The smallest lessors, those with annual volume less than \$50 million, experienced significant growth, increasing new business volume by over 28 percent.

As Figure 11 indicates, volume originated indirectly increased slightly over 2004 as lessors increased their reliance on third parties to generate business. Vendor and captive programs continued to be important, generating nearly half lessors' new business volume in both 2005 and 2004.

The top five end-user industries generated nearly 60 percent of new business volume, virtually unchanged from the previous year. However, three of the top five experienced a decline in volume over the previous year. As Figure 12 shows, the volume of equipment sold to the wholesale/retail industry experienced the sharpest decline, 7.8 percent, while the volume of

equipment sold to both the construction and manufacturing industries declined moderately, 4.3 percent and 3.1 percent, respectively. In contrast, the volume of equipment sold to the services industry grew significantly.

As a percentage of total volume, the top five equipment categories grew significantly over 2004 (See Figure 13). A 20 percent decline in construction equipment volume was more than offset by a 291 percent increase in corporate aircraft. Analysts speculate that the decline in construction equipment could be the result of the industry planning for the expected slowdown in new home construction. In addition, new business volume in both medical equipment and trucks and trailers grew versus the previous year.

In March, the General Aviation Manufacturers Association reported that, while 2005 was a record year for the industry, total sales increased by just over 27 percent versus 2004. This indicates that the increase in corporate aircraft volume reported in this year's Survey may be the result of one or two respondents entering that business in 2005 rather than a significant increase in corporate aircraft sales.

The use of tax-oriented and leveraged lease products declined very slightly from 2004. As Figure 14 shows,

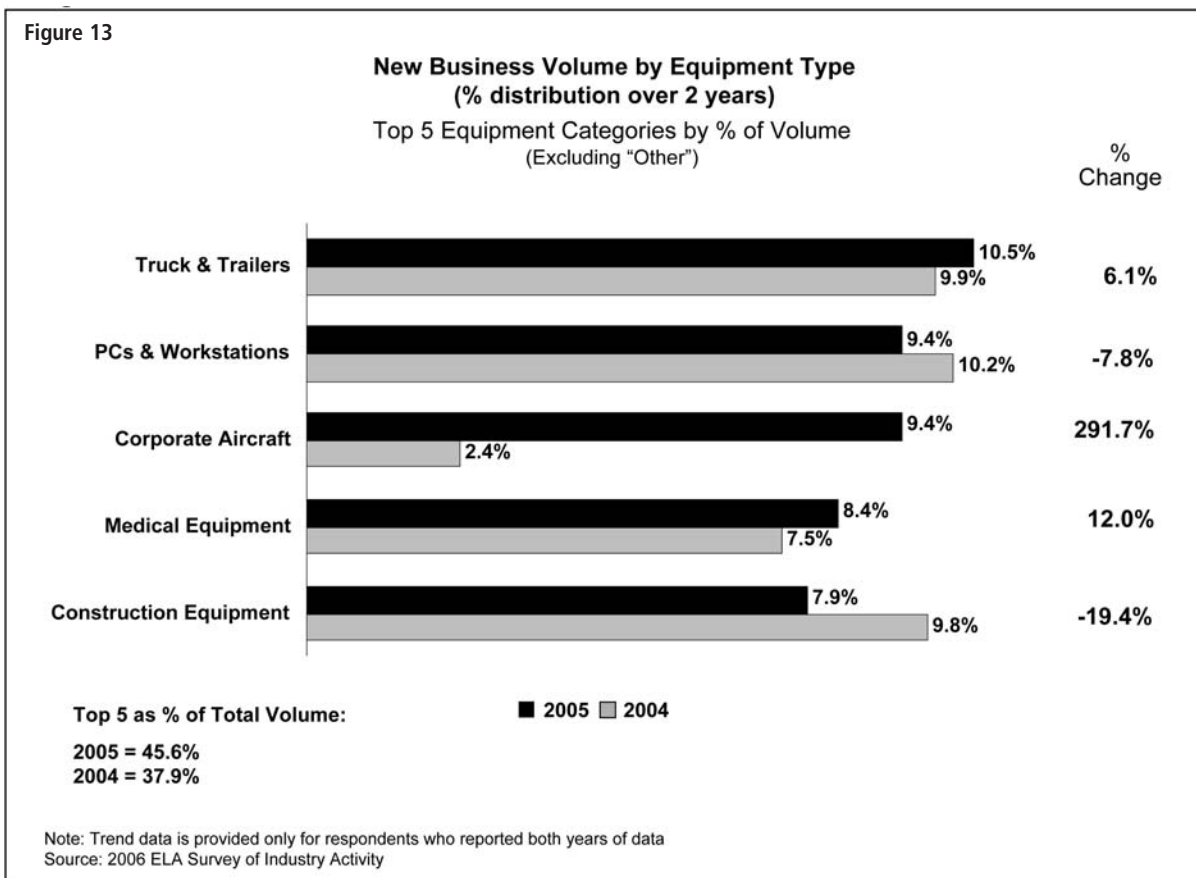


Figure 14

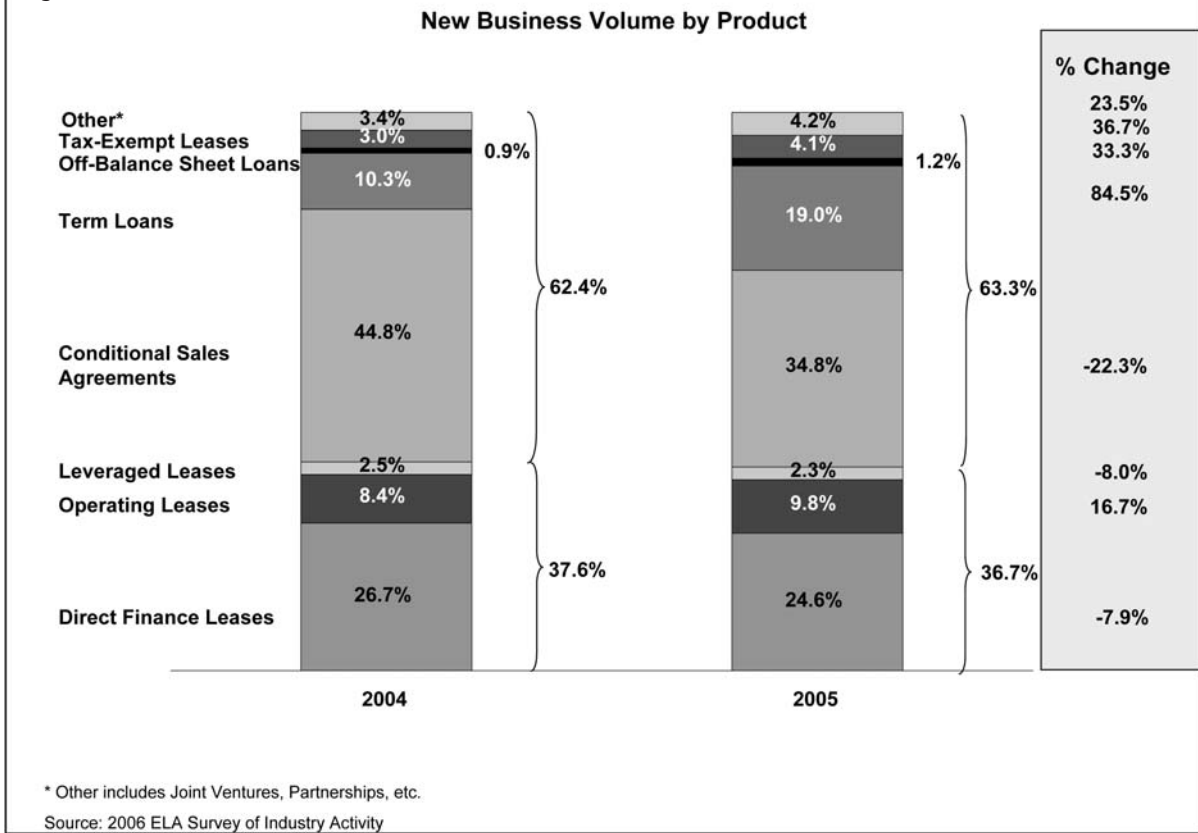


Figure 15

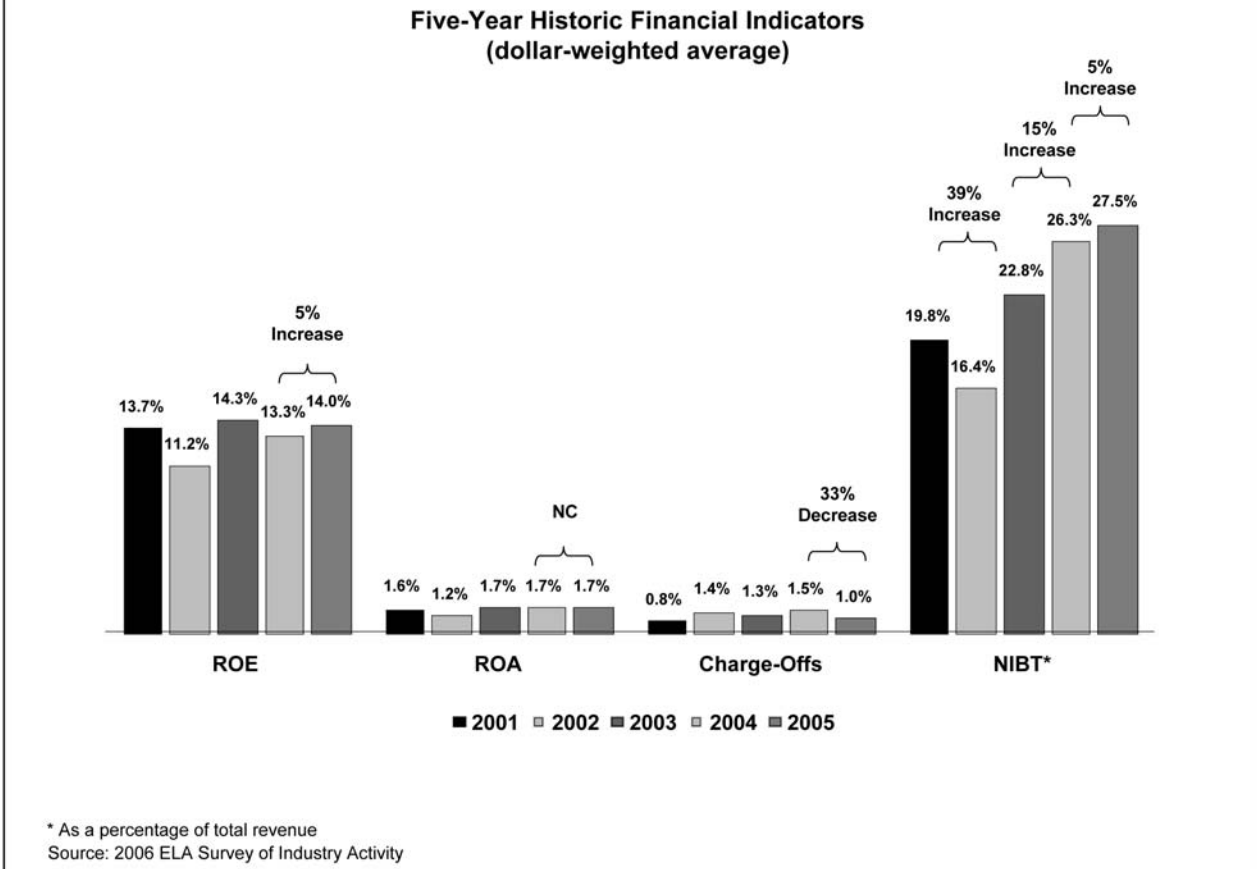
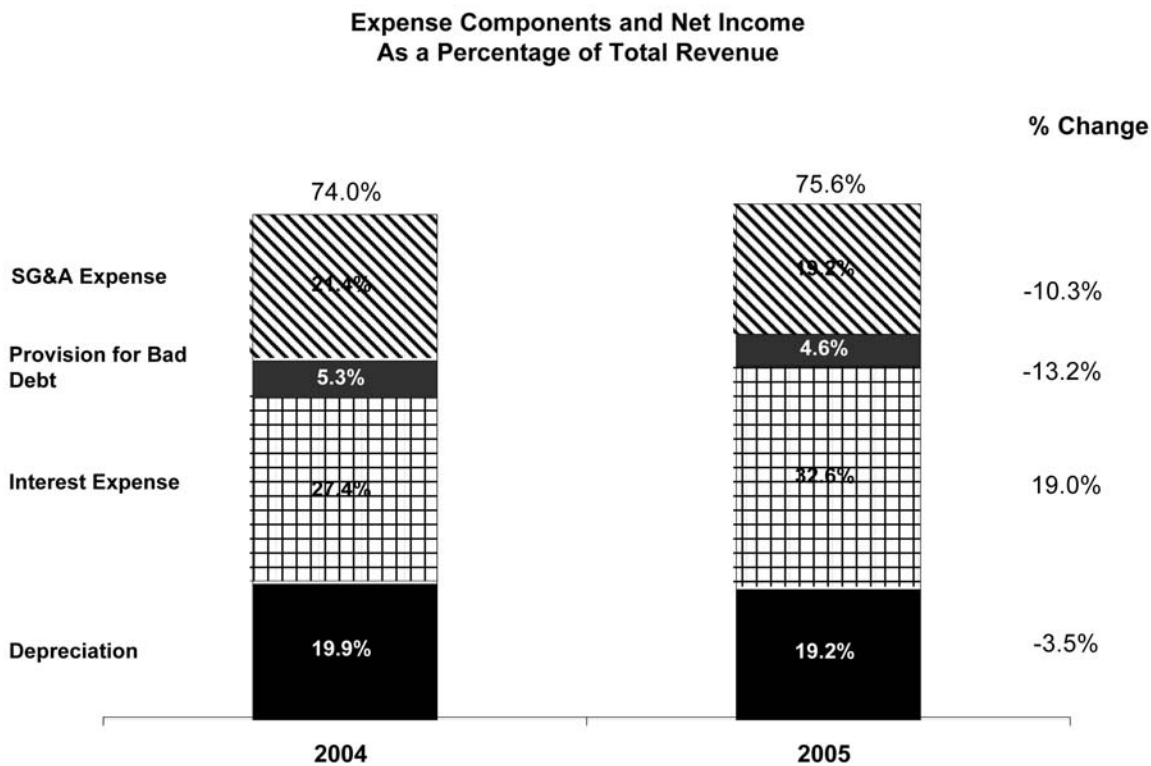
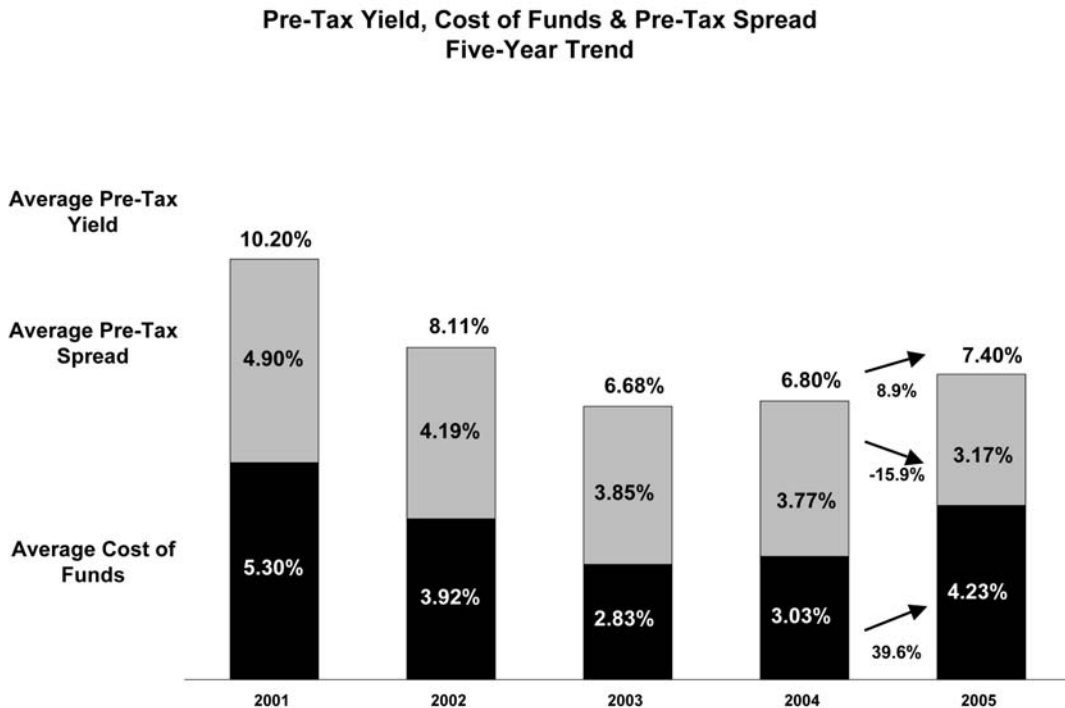


