Industry Future Council Report 2010

EQUIPMENT LEASING & FINANCE FOUNDATION

Your Eye On The Future

The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

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ABOUT THE INDUSTRY FUTURE COUNCIL REPORT

The annual Industry Future Council (IFC) Report is the product of an intensive two-day discussion with industry leaders. The task of the IFC is to identify trends, issues and possible future events that could affect the equipment leasing and finance business.

The Report summarizes the IFC members' discussions and includes a set of relevant questions. There are no "right" answers to these questions. Rather, it is the hope of the Foundation that readers will ask these questions within their own companies and find them useful in thinking about and preparing for the next one to three years. The IFC Report is another tool for executives to use in strategic planning.

WAITING FOR THE FUTURE

"Reasonable people are glued to the floor right now." – A 2010 Industry Future Council member

Forget "The Future is Now." According to the 2010 Industry Future Council, the future is at least 10 months away. The IFC surveyed the equipment leasing and finance landscape from the vantage of early February 2010 and concluded that the industry is frozen in place, and likely to remain so into 2011. And though the IFC was not without optimism, there was a clear consensus that when the thaw does come, the industry will be different in some fundamental ways.

The Equipment Leasing & Finance Foundation convenes the IFC each year to discuss and debate the future of the industry and try to glean what the business landscape will look like in three to five years. The Council's makeup changes from year to year to ensure diversity of perspective. The IFC always includes the chairs of ELFA's five Business Councils, as well as key players from all over the equipment finance sector, joined by representatives from the banking, investment banking and private equity industry.

This report is the product of that meeting. To encourage the free exchange of ideas, quotes are never attributed to specific IFC members.

The Hangover

IFC members hail from diverse quadrants of the equipment finance business. Some are relatively insulated from the capriciousness of the markets; some say they have actually been growing. Others admit their companies have struggled. Asked about the state of his business, one IFC member shrugged and said, "Well, at least 2009 is over."

Like much of the rest of the economy, these equipment finance executives look at a business and industry very different from what it was just a couple of years ago. "Ninety percent of book is the new book," said one IFC member, to general agreement. The devaluation of assets spread from housing to autos, to construction equipment and finally to companies themselves.

Reporting what they saw in their markets, Council members didn't have many bright spots to point to. Construction equipment is "very depressed." Aviation is "very quiet" and expected to remain so for another year. In rail, there's no demand for locomotives or grain cars. The surplus of equipment in transportation is being absorbed and some over-the road equipment will soon have to be replaced. Customers are holding IT equipment longer. The venture capital market is "a disaster."

Whatever their specific situations, all IFC members agreed: the tough economic times are widespread and will be with us for quite some time.

"We're in for a long, slow recovery," asserted one small ticket lessor. "We had a credit-based economy" driven by consumer spending financed on credit and home equity," he said. When consumers could no longer do that, "they stopped spending."

The lack of consumer demand has rippled out to companies and industries, earning this downturn the distinction of being called, "The Great Recession," As one IFC member remarked. "It's everywhere, not just in one segment, or a few." That's an important point, since markets have become decentralized and have come to include emerging nations. Some markets will recover quicker than others, but as of February, tough times were still widespread.

For the equipment finance sector, the recession manifests itself in two major ways.

Demand – How much of the current demand levels are a result of the economic environment? How much of the demand may be part of a long-term resetting of future demand? What do we do about the change in demand?

To a degree, capital investment in equipment mirrors employment trends, in that it's a reflection of business confidence. Not surprisingly, with near-10 percent unemployment, originations are soft.

And, just as businesses in the midst of a hiring freeze must replace key workers who move on or retire, companies must replace mission-critical equipment at the end of its useful life. Maintenance and some capital expenditure must occur. So, as one IFC member said, "There's always going to be some demand."

But generally, "deleveraging cleared a lot of demand out of the marketplace," according to another.

One council member noted that "There's demand, but it's in the wrong place." There are plenty of B and C credits in need of finance, he explained, "but credit-worthy equipment users are tending to use cash."