Figure 16



Source: 2006 ELA Survey of Industry Activity

Figure 17



Source: 2006 ELA Survey of Industry Activity

this year's respondents booked 36.7 percent of total new business through those products versus 37.6 percent in 2004. Illustrating the industry's trend toward general equipment finance, the volume booked as term loans grew almost 85 percent over 2004 to comprise nearly 20 percent of total volume.

Industry Perspective and Potential Implications

As discussed earlier, continued economic expansion will fuel growth in the equipment leasing and finance industry. However, growth by equipment type and end-user industry will be uneven as economic and technological changes impact segments differently. In addition, it is likely, at least in the near-term, that customers will continue to prefer loans versus more complex products.

Potential Implications

➤ While all lessors must continually monitor their markets and anticipate potential changes in the environment, niche players with a focus limited to a small number of market segments or equipment categories must be particularly cognizant of events that could impact their business. Lacking the diversity to insulate themselves from a shock to one of their niches, these lessors must develop strategies to anticipate and react to changes in their markets. For example, lessors that currently focus on one or two segments should identify alternative segments in which they can successfully participate and uncover the trigger events that will cause them to shift focus

➤ Players can no longer limit their focus to leasing. As discussed elsewhere, the market demands a broad array of products and solutions. Lessors that cannot or will not respond will under perform versus competitors

Profitability and Funding

This year's respondents reported that both net income and ROE improved in 2005 while ROA remained unchanged. Pre-tax yields improved moderately, but spreads declined, driven by an increase in the cost of funds. Leasing profitability rose in large part because of companies' ability to reduce expenses and improve credit quality

As shown in Figure 15, both net income before taxes and ROE grew by five percent over 2004. ROA remained unchanged for the third year at 1.7 percent. As Figure 16 indicates, lessors were able to improve

net income by reducing expenses and cutting provisions for bad debt. Increasing rates, however, drove interest expense sharply higher.

Average pre-tax yields increased significantly in 2005 to 7.4 percent (See Figure 17). However, a 120bps increase in the cost of funds drove average pre-tax spreads down almost 16 percent to their lowest level since the Survey began.

Figure 18 shows that while the smallest lessors (by annual volume) operate with the highest cost of funds, they are able to command high enough prices to earn pre-tax spreads rivaling pre-2001 levels. There are a number of possible explanations for the high returns small lessors are able to earn. A number of executives we spoke with stated that small lessors tend to differentiate themselves by offering high levels of personal service and that some customers are willing to pay a premium to receive superior service. However, as we discuss below, an analysis of small lessors' delinquencies indicate that they may also deal with lower quality credits than larger lessors and that the premium they earn is tied to the additional risk they are taking.

Figure 19 indicates that while Third Party lessors enjoy pre-tax spreads approaching 6 percent, the costs associated with this business model are substantial, producing net income of 17.5 percent, well below the overall average and the other business models.

Industry Perspective and Potential Implications

2005 again saw increased margin compression as the market continued to be flooded with capital. Most executives stated that margins shrank through the second quarter of 2006 with the rare of compression slowing. However, short of a significant decline in credit quality or an economic downturn, few within the industry believe that capital will flee the market or that margins will return to where they once were.

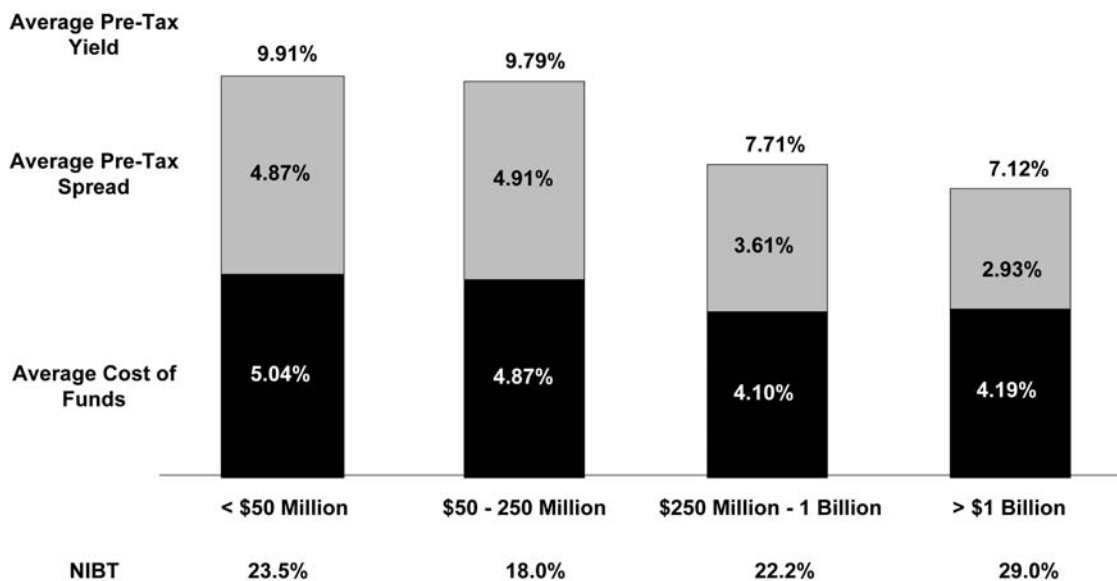
Potential Implications

➤ The rate of improvement in net income has slowed significantly over the past two years, indicating that lessors are having an increasingly difficult time increasing profits through expense reduction and operational efficiency. Unless lessors are able to increase margins, profits may begin to erode

➤ Although some executives indicate that the rate of margin compression may have leveled off, margins remain at record low rates. In order to improve yields,

Figure 18

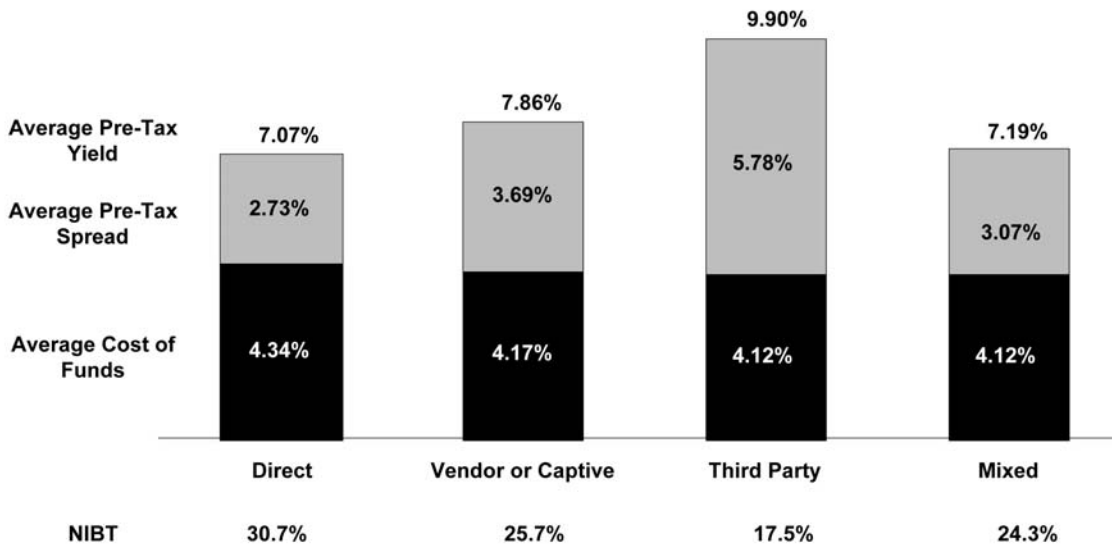
2005 Pre-Tax Yield, Cost of Funds & Pre-Tax Spread by Lessor Size [Annual Volume]



Source: 2006 ELA Survey of Industry Activity

Figure 19

2005 Pre-Tax Yield, Cost of Funds & Pre-Tax Spread by Business Model



Source: 2006 ELA Survey of Industry Activity

lessors must develop a value proposition for which some customers will pay a premium. Several small lessors appear to have created such a value proposition and found the customers that value it. Other lessors must do the same

Portfolio/Credit Quality

Overall, credit quality and portfolio performance continued to improve in 2005. Delinquencies, measured as receivables over 31-days, declined by nearly five percent over 2004 (See Figure 20). Receivables over 90-days declined nearly 23 percent to .7 percent.

While the smallest lessors may produce the highest returns, they also have the highest delinquencies. As Figure 21 indicates, lessors with annual volume less than \$50 million reported nearly six percent of receivables over 31-days, over half of delinquencies exceed 91-days. As discussed above, this could result from accepting riskier credit or from small lessors being unable to devote the same resources to the collections process as larger lessors.

Figure 22 shows that average charge-offs declined from 1.5 percent of net receivables in 2004 to one percent in 2005. Median charge-offs remained unchanged at .5 percent.

Industry Perspective and Potential Implications

A number of lessors noted that credit quality is extremely good. One executive stated that, "In 25 years in the business this is as good as I have ever seen it [credit quality]." Of course, economic conditions directly impact credit quality, and the economy has been expanding for several years. In addition, credit-scoring models have reach maturity and their positive impact on portfolio performance is evident.

Potential Implications

➤ In order to generate higher margins, some lessors may be able to create separately managed portfolios of lower quality assets. However, building this type of portfolio requires strong underwriting skills, collections, and asset management capabilities

➤ While overall credit quality remains strong and is expected to remain so in the near-term, specific market segments may experience difficulty meeting their lease and loan obligations. For example, as the housing market slows, lessors could experience delinquencies from the construction industry. Portfolio managers should be prepared to act quickly in the event

of segment specific difficulties

➤ Portfolio credit quality cannot get any better than it is today. In fact, several of our client banks are increasing 2006 reserves in expectation of a less sanguine risk environment. Lessors need to evaluate their reserves, potentially increasing them from prior years. No one expects a major credit decline but conservative lenders are preparing for a return to what they consider more normal times

Operations

The 2006¹ Survey focuses on several aspects of lessor operations, including:

- Application processing
- Equipment remarketing
- Employee distribution
- Operational efficiency

Application Processing

This year's respondents approved over 72 percent of the applications submitted, representing just over 70 percent of the total dollars submitted (See Figure 23). Lessors booked and funded or sold nearly 55 percent applications submitted, or 50 percent of the dollars submitted. This year, lessors "lost"⁸ just over 20 percent of the dollars submitted and approved.

Equipment Remarketing

Survey respondents reported that the original lessee purchased over 50 percent of leased equipment (by fair market value lease volume) and renewed the lease on an additional 24 percent (See Figure 24) of equipment. Equipment remarketing activity in 2005 closely matched 2004 activity.

Large-ticket lessors reported that the original lessee purchased over 75 percent of leased equipment and renewed the lease on an additional 10 percent of equipment leased. Small-ticket lessors reported that only 64 percent of leased equipment remained with the original owner. This is likely because of the high rate of obsolescence for small ticket equipment.

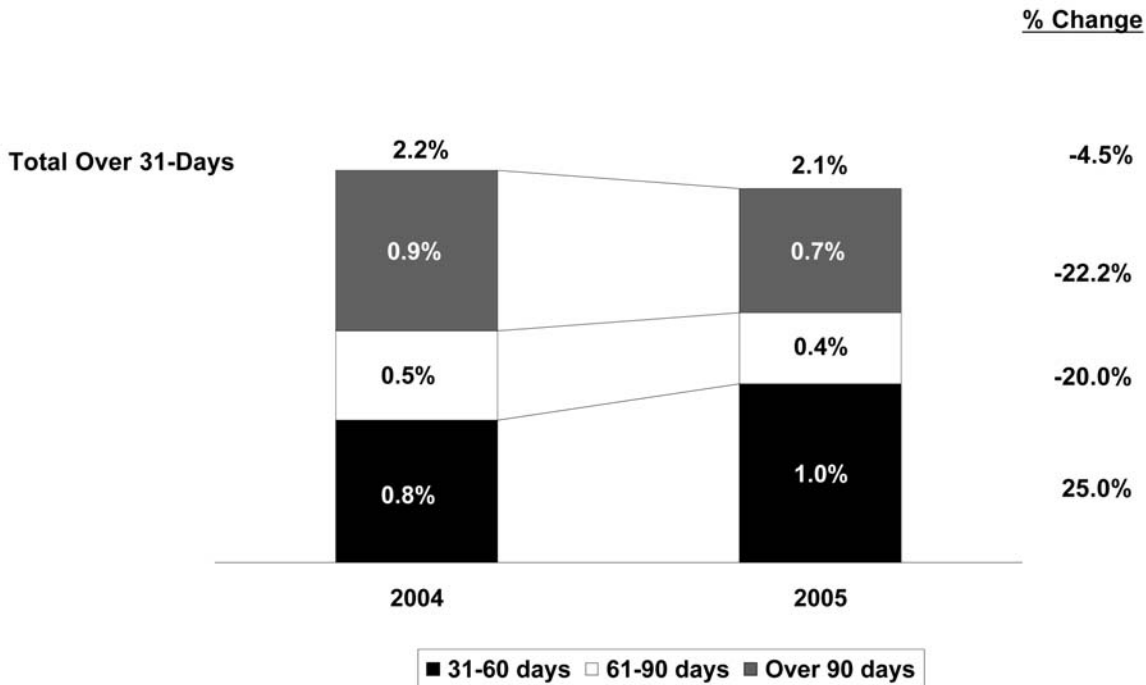
This year's Survey captures a significant amount of new data related to asset management and residuals. While no trends emerge from the first year of data, we expect to increase our focus on this area in next year's Report.

Employee Distribution

Despite a 10 percent increase in volume, between

Figure 20

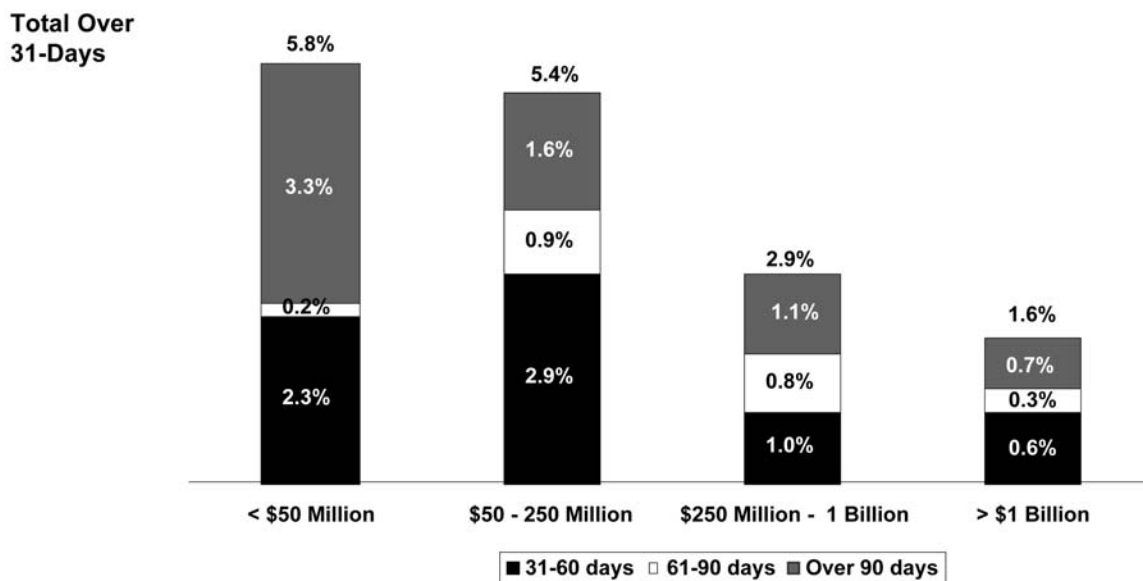
Accounts Receivable Aging – Over 31-Days



Source: 2006 ELA Survey of Industry Activity

Figure 21

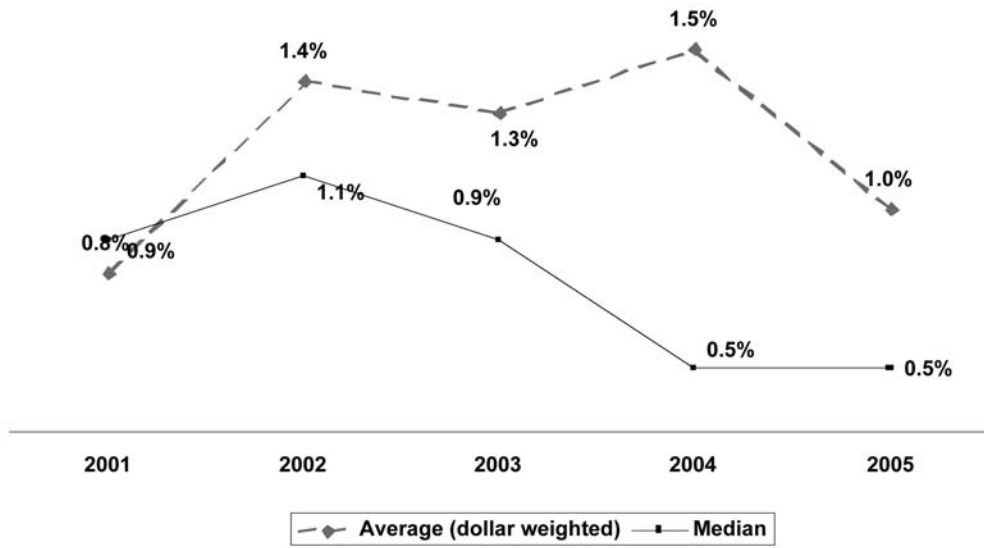
2005 Accounts Receivable Aging – Over 31-Days by Lessor Size [Annual Volume]



Source: 2006 ELA Survey of Industry Activity

Figure 22

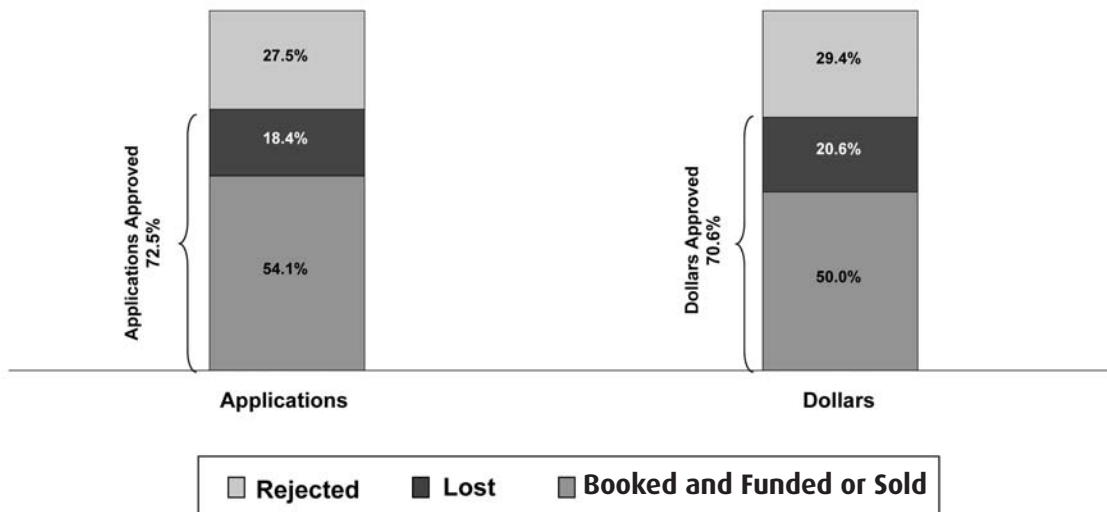
**Full-Year Loss (Charge-Offs) – Five Year History
(as a % of net receivables)**



Source: 2006 ELA Survey of Industry Activity

Figure 23

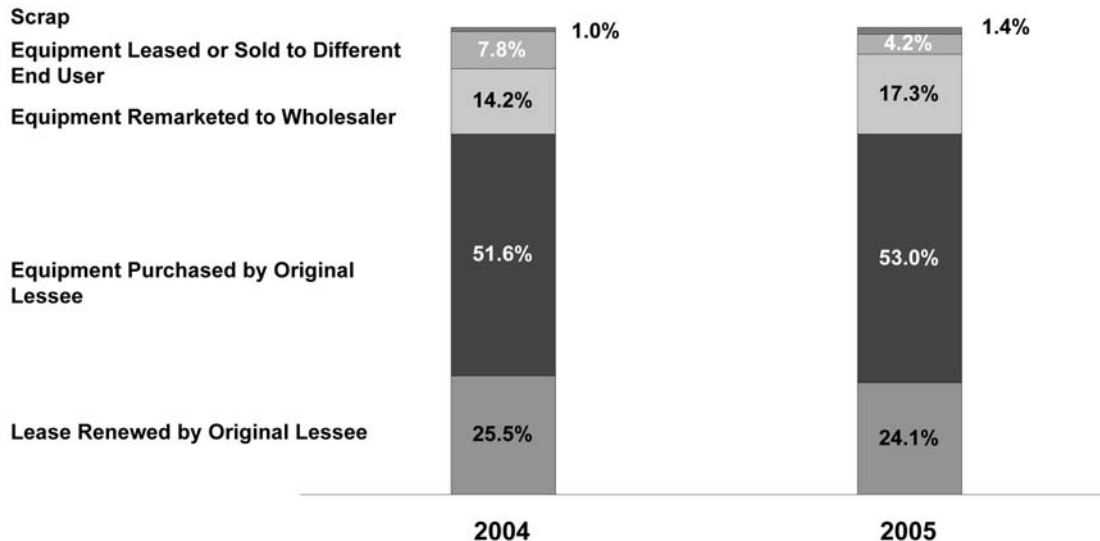
**2005 Applications Processed
(% of applications and dollars submitted)**



Source: 2006 ELA Survey of Industry Activity

Figure 24

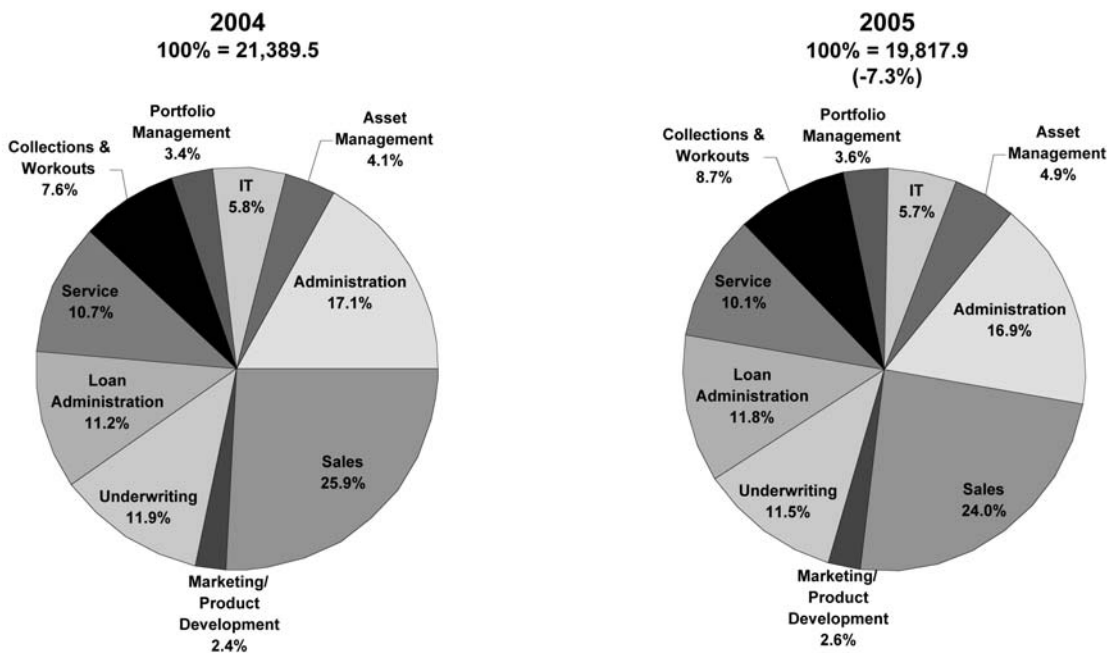
Equipment Remarketing
% of Fair Market Value Lease Volume