But the economy is affecting more than just new demand. A health care equipment lessor noted that technical obsolescence is no longer the spur to leasing it once was. Customers are happy to settle for older but still serviceable imaging equipment at a lower cost.

There were those IFC members who believed demand would rebound fairly quickly. Citing the cyclical nature of business, one said, "people are burning through inventory," and manufacturers will have to ramp up production soon.

Small Ticket

Small ticket lessors at the IFC characterized the business as "flat or down," and said that the economy is inducing potential customers to hold on to equipment longer than usual. For independents, access to capital is crucial, and those that have it are likely to thrive. Funding is the differentiator that will enable companies to increase market share.

Middle Ticket

Middle market lessors are "waiting for demand to return," in the words of an IFC member. Many companies are using the interim to rethink their structure, but the emphasis is on stability. For independents, funding will be a key differentiator over the next few years. Bank-owned companies with access to deposits, and manufacturing captives have a clear edge in this area. IFC members stressed that there will always be room for independent equipment finance companies, but that there remains the age old phenomenon that a certain size will attract an acquirer, and only a very few independents will "break through" the size barrier while remaining independent.

There was a sense that what used to be simply "the market" is now many separate markets. Several of the IFC members – not surprisingly from larger captives – looked to international markets for growing demand. "The U.S. won't be the strongest market," said one. "Our cost of living is too high, and we're not going to create enough jobs over the next few years." China, Brazil, India and Russia will be the drivers of the world economy.

Liquidity – When liquidity re-enters the market, in what forms will it take?

"There's a mountain of liquidity sitting on the sidelines right now," another panelist noted. That money is "trying to get into the market," he said, but economic uncertainty has it frozen in place. That's not surprising, given that the financial crisis was a phenomenon of the credit markets. One IFC member characterized the last year as "nuclear winter" for funding. And although things have thawed slightly, there is still a long way to go.

The industry lacks a good source of long-term matched funded debt. "Legacy deals," in the words of one IFC member, are still tainting perceptions.

Looking at specific sources of funding, the IFC noted that private equity firms, which had taken an interest in equipment finance prior to the financial crisis, have pulled back. "The market simply did not provide the returns private equity wanted," said one member.

"Standards have gone up and private investment firms are looking for absolutely bullet-proof deals," another added. Generally, sources of equity will remain sidelined until they see industry pricing increase.

The DC Difference

In discussing funding, member after IFC member noted that, in the words of one, "banks aren't functioning normally." They are reluctant to lend in the first place, and when they renew large credit lines, they do it at lower dollar amounts and with more aggressive terms. "Availability trumps price at this point," said one middle market lessor.

The reason: the federal government's unprecedented involvement in the financial sector, and its leveraging of that involvement for political purposes. There are very real, stated "threats" being promulgated or proposed every day, coming from Congress, the White House and regulators. Actions sometimes appear arbitrary and contradictory – a state of affairs that an IFC member said has "reasonable people … glued to the floor right now."

Until the government begins to signal a more predictable, rational direction to its actions, "It's going to be a long year for banks," as one IFC member put it. In his experience, "the community and regional banks I talk to are frightened of this congress, and are sitting on cash." Those banks, he said, are "ignoring customer demand."

In the aftermath of the financial crisis, "the Feds have figured out which screws to tighten to try to make sure it never happens again," according to a bank lessor, who said he's seen far too much of regulators in the past year. He wasn't alone.

Members noted the current adversarial relationship between the government and banks. "Regulators are concerned about safety and stability," said one. "They don't care if you lend another dime." But this is occurring at the same time Washington, D.C. is demanding banks start lending again, which sews confusion about the government's ultimate policy aims. It also breeds resistance to non-traditional operations within banks.

Large Ticket

Large ticket members of the IFC say there remains an oversupply of equipment in most sectors, including aviation, blue water shipping and rail. IFC members speculated that companies with long-term funding sources will have the opportunity to do sale-leaseback transactions.

Nor is funding the only aspect of the business being impacted. Medical equipment lessors said that the stalemate over healthcare reform has stalled capital investment in that sector. Some, who deal with construction equipment, expressed hope that last year's $787 billion stimulus would eventually find its way into their business. Others expressed skepticism, citing the stimulus' apparent failure to bring unemployment under control.

Quite aside from whether the government's actions have helped or hindered economic recovery, IFC members feared the huge brush legislators and regulators use to paint with. "My biggest nightmare," said a manufacturing captive, "is waking up as a bank." Independents, too, said they feared being swept up in regulation meant for banks or other financial entities.

The upshot is the sense that what the government does and says – and what it doesn't do or say – are more important to the equipment finance industry in 2010 than at any time in decades.

Positioning – For how long with this "Elbow room" exist before competition re-enters the space?

There, according to the IFC, is how things stand in the first months of 2010. The business is currently marked by soft demand, tight liquidity and a sense of fear and frustration at the erratic and often bully-like actions of the government and the slowness of economic recovery.

But again, the IFC is about the future, and members expressed a good deal more optimism about the long term. Equipment finance, they said, is in better shape than other financial services industries, and they feel it is better positioned for the eventual upturn.

Certainly, much has to happen for the economy to enjoy that upturn. The IFC worried about the fundamentals of the economy and mentioned the specter of a "double dip" recession. There was much discussion of whether certain "bright spots" in the economy were "false fronts," masking weakness. Some anticipated a "second wave" of large scale bank write-downs on commercial real estate assets. Members generally agreed that consumer spending must improve, followed by several months of significant reduction in unemployment before the needed optimism will spur growth. "We're in a very reactive environment," one said. "Nobody's going to lend aggressively until we see sustained improvement."

But equipment finance has weathered tough times before, and will again. Indeed, on a relative basis, companies engaged in equipment leasing and finance fared better than others in the finance sector during the recent recession, re-affirming the efficacy and strength of the basic financial products in this industry.

IFC members stressed the importance of forming and maintaining relationships in what has always been a relationship business. That should be easier than it used to be. Those companies that come through the recession will find themselves with a bit more elbow room than they once had, as companies have exited the market over the last two years. That, according to the IFC members, is not a permanent situation. New players will come in as opportunities arise.

For any company that's made it this far, now is the time to "tune the engine," as one IFC member put it. Success over the next 2-4 years will depend on how they position themselves and execute in several key areas. And although the IFC agreed that "staying strategic in times like this is difficult," successful firms will re-examine their assumptions, their business plans and themselves. The future will not look like the past.

Access to Capital – Banks must eventually begin lending again. But as has been proven over and over, diversity of funding is crucial. For independents, funding will be an existential worry. Asked for likely sources over the long run, IFC members suggested pension funds and insurance companies. Direct investment from Chinese and other "foreign" sources was another possibility, as was indirect U.S. government investment through investment tax credits.

IFC members disagreed on the viability of securitization as a funding source going forward. One member argued that securitization could be a good source for proven veterans, "If your securitizations performed reasonably well through the downturn, your credentials will allow you access to that market in the future" he said. Another said that the bar had been raised and regulations on securitization had become so burdensome as to make it impracticable for lessors. Even if you can do it, it may not make economic sense. "The ratings agencies won't be as important as they used to be," said one securitization veteran. "You're going to have to do fundamental underwriting."

Much of the equity the industry relies on is currently on the sidelines, and equity presents the toughest part of the funding equation over the next couple of years. Those reluctant sources of equity might be enticed into the market if lingering risks could be cleared up (ie. the legacy deals mentioned above), and if pricing increases.

But while we may be in extraordinary circumstances regarding liquidity, IFC members gave no sense that the fundamentals of attracting money were really different. Equipment financiers need a story and a value proposition, a track record, a strong portfolio and quality, experienced management.