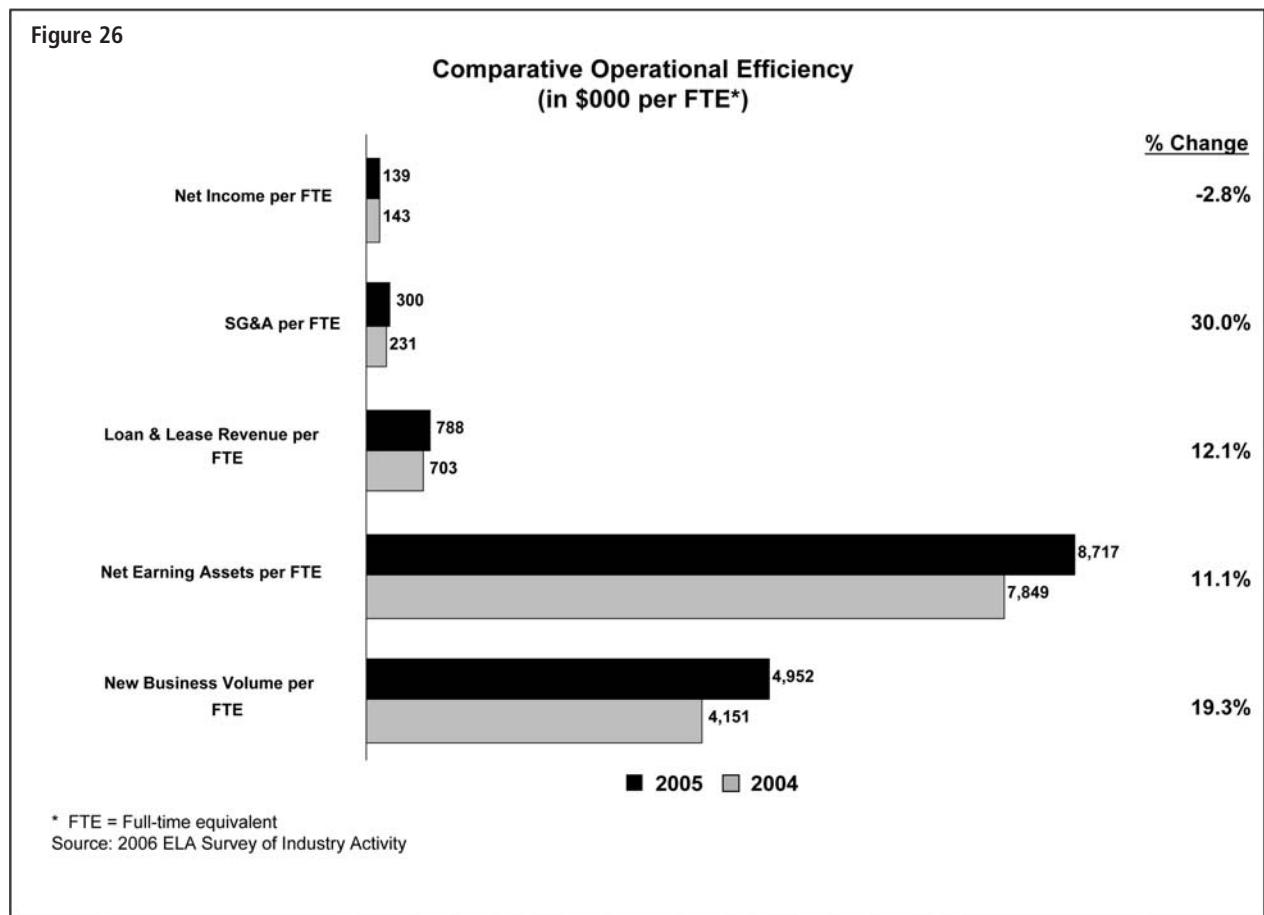
Source: 2006 ELA Survey of Industry Activity

Figure 25

Full-Time Equivalent Employees



Source: 2006 ELA Survey of Industry Activity



2004 and 2005, Survey respondents shed over 1,500 jobs, over 7 percent of their headcount. As Figure 25 indicates, cutbacks appear to have been concentrated in sales and administration. With a few exceptions, employee distribution remained similar to the previous year. Part of the FTE reduction was the result of a number of bank mergers that were completed in 2005. However, Independents reported the largest reductions.

Other than the two areas previous noted, the only area in which a significant change was reported involved collections and workout. In 2004, 7.6 percent of lessors' FTEs occupied these positions. In 2005, the number of collections and workout FTEs increased by nearly 15 percent. This reallocation of resources could indicate that lessors are anticipating delinquency or credit problems in the near future.

Overall, headcount data indicates that lessors continue to improve productivity and efficiency, enabling them to generate more business with fewer FTEs.

Operational Efficiency

Overall, lessors' reduction in FTEs translated into

improved efficiency. As Figure 26 shows, lessors gained efficiencies in nearly all areas except net income per FTE, which declined by nearly three percent and sales, general, and administrative expense per FTE, which increased by 30 percent.

New business volume per FTE increased by nearly 20 percent and loan and lease revenue per FTE grew 12 percent. Both of these ratios indicate that although lessors reduced their sales staff, they were able to generate increased productivity from those remaining. Overall, it appears that at least some lessors may have shed headcount in an attempt to increase profitability despite declining margins.

Industry Perspective and Potential Implications

Although lessors were able to improve operational efficiency in 2005, it is clear that they may have reached a point of diminishing returns. Despite the most significant reduction in headcount in the past several years, they were able to produce only a fraction of the growth in net profitability of previous years.

A significant number of approved applications continue to fail to be booked. In 2005, lessors collectively

lost almost 30 percent of their new business volume either to a competitor or to an alternative source of funding (for example, cash, existing bank line, or equity funding). Since these are applications that are already approved, not only did lessors lose the business, but they lost the time and resources they invested in processing and underwriting the application.

Potential Implications

➤ Lessors need to focus not only on cost reduction but also to identify products, equipment types, and customers that can generate higher yields without significantly compromising portfolio quality. One way to improve yields is to identify why a substantial number of applications that lessors have processed and approved are not booked. Lessors that can reduce the flow of “lost” deals will see a marked impact on their bottom line

➤ While most lessors may have maximized the operational efficiencies available through automation, the best players are leveraging technology to improve customer service and are striving to create superlative experience for which a meaningful number of customers are willing to pay. Other players, particularly banks, are leveraging technology to increase their share of the customer’s available wallet. However, lessors should approach technology investments with well-conceived business plans and clearly defined expectations

Accessing the Customer:

The Increasing Importance of the Vendor Channel

Lessors currently generate over 25 percent of the industry’s new business volume through vendor programs. Independents that have flourished in the face of their expected demise have done so in part by leveraging the vendor channel to “even the playing field” with Captives and Banks. Given the importance of the channel, and the likelihood that it will continue to grow in importance, we asked executives from a number of the top players in this market to discuss some of the challenges related to vendor programs and key factors required for success.

Competitive Environment

While small manufacturers have been, for the most part, overlooked by larger players, several small independent commercial finance companies have focused on the market and been extremely successful. As a

result of their success, a number of large players, including GE Capital, CIT, US Bank, and Wells Fargo have also recently taken an interest in this segment. However, in the view of one lessor, “Given their cost structure and internal hurdle goals, there is a limit to how far down the food chain the big guys can go. They cannot make their numbers from a \$10 or 15 million manufacturer.”

A number of small independent finance companies are focusing on small ticket vendor program. Because there are so many small vendors and relatively few players in the market, competition for vendor relationships may not be as intense as it is in other areas of commercial finance. However, fierce competition exists from numerous sources, including bank and credit card companies, to provide financing to the end customer. A manager noted, “Just because we have the vendor program does not mean that we automatically get the deal. We are competing on every level for that deal, with the banks that offer check accessible lines of credit to the credit card companies with mileage programs. It is rarely easy.”

Service Models

Lessors serve the market through one of two distinct value propositions:

- Generalist/Wholesale approach – Providers employing this approach typically operate across a wide range of industries with little in-depth knowledge of any one segment. They primarily compete on price and typically have highly automated and efficient processes
- Knowledge-based/Customer intimate approach – Providers possess in-depth industry experience and understand the needs of the customer, industry terminology, etc. Typically, knowledge-based providers confine their activities to a limited number of industry segments. They price higher than generalist providers and rely on industry experience and contacts for competitive advantage

The vendors’ choice of provider and service model depends on its own needs as well as the needs of its customers. For example, medical equipment vendors typically require a knowledge-based, high-service approach to meet the needs of its customers. In contrast, the materials handling industry often values price more than service.

With both models, programs with recourse back to the vendor in the event of loss are rare. However,

there are times when the vendor wants the lender to finance deals that are below the lender's minimum credit criteria. To mitigate these situations, vendors and lenders often establish ultimate net loss pools. For each transaction that falls outside the lender's credit standards, the vendor contributes an agreed to percentage of the deal to the pool. The worse the credit, the higher the percentage of the deal the vendor contributes. The lender is made whole on any losses from the pool. However, as vendors increasingly leverage funding partners that specialize in sub-prime credit, ultimate net loss pools are becoming less common.

Regardless of the model, lenders and vendors must clearly state their expectations from each other and the program. Among the elements typically detailed in a vendor finance agreement:

- Minimum credit standards – The lender specifies the credit criteria and the types of deals that are acceptable
- Expected volume – Particularly when there is more than one funding source, both sides agree on what percentage of the applicable deals the lender receives
- Turnaround time – The lender sets expectations around underwriting and credit decisioning. Typically, in small-ticket, decisions are returned within hours or even minutes
- Funding time – The lender and vendor agree on how long it will take the lender to fund each deal. The industry standard is same-day funding

Sales Approaches

The combination of a provider's service model and target market largely determine its sales approach. For providers targeting the very low-end of the market, economics requires the use of alternative delivery channels.

One lessor has developed a telephone-based direct marketing platform that focuses sales executives' efforts on the highest potential prospects. The basis of the platform is the company's database of thousands of prospects. The lessor developed and updates this database with information from numerous sources, including third-party marketing services, industry organizations, trade shows, etc. Its typical target is a vendor with \$1-5 million in annual sales that has had limited access to commercial finance programs.

The sales management application provides potential prospects to the sales executives for solicitation. In addition, they use sophisticated contact management software, including predictive dialing technology, to manage the solicitation campaign. The software allows the sales executive to manipulate the database, fax material and send emails to targets, produce correspondence and documents, track activity, and numerous other activities.

These tools help to focus sales calling time on those prospects most likely to become origination sources. Once the dealer becomes an active deal source, the contact management tool tracks end-user activity, allowing the sales executives to effectively market directly to the end-user to generate additional sales and renewals.

In contrast, players focusing on larger prospects believe that face-to-face sales remain critical for success. They typically divide territories by geography and employ traditional field-based salesmen to generate business. One senior executive of a Bank lessor's vendor finance unit stated that, "Technology has certainly facilitated the customer service aspect of this business, but no vendor of any substance is going to turn his customers over to someone he has never met and only spoken with on the telephone." The take-away is that, while the direct sales approach is expensive, it may be required to sell to larger companies.

Service-oriented providers employ a hybrid approach, using field-based salespeople to originate business and close deals, but relying on telephone-based RMs for ongoing service and account management. One senior manager noted, "We cannot sell high-touch service as our value proposition and then have customers unable to reach their account manager because he is on the road. In our telephone-based account management model, customers have a consistent point of contact. It is not like many call centers where the person who answers the telephone knows nothing about your business." That lessor's model includes incentives for the telephone-based account manager and the field-based salesperson to cooperate and work together to both generate and retain business.

Barriers to Entry

The most significant barrier to entry relates to the availability of experienced people. Within the com-

mercial finance industry, turnover among experienced professionals is extremely low, as companies work aggressively to retain those employees. Typically, seasoned personnel become available as a result of an “event” in the industry, usually an acquisition. For example, when CitiCapital purchased Associates, a number of experienced truck finance people entered the market. When CitiCapital sold its truck portfolio to GE Capital, more experienced truck financiers entered the market, including the current president of US Bank Equipment Finance. We know one firm that could almost be renamed Heller II, given all the employees that came to that company after the GE Capital acquisition. Lacking such an event, one recent client anticipates that it could take 12 months or more to hire an experienced commercial equipment salesperson.

Particularly in small-ticket, technology is another barrier to entry, although not nearly as significant as it once was. The CEO of a recent start-up estimates that his company invested less than \$2 million two years ago when it custom built its transaction-processing platform. In his view, creating the technology de novo provided a competitive advantage over companies running existing systems. “We had the latest technology and no legacy issues. But, that advantage only lasts until someone else comes along with the latest system.”

Industry Trends

The most significant trend impacting this industry has been the vendors’ move away from exclusive arrangements in which a single provider owned the program and was the sole funding source for all but the worst deals. Today, vendors prefer to work with three or four providers, one of which, typically, has an appetite for sub-prime credits. The vendor retains control of both the program and the customer and participates in the front-end process to varying degrees. More sophisticated vendors may verify documentation and score the credit internally, sending the deal to the most appropriate funding source based upon established criteria. Industry executives believe that vendors’ use of third-party scoring applications to screen deals will continue to increase as its cost declines and the customer insight it provides increases.

The other major trend in the industry has been the vendors’ decreased interest in private label programs. Related to issues raised due to recent leasing industry scandals, vendors understand that they may have some liability if their name is on a financing program, even if a third-party is completely responsible for the program. As a result, some vendors’ desire to appear to have their own finance company has dwindled.

Key implications to the industry of these trends? Providers are less able to rely on contractual exclusivity and instead must compete on approval and funding time with other funding sources.

FIC Perspective

While vendor programs offer Independents the opportunity to exploit their point-of-sale advantage to develop low-cost origination, a number of key skills are required for success. Industry executives agree that one key competency required for success in small ticket vendor finance is the ability to execute. A CEO stated, “There is no real secret in this business. I am more than happy to show any competitor our business plan, give them a tour of our facilities, and demonstrate our technology. In fact, I have done just that numerous times with competitors. The model is straightforward, but, if you cannot execute on it, you will never succeed.”

Experienced people provide another critical element for success. Each successful player in this market was founded by industry veterans with over 20 years of experience. Many executives noted that the availability of experienced people, more than any other factor, drives a company’s focus on a specific segment or niche. For example, one Bank lessor operates with a specialty in a segment that would not appear to provide a significant opportunity for a large bank player. An executive explained, “The reason that we ended up in that niche is that a very experienced guy became available, and we hired him. He happened to have a specialty in this segment, so that became a focus area for us.”

Additional success factors include:

- Commitment to the market – As a number of executives commented, “To be successful, you have to fully commit to the market. It may take a year or two to become profitable, particularly if you are starting de novo. But, if you come in and then pull out, don’t

plan on coming back in again. This segment has a very long memory.”

- Access to the target segment – Most interviewees agreed that it is important to understand the language of the industry and to have relationships with a number of industry players
- Clearly articulated value proposition – As one manager stated, “Ease of doing business is the hallmark of small-ticket vendor finance. You have to be able to clearly explain to the vendor what is in it for him, what is in it for the customer, and what is in it for you. You must also spell out what you expect from the vendor (related to volume and quality of deals) as well as what he should expect from you (turnaround time, funding time, etc.). You also need to ensure that you do what you say. That is where most lenders fail.”

Lessor Profitability

Respondents to the 2006ß Survey reported healthy volume increases for each lessor type. Market share, as a percentage of new business volume, remained constant with the previous year. Declines in pre-tax spreads impacted all lessor types, but Banks, with the

sharpest increase in cost of funds, suffered more than the other lessor types. Banks remained the most profitable lessor type based on ROE and net income.

Banks

As shown in Figure 27, Banks grew new business volume by over 11 percent to just under \$47 billion. Their market share, however, remained unchanged at 45 percent of total new business volume.

Banks continue to be extremely profitable, as Figure 28 indicates. At 18 percent, Banks’ ROE is significantly higher than the industry average as well as other lessor types. In 2005, Banks’ net income before taxes reached 28.7 percent, again higher than both the industry average and for other types of lessors.

Banks generate over 54 percent of new business volume directly (See Figure 29) and over 30 percent through vendor programs. Banks typically have little involvement in providing captive programs, explaining why they generated no volume through that channel. In addition, Banks generated 13 percent of new business volume through brokers and portfolio purchases. Overall, the distribution of the Banks’ new

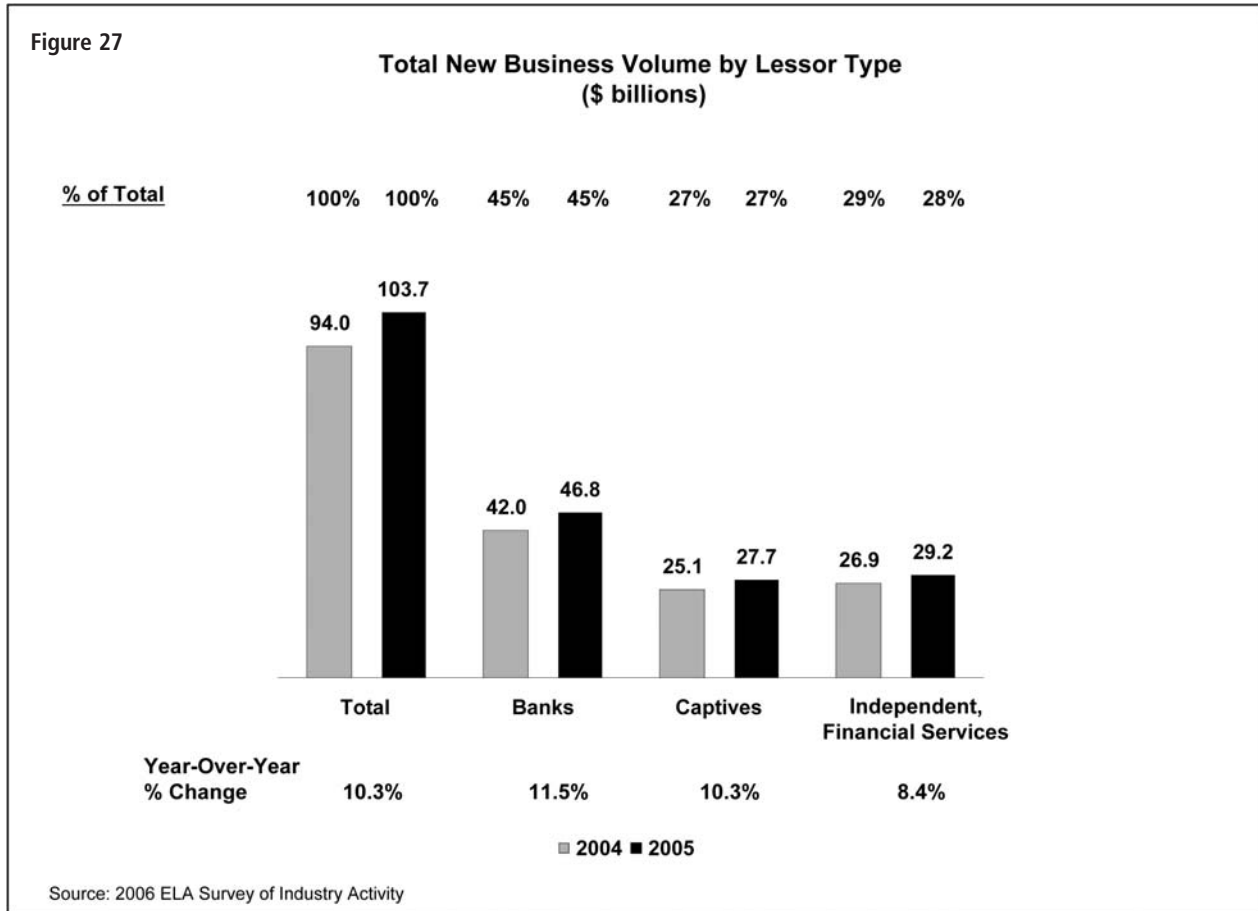
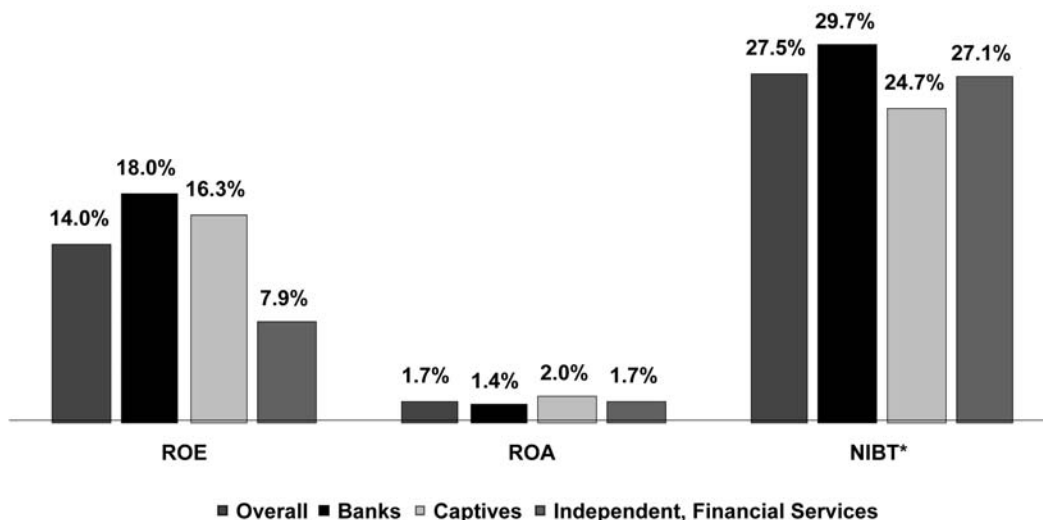


Figure 28

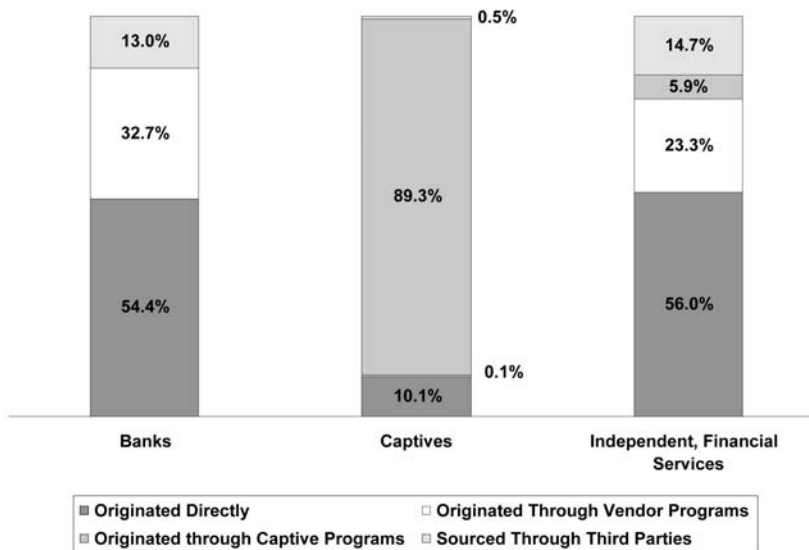
**2005 Profitability
By Lessor Type**



* As a percentage of total revenue
Source: 2006 ELA Survey of Industry Activity

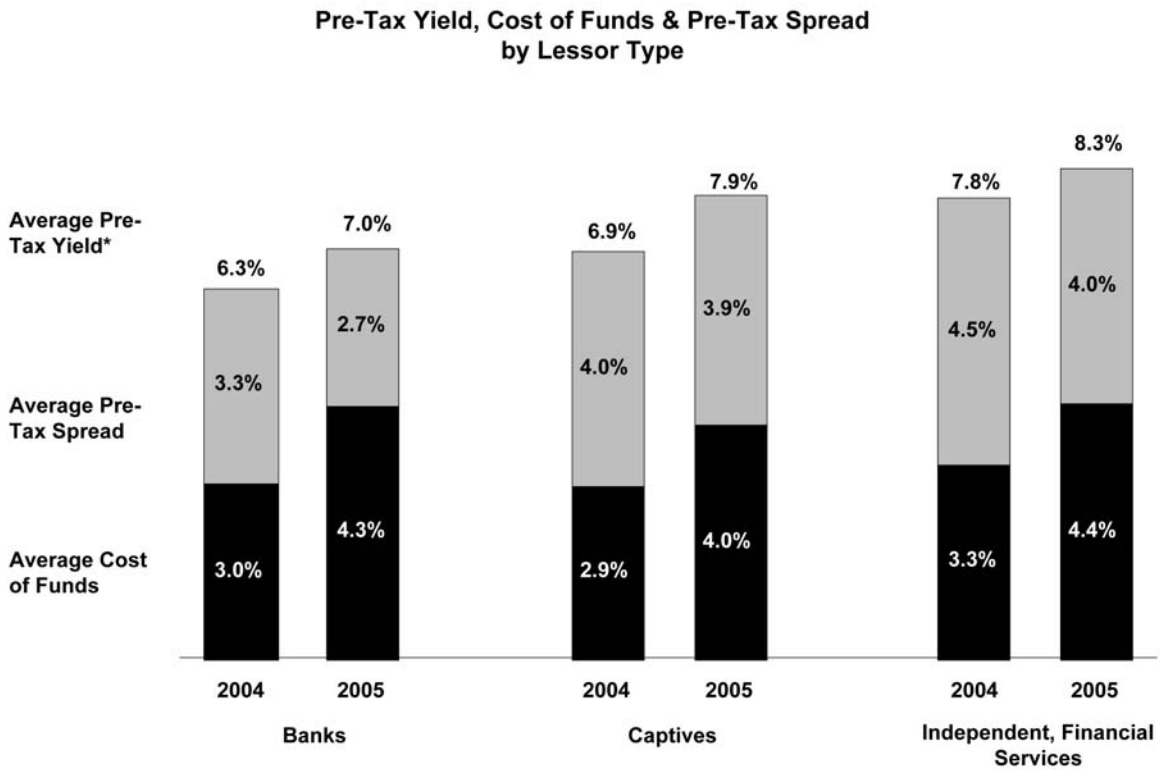
Figure 29

**2005 Total New Business Volume by Origination
Channel
by Lessor Type**



Source: 2006 ELA Survey of Industry Activity

Figure 30

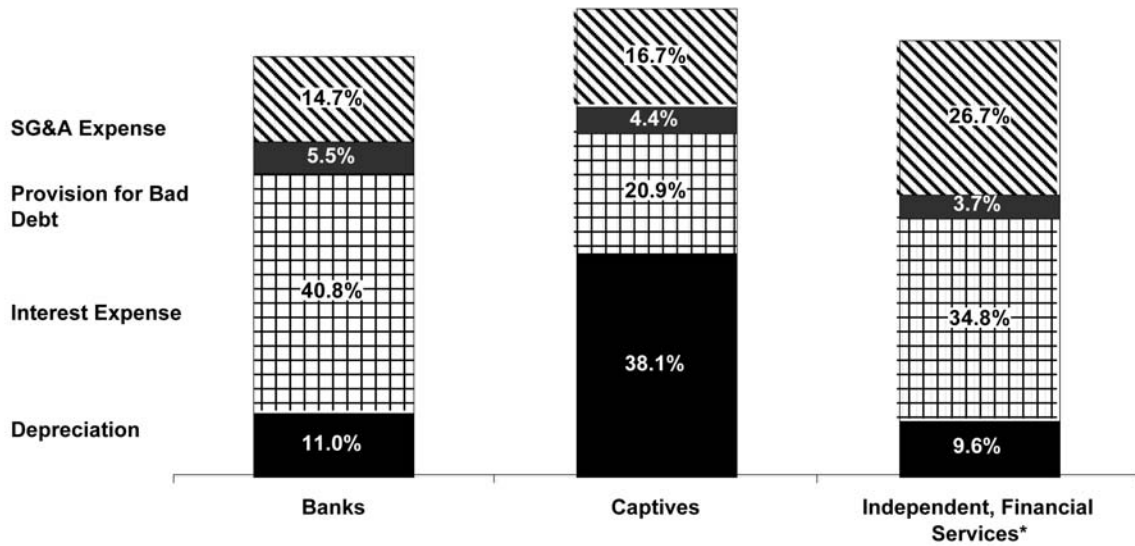


* May not total due to rounding

Source: 2006 ELA Survey of Industry Activity

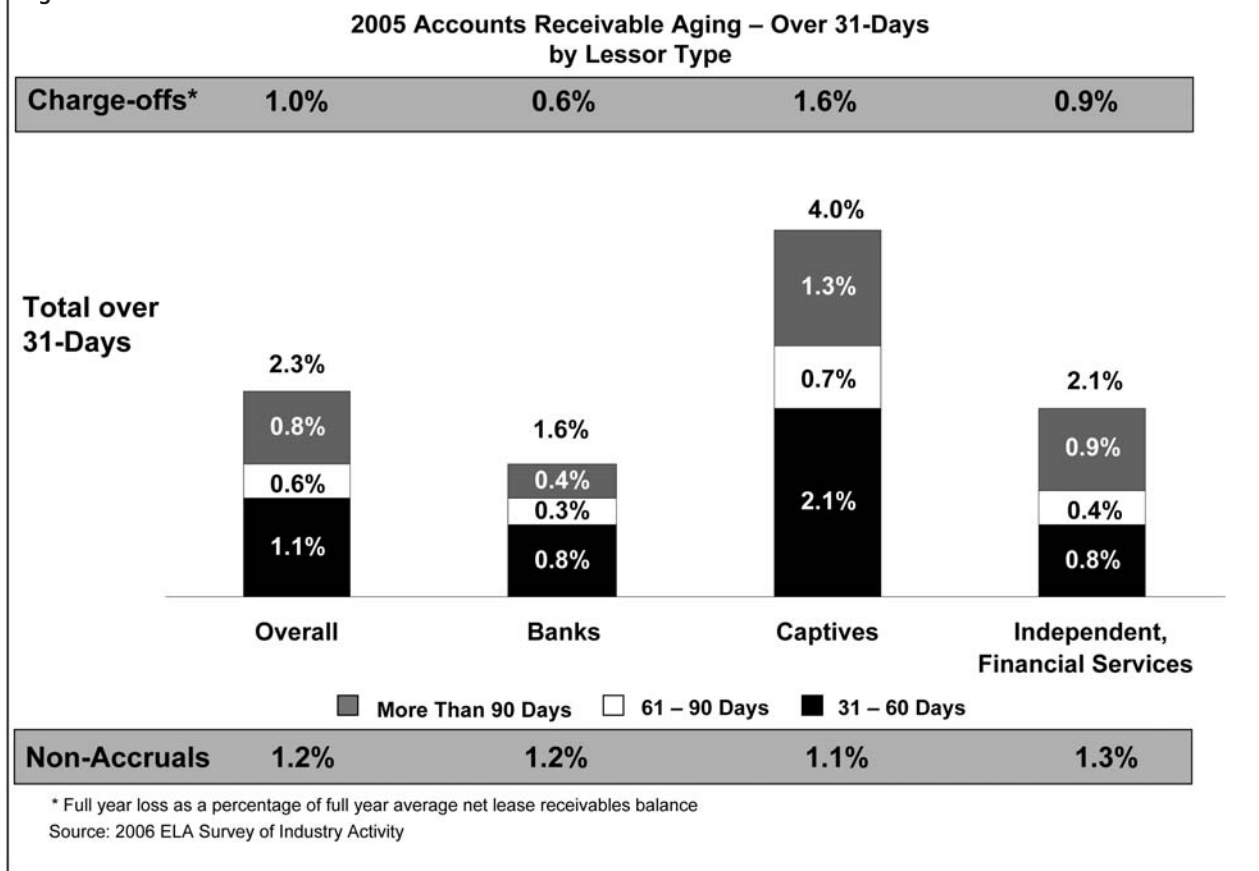
Figure 31

2005 Expense Components as a Percentage of Total Revenue by Lessor Type



Source: 2006 ELA Survey of Industry Activity

Figure 32



business volume by channel in 2005 is not materially different from the previous year.

In 2005, Bank respondents reported that their cost of funds increased 130bps over the previous year to 4.3 percent, significantly higher than Captives' cost of funds and just 10bps below Independents (See Figure 30). In discussing the apparent loss of Banks cost of funds advantage, executives suggested two possible and inter-related explanations. One manager noted that, "Part of the banks' preparation for Basel II includes implementing processes and systems that more accurately track the cost of capital across the organization. It is likely that the availability of more accurate information, as well as the implementation of Basel II itself, are responsible for the sudden significant increase in Banks' cost of funds."

Despite increasing average pre-tax yield from 6.3 percent to seven percent, Banks' pre-tax spread decreased to just 2.7 percent, far lower than other lessor types.

As in previous years, the Banks' depreciation expense is relatively low, 11 percent of total revenue in 2005 (See Figure 31). This indicates that Banks are less likely to retain ownership of equipment, meaning

that they are more likely to employ loans and loan-like products to book deals. Banks' sales, general, and administrative expense remains lower than other lessor types. This likely reflects the fact that a number of Banks have little or no outside origination activities and rely entirely on referrals from the business and commercial bank.

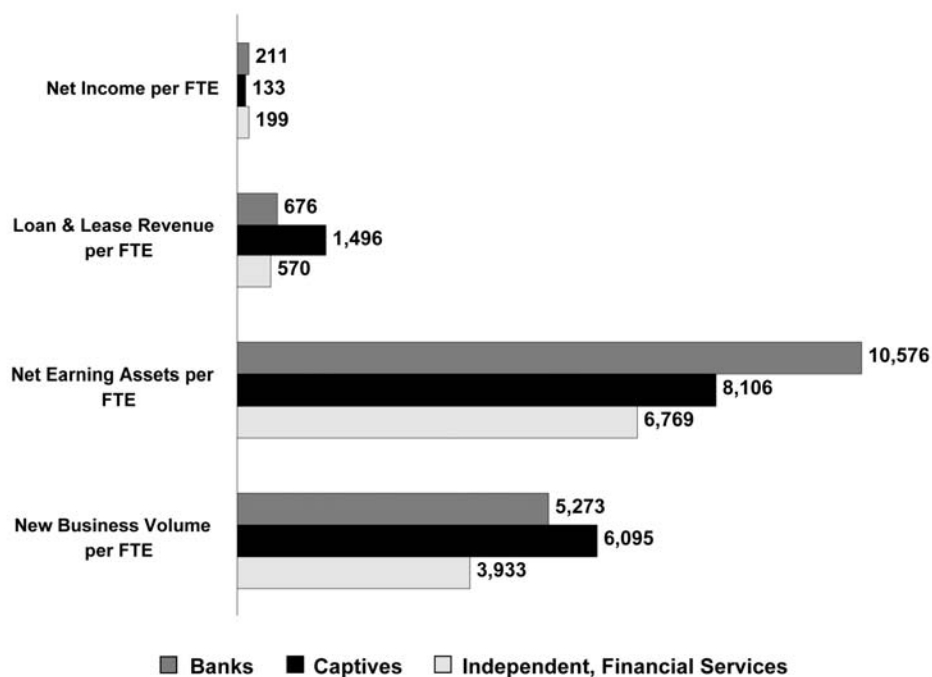
Banks' propensity to work with only the highest credit grades appears evident in its delinquency data as shown in Figure 32. Banks reported that receivables over 31-days were just 1.6 percent of net receivables. For 2005, Banks reported charge-offs of less than one percent.

As shown in Figure 33, Banks' operational efficiency is mixed. While they outperform Independents in every category, they lag Captives in both new business volume per FTE and loan and lease revenue per FTE. Banks outperform the other lessor types in net income per FTE, a further demonstration of their profitability.

Banks remain a formidable competitor in the equipment leasing and finance market and will continue to do so going forward. Some in the industry may still cling to the hope that they will leave the market at the first hint of trouble. Given their investment in the

Figure 33

**2005 Comparative Operational Efficiency
By Lessor Type
(in \$000 per FTE*)**



* FTE = Full-time equivalent
Source: 2006 ELA Survey of Industry Activity

industry and bank management's desire to provide broader financial solutions, in our view, expecting significant retrenchment of banks is more a dream than a hope. One Bank executive stated, "The community banks may exit the market at the first hint of a credit downturn and some regional banks might leave if they started taking significant losses. The big banks, Bank of America, Chase, CitiCapital, Wells Fargo, etc., they are here to stay."

Captives

As shown in Figure 27, Captives reported that new business volume grew by over 10 percent in 2005, and their share of market remained unchanged at 27 percent of total new business volume. As Figure 28 indicates, Captives remained profitable, generating net income before taxes of 24.7 percent, ROE of 16.3 percent and ROA of 2 percent.

Not surprisingly, Captives generated over 89 percent of their new business volume through their own captive programs (See Figure 29). In addition, the lessor type overall originated just over 10 percent of its new business volume directly, likely the efforts of a number of Captive lessors which also operate as generalist

equipment financiers.

As Figure 30 shows, Captives' cost of funds increased by 110bps to 4 percent. However, they were also able to increase pricing enough that they suffered spread compression of just 10bps. As reported in this year's Survey, Captives have the lowest cost of funds of the three lessor types. However, it is possible that their reported cost of funds is artificially low due to subsidized funding from the parent.

As shown in Figure 31, depreciation is a significant expense for Captives, indicating that they typically retain ownership of the equipment. While interest expense and selling, general, and administrative expenses are low, the Captives' provision for bad debt may be too low, based on the delinquencies shown in Figure 32.

Captives reported four percent of receivables past 31-days, the highest of the three lessor types. In addition, they reported charge-offs of 1.6 percent. However, a number of lessors stated that although Captives may write-off an account, their knowledge of the equipment and their ability to sell it typically means that they are not forced to take significant losses.

Not surprisingly, Captives operate as the most effi-

cient group in generating new business volume (See Figure 33). In addition, because of their heavy dependence on lease and loan revenue (versus fees and gains on residuals), Captives also generate more loan and lease revenue per FTE than both Banks and Independents.

Captives will continue to exploit their point-of-sale advantage as well as their superior equipment knowledge. In addition, the best players are becoming increasingly successful at integrating the sale of financing with the sale of the product. In financing the parents' products, Captives will become very difficult to beat.

Independent, Financial Services

Independents also reported growth in new business volume, although at a slower rate than Banks and Captives. As shown in Figure 27, the Independents' volume grew 8.4 percent to just over \$29 billion. Market share remained virtually unchanged from the previous year at 28 percent of total new business volume.

In 2005, Independents generated net income of just over 27 percent and ROA of 1.7 percent (as shown in Figure 28). Respondents generated ROE of 7.9 percent, far below both Banks (18.0 percent) and Captives (16.3 percent).

In 2005, Independents generated 56 percent of their new business volume directly from end-customers (See Figure 29). The vendor channel was an important origination source, providing over 23 percent of Independents' new business volume. In addition, they sourced nearly 15 percent of their volume through third parties.

As Figure 30 shows, Independents also experienced significant margin compression. While pricing increased by 50bps, the cost of funds increased by 110bps, resulting in reduced margins. Overall, Independents command the highest average yield of the three lessor types, but also have the highest cost of funds.

Figure 31 shows that selling, general, and administrative expenses are significant for Independents, comprising nearly 27 percent of total revenue versus almost 15 percent for Banks and almost 17 percent for Captives. Interest is also a significant expense, comprising almost 35 percent of total revenue.

Independents reported low receivables and charge-offs for 2005. As Figure 32 illustrates, the percent of

net receivables over 31-days due was 2.1 percent, and charge-offs for the year were less than one percent.

Because of their need for a relatively larger external sales organization, Independents will be unable to compete on efficiency with Banks and Captives. However, as Figure 33 shows, Independents generated more net income per FTE than Captives, indicating the despite their need for a larger sales organization, Independents are lean and highly productive.

For Independents, a number of trends emerged in last year's Report and have grown increasingly important today. The most important trend that emerged is that many smaller Independents have created market niches for themselves and many are thriving. As discussed above, those niches often related to a market segment or equipment category viewed as "under the radar" of the banks and large Independents. The second trend concerns the growth in importance of the vendor channel. Exploiting this channel provides smaller dealers and manufacturers with opportunities they could not obtain from large lessors and it allows the small Independents to develop lower-cost originations. Independents that both continue to exploit their niches and remain flexible enough to operate outside the realm of their larger competitors will continue to grow.

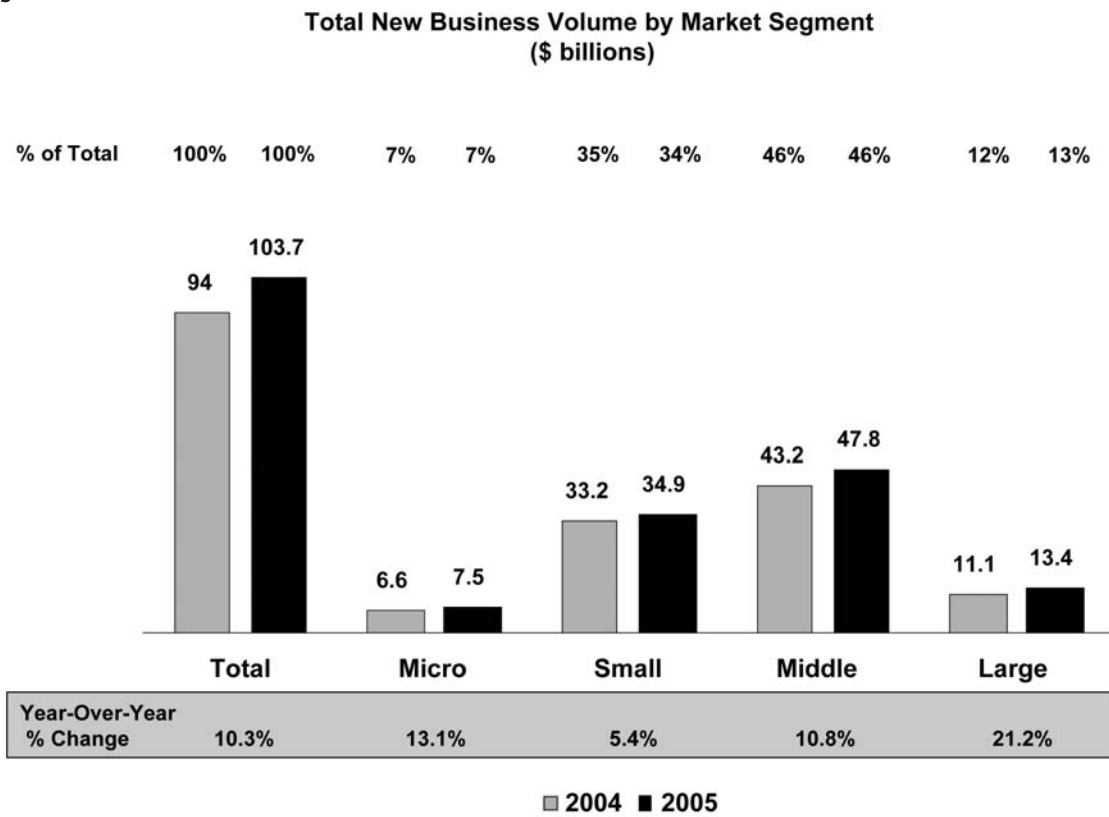
Market Segment Profitability

This year's analysis of the leasing industry by market segment identifies some of its key characteristics and uncover drivers of profitability. Overall, lessor type remains the dominant driver of profitability in the industry. As discussed in previous sections, factors such as cost of funds, access to customers, and operational efficiencies are inherently related to lessor type and little influenced by transaction size. In this section, we focus on the components of profitability and assess the skills required for success within each segment.

The defining characteristics of each transaction size can be indicative of the necessary competencies required to play in that segment:

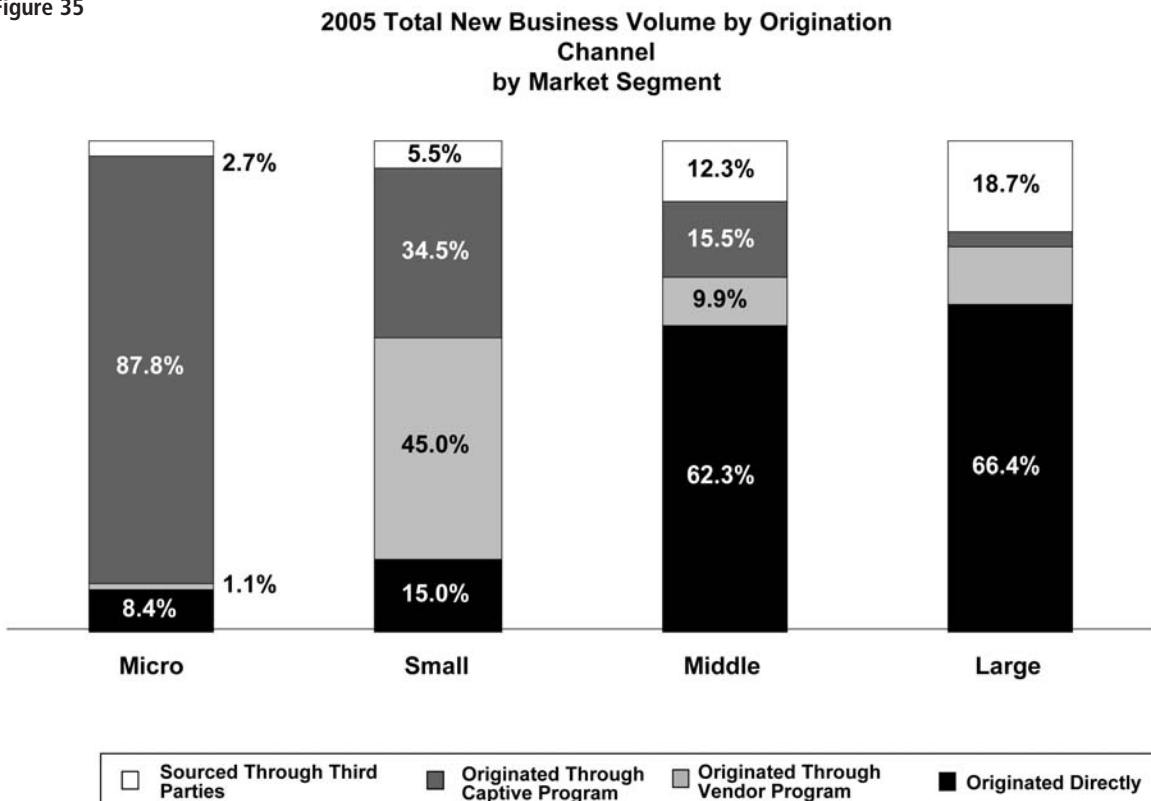
- **Micro-Ticket** – Among the characteristics defining this segment are: vendor/captive origination, high pricing/spread, and high delinquencies and charge-offs. Requirements for success include low-cost origination, highly automated processes, sophisticated portfolio management, and superior asset management skills.

Figure 34



Source: 2006 ELA Survey of Industry Activity

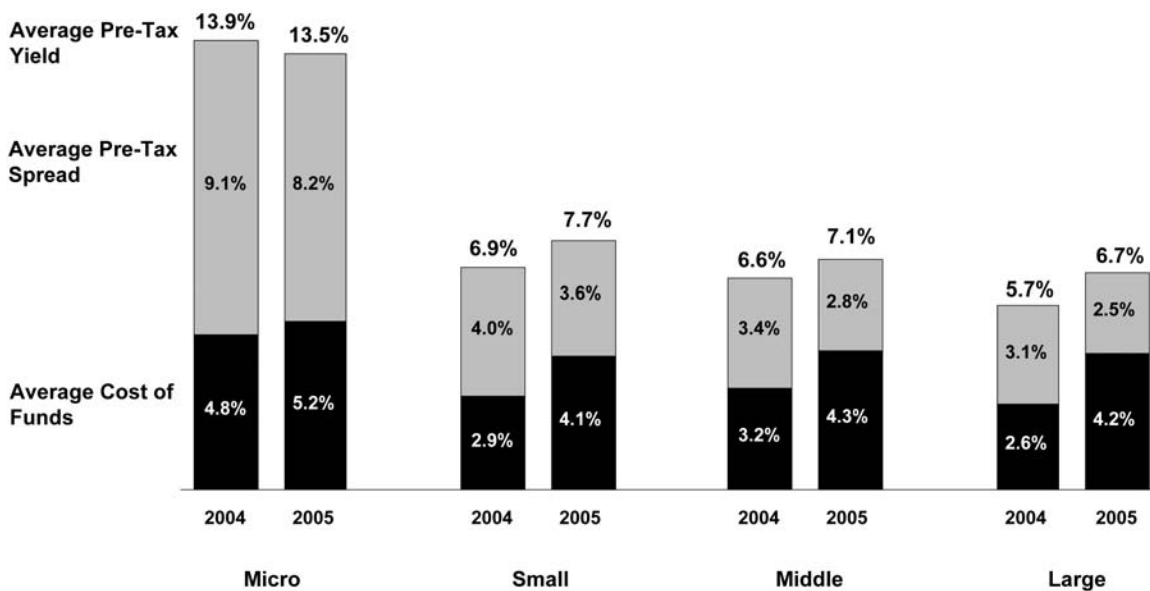
Figure 35



Source: 2006 ELA Survey of Industry Activity

Figure 36

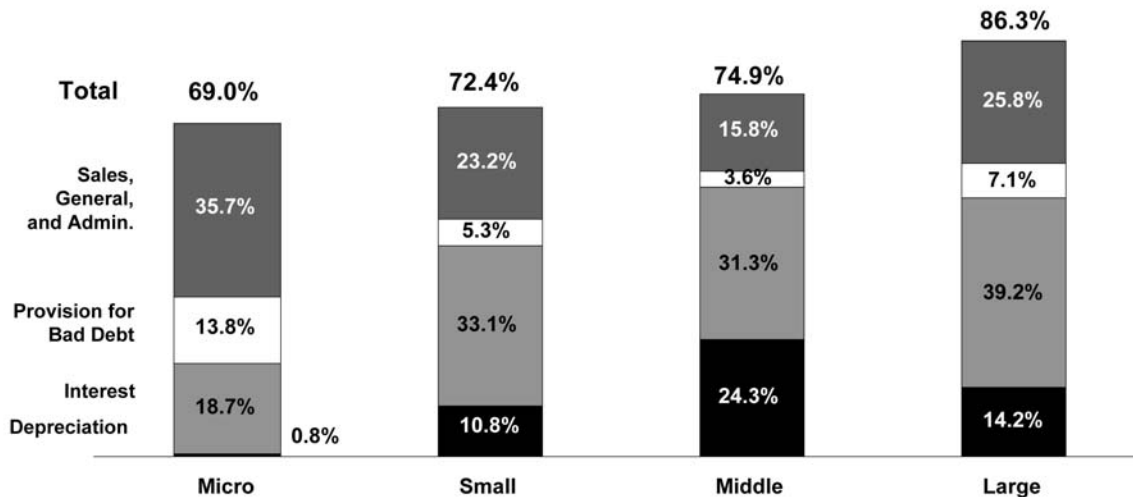
**Pre-Tax Yield, Cost of Funds & Pre-Tax Spread
by Market Segment**



Source: 2006 ELA Survey of Industry Activity

Figure 37

**2005 Expenses as a Percentage of Total Revenue
by Market Segment**



Source: 2006 ELA Survey of Industry Activity, FIC Analysis

- **Small-Ticket** – As with the micro-ticket segment, key definers include: vendor/captive origination, high spreads, and high delinquencies and charge-offs. Keys to success in this segment are very similar to those of the micro-ticket segment: low-cost origination, highly automated processes, sophisticated portfolio management, and superior asset management skills.

- **Middle-Ticket** – Narrow spreads and heavy competition define this transaction segment. While operational efficiencies are critical, the key to survival, if not success, centers on the various players' ability to differentiate themselves from the competition and deliver some unique value for which some segment is willing to pay a premium.

- **Large-Ticket** – Large-ticket volume is back but not to the position it held several years ago. Today, large-ticket more closely resembles middle-ticket in that competition and pricing pressure are prevalent. As we noted last year, the keys to success will no longer be sophisticated structuring capabilities and cross-border expertise. Instead, keys to success will be access to customers, access to funding, and equipment expertise.

Micro-Ticket

Overall, the micro-ticket segment enjoyed strong growth in 2005 with most business sourced through a single origination channel. The high pricing and large spreads typically associated with the segment are offset by delinquencies and charge-offs. While the segment generates impressive ROEs, net income and ROA lag the other segments.

As Figure 34 shows, micro-ticket lessors reported that new business volume increased by over 13 percent in 2005 and that market share remained unchanged from the previous year at seven percent of total new business volume. Total micro-ticket volume for the year was \$7.5 billion, nearly 88 percent of which was generated through captive programs (See Figure 35).

As Figure 36 illustrates, micro-ticket commands very high pricing and attractive returns. While the average cost of funds was higher than for other segments, micro-ticket lessors generated average yields of 13.5 percent and spreads over eight percent. Despite the impressive returns, micro-ticket margins fell by 90 basis points on pricing pressure and increased cost of funds.

Figure 37 illustrates that micro-ticket lessors operate

with a relatively low cost structure. As we noted in previous years, the extraordinarily high sales and administrative expense is related to a small number of Captives included in the segment. Given that much of micro-ticket volume is generated at point-of-sale, sales expense should be among the lowest for all the segments.

Micro-ticket lessors typically do not retain ownership of the assets, resulting in extremely low depreciation expense. The segment's provision for bad debt reflects the risk associated with the segment. Figure 38 shows that delinquencies and charge-offs are significantly higher than for other segments. Due to its high margins and relatively low cost structure, the micro-ticket segment generates net income before taxes over 30 percent (See Figure 39). In addition, the segment generates 3.4 percent ROA and 17.7 percent ROE.

While the micro-ticket segment can generate higher than average returns, lessors clearly must possess particularly strong credit and portfolio management skills in order to be successful.

Small-Ticket

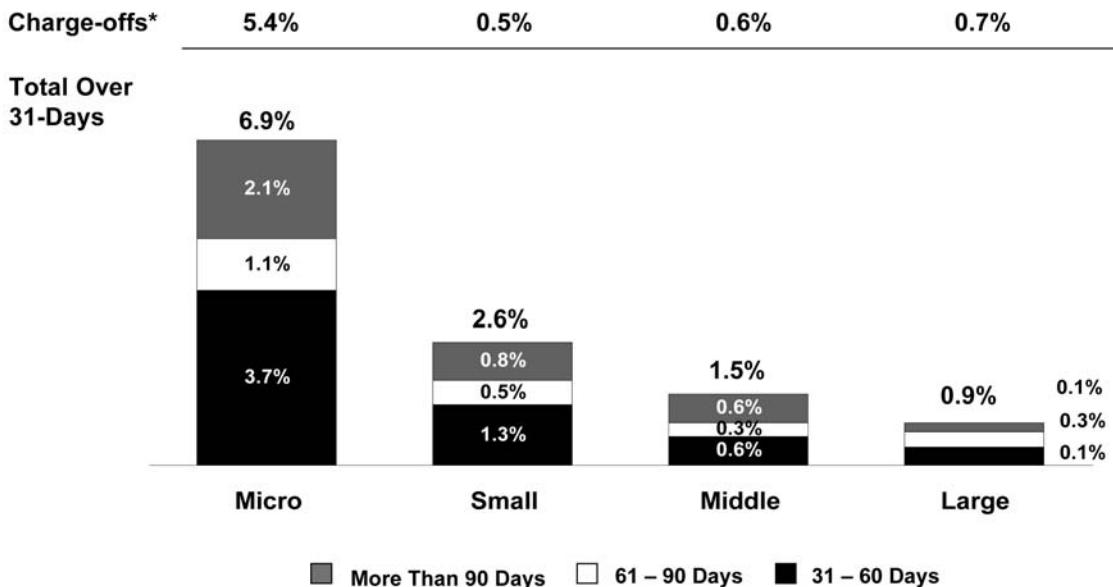
This year's small-ticket respondents reported that growth for the segment substantially lagged other groups. As with all segments, margins shrank as price increases were unable to keep up with increases in the cost of funds. Delinquencies remained low, but overall profitability for the segment was weak.

This year's Survey includes a separate analysis of the small-ticket segment. As shown in Figure 40, nearly 73 percent of Survey respondents are active in the small-ticket segment. Banks show the least involvement in the segment, with just 65 percent of Bank respondents reporting activity. All Captives report being active in small-ticket as do nearly 74 percent of Independents. A number of Bank respondents outsource small-ticket deals to third parties. These are primarily middle-ticket players that understand the fundamental difference in approach required for small-ticket and have chosen to concentrate in their area of expertise.

As Figure 34 shows, small-ticket volume also grew in 2005, but at a much slower pace versus other segments. For the year, small-ticket grew by 5.4 percent, compared with nearly 11 percent for middle-market and over 20 percent for large-ticket. Lessors generated

Figure 38

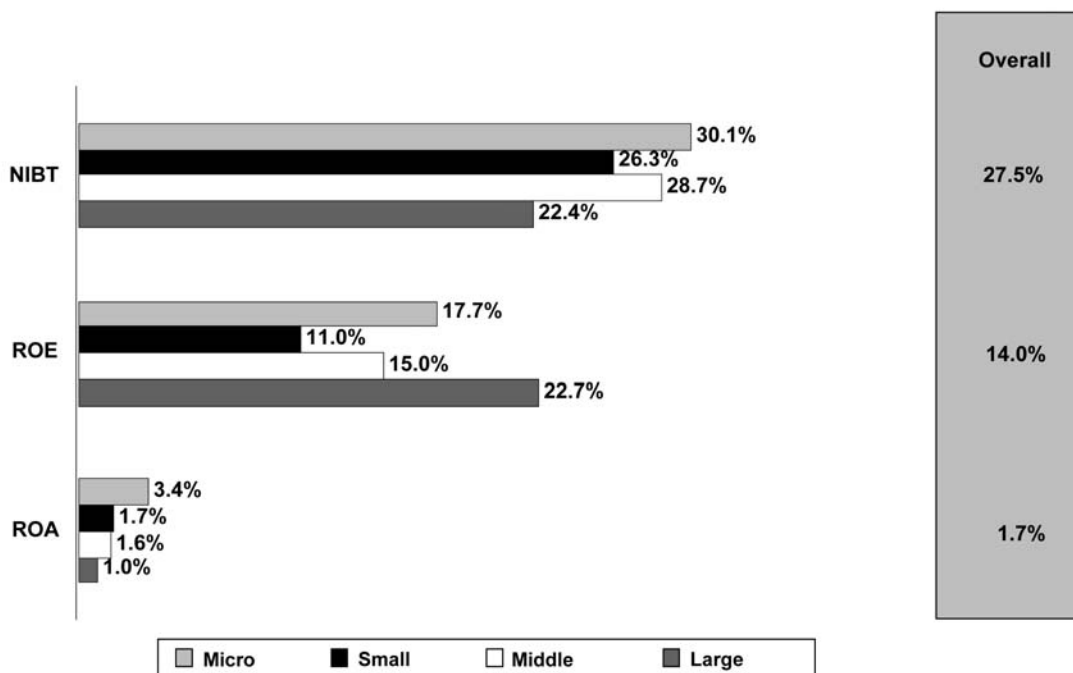
**2005 Accounts Receivable Aging – Over 31-Days
by Market Segment**



* Full year loss as a percentage of full year average net lease receivables balance
Source: 2006 ELA Survey of Industry Activity

Figure 39

**2005 Profitability Ratios
by Market Segment**



Source: 2006 ELA Survey of Industry Activity

over three-quarters of small-ticket volume through the vendor and captive channels (See Figure 35). Direct originations contributed 15 percent of new business volume

Small-ticket also suffered from margin compression in 2005. As Figure 36 shows, cost of funds for small-ticket lessors increased by 120bps compared with an 80bps increase in yield. As a result, spreads for the segment declined by 40 bps.

Small-ticket lessors retain ownership of some equipment, resulting in depreciation expense of 10.8 percent (See Figure 37). Interest and selling, general, and administrative expense are the two most significant expense items for the segment. Relatively low provision for bad debt indicates that the segment is much less risky than micro-ticket. In fact, as we see in Figure 38, delinquencies were 2.6 percent of receivables and charge-offs for 2005 were less than one percent.

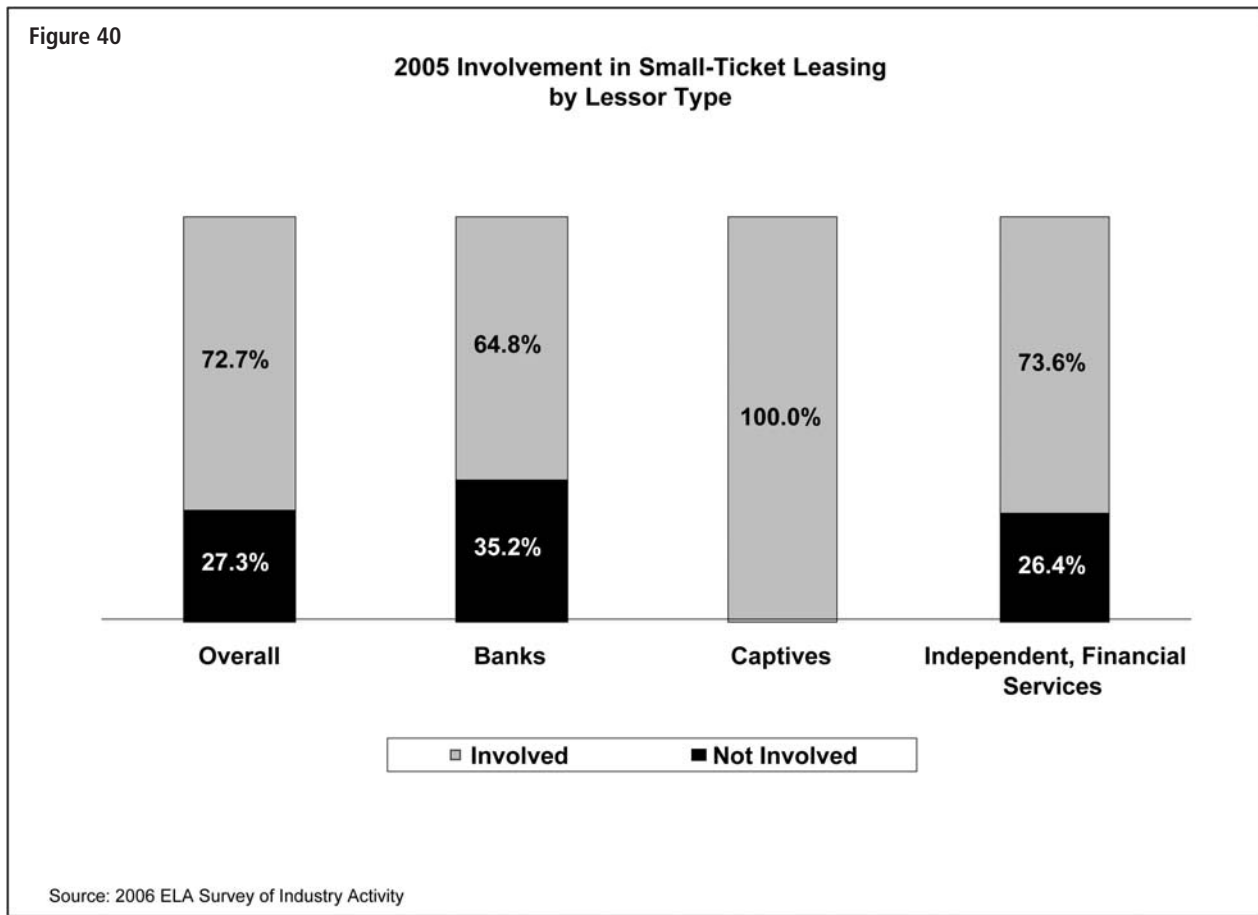
One factor contributing to the small-ticket lessors' portfolio performance is the use of credit scoring. As Figure 41 shows, nearly 61 percent of respondents that are active in small-ticket use credit scoring. In addition, nearly 43 percent of small-ticket lessors

report using auto-decisioning technology to adjudicate at least some small-ticket transactions. In 2005, small-ticket players leveraged scoring technology to decision over 73 percent of small-ticket volume, a significant increase over the previous year. However, given the requirement for fast, low-cost, and highly automated processing that is the hallmark of this segment, it seems difficult to comprehend any lessor manually underwriting small-ticket transactions. Yet, as shown in Figure 41, in 2005, respondents manually underwrote over 27 percent of small-ticket transactions totaling \$8.6 billion. We believe those companies may be at a cost and credit quality disadvantage.

As Figure 39 shows, segment profitability is mixed. Small-ticket ROA is 1.7 percent, higher than the other segments. However, ROE lags the others at 11 percent and net income is unimpressive at 26.3 percent of revenues. Certainly one approach for improving segment profitability is to reduce underwriting costs and improve credit quality through the increased use of credit scoring technology.

Middle-Ticket

Respondents reported that middle-ticket volume



grew in 2005 to \$47.8 billion. Middle-ticket lessors also experienced decreased spreads resulting from cost of funds increases that could not be recovered through pricing. Overall credit quality for the segment was strong as was overall profitability.

As Figure 34 shows, middle-ticket volume grew at approximately the same rate as the industry, and market share remained unchanged over the previous year at 46 percent of total new business volume. In contrast to both the micro- and small-ticket segments, middle-ticket lessors originate most volume directly. In 2005, respondents reported originating over 62 percent of new business volume directly. Captive and vendor programs contributed an additional 25 percent and lessors sourced the remaining 12 percent through third parties.

Middle-ticket lessors experienced an 110bps increase in the average cost of funds, as shown in Figure 36. While yields did improve by 50bps, the net result was a 60bps decline in spreads.

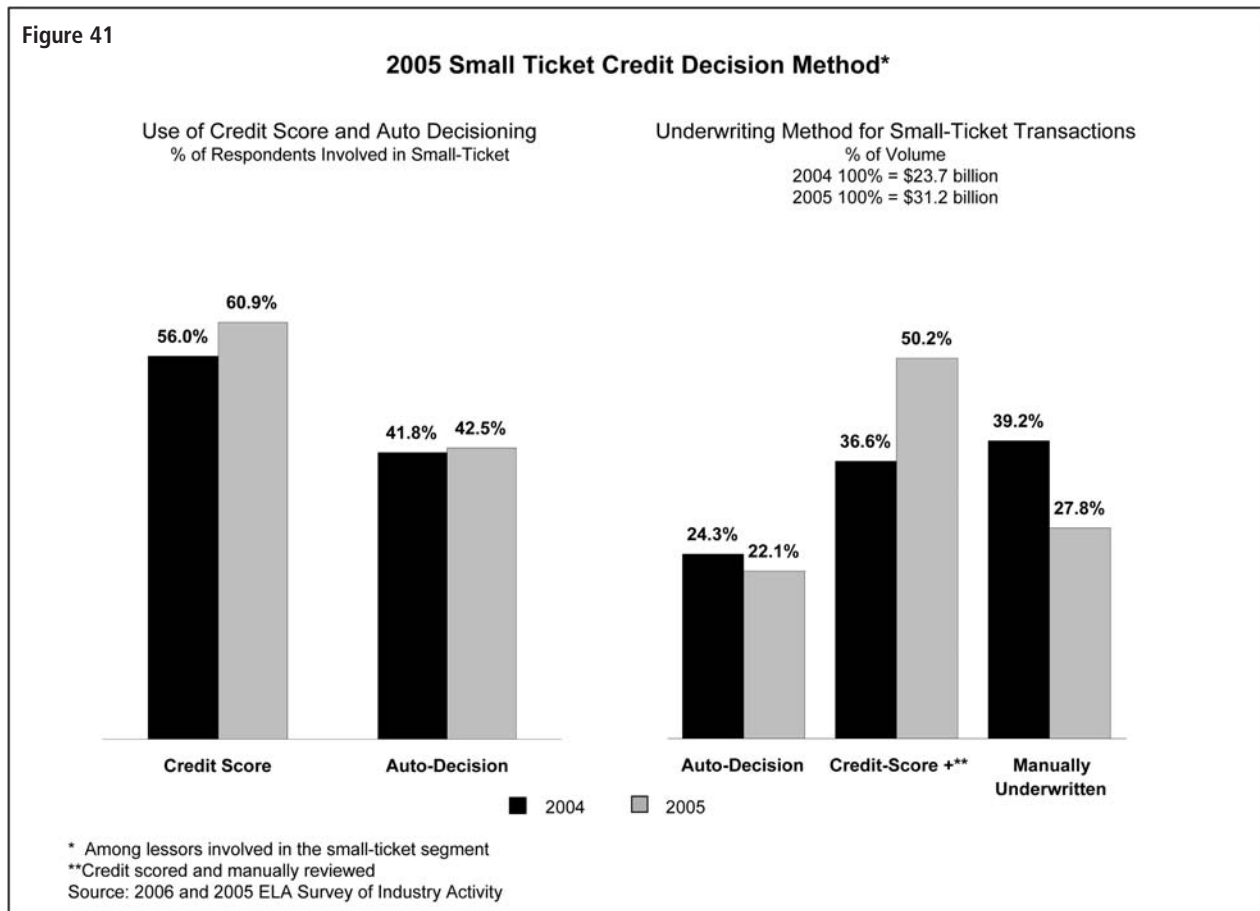
Middle-ticket lessors reported the highest depreciation expense of the four segments, indicating that they are more likely to structure deals as leases versus loans (See Figure 37). The middle-ticket segment

reported the lowest provision for bad debt of the segments despite reporting more delinquent accounts than large-ticket (See Figure 38). In 2005, middle-ticket lessors reported 1.5 percent of receivables past 31-days due versus less than one percent for large-ticket. Charge-offs for the year totaled less than one percent.

As Figure 39 suggests, middle-ticket appears to be an attractive segment. Lessors in the segment reported earning 28.7 percent net income, 15 percent ROE, and 1.6 percent ROA. The middle-ticket rivals large-ticket in terms of profitability.

As we noted at the beginning of this section, a key attribute of successful middle-ticket players centers on their ability to identify market niches where they can leverage their internal expertise to offer an attractive value proposition to a customer segment willing to pay a premium. Successful players have identified their niche in terms of equipment type, customer segment, credit grade, or even delivery channel. Players that continue to approach the market as all things to all customers will earn smaller margins and smaller profits.

Figure 41



Large-Ticket

Over the past two to three years, the large-ticket segment experienced a fundamental change. While respondents reported robust volume growth in 2005, the composition of that volume differs from three years ago. Evidence of that change and its implications can be found in the margin compression that was, until recently, unheard of in the segment.

Respondents to the 2006 Survey reported that large-ticket volume grew a robust 21 percent in that year to \$13.4 billion. Market share remained virtually unchanged from the previous year, increasing from 12 percent to 13 percent. While the segment's growth rate would indicate that it has returned to its previous health, the transactions that comprise today's large-ticket volume are likely to be very different than previously. As one large-ticket executive stated, "Today, we are doing real large-ticket equipment deals. Four years ago, we could reach \$400 million with one cross-border sale and leaseback deal. Today, we reach \$400 million by booking 40 \$10 million railcar transactions. It is not as glamorous, and it does not pay nearly as well."

The executive also noted that without the financial structuring that was the hallmark of large-ticket, today's large-ticket equipment finance deals must often compete on the basis of price against the customer's traditional sources of capital: commercial banks and the capital markets.

As Figure 36 illustrates, both pricing and margins for large-ticket transactions are substantially below where they once were. In 2005, respondents reported that large-ticket transactions yielded the lowest spread of all segments. In addition, as shown in Figure 37,

large-ticket has the highest cost structure of all the transactions, with interest expense the largest item. Although lessors reported a 7.1 percent provision for bad debt, Figure 38 shows that large-ticket lessors reported both delinquencies and charge-offs of less than one percent.

Given the low yields and spreads this segment generates and its high cost structure, it is not surprising that it generates the lowest ROA and net income of all the segments. As Figure 39 shows, net income for the segment was just over 22 percent in 2005 and ROA was one percent.

As large-ticket lessors continue to rebuild segment volume, they will need to begin to address issues related to its cost structure. If the current large-ticket environment continues to force lessors to compete on price with banks and the capital markets, the segment will not be viable in its current form. Lessors must find ways to drive out costs, or they must find a value proposition that will allow them to generate significantly higher returns.

Concluding Thoughts

As they take advantage of the opportunities offered by their expanded focus, lessors will continue to face the same challenges as other financial services providers: regulatory changes, shrinking margins, and increased competition from a variety of entities from outside financial services. Going forward, the ability to adapt to change, which has been the industry's hallmark, will continue to be a critically important strength.

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