Q. How diverse are our funding sources?

Q. Have we investigated new sources (foreign investment, pension funds, insurance companies)?

Q. Do we have a securitization track record? If so, does securitization make financial sense for us?

Pricing – Pricing transactions is a core discipline in equipment finance. Companies that do true risk-adjusted pricing –whether they syndicate or hold their own paper – will be more profitable.

Pricing is where many in this business have gotten into trouble. In a commoditized business with tight margins, the temptation to compete on price often results in a race to the bottom, squeezing profitability for the whole market. When volume declines, companies need to raise prices to compensate. Indeed, several IFC members expressed surprise at how quickly pricing had begun to revert to pre-recession, aggressive levels. "It's almost as if we hadn't learned anything," said one.

But pricing is also the area that offers the most opportunity for innovation. As one IFC member put it, "Historically, we've facilitated equipment acquisition. In the future, we'll facilitate equipment utilization."

The traditional equipment leasing model is based on dollars-per-month based on original equipment cost. Newer models include price per unit of consumption, risk sharing, barter, and service contracts (in which the equipment is included but not "featured" – essentially the cell phone model). All have one thing in common: the equipment is no longer the primary focus of the transaction. Loosely called "bundling" or "managed services," these concepts have been growing market share for a decade. As one panelist said, "It's basically a semi-secured loan."

But managed services aren't yet widely offered in the industry, for several important reasons. "These are

Service Providers

As equipment finance goes, so go the companies that serve them. A service provider on the Council called the current environment "pretty grim." And, although lessors have cut staff, their productivity is up, so service providers who might have benefitted from outsourcing have not seen that trend manifest.

great customer solutions," said an IFC member, "but not all providers can play. The devil's in the details."

For example, there's a very different risk dynamic when the traditional "hell-or-high-water" lease obligation is intertwined with a contract requiring provision of services. The entire transaction is exposed to future performance issues. Also, managed services are currently common only in some equipment categories, but are predicted to become more prevalent. The IFC discussed the relative advantages enjoyed by captives over banks and independents in providing this structured product.

One other factor will hinder such structured finance offerings, at least in the short term: in this regulatory environment, "plain vanilla" rules. Transparency and simplicity are at a premium, and complex transaction models are viewed with suspicion by regulators and investors.

Various factors also contribute to the final price: relationship, origination method, deal size, asset type and term, among others.

Measure for Measure

How do equipment finance companies measure their success? ROA? ROE? It's a question the IFC discussed at some length, and the Council concluded that there are no standard measurements in this business. ROA and ROE mean different things to different companies. Without standardization, it's difficult for investors and regulators to understand the business. One IFC member suggested looking "at industries where the risks are lower and the returns are less," to see what measurements they use. "We may be heading in that direction anyway, so we'll need different measurements."

Q. Does our pricing reflect all our risk?

Q. Do we deal in equipment and markets that lend themselves to newer forms of pricing?

Syndication – Some IFC members foresee a greater role for syndication in the future, as fewer companies want to hold paper. Right now, they said, "Syndicators are a club of people who've known each other for years and have internal treaties between their companies that facilitate it."

That club is small, and the terms of syndications must be standardized in order for it to grow. But IFC members suggested that there would be "club deals" that functioned like leveraged loans – "People bid to get in on a deal that has clearly-understood terms. Everybody takes a piece," thereby spreading risk and placing some premium on originations.

Q. Is syndication an attractive model for us?

Q. Do we have an in with the "syndicators' club?"

Credit and Portfolio Management – How will businesses respond to their underwriting guidelines as the economy improves?

In the words of one small ticket lessor on the IFC, "We need to leverage what we've learned the last two years. We all know what a real 'A' credit looks like now."

That statement was echoed by all, and the IFC agreed that if you're still in the market now, you probably have a pristine portfolio. It's a fundamental point of strength. One IFC member asserted that, "We're probably building the best portfolios in the history of this industry." Risk management – always at the core of equipment finance – is even more crucial to success.

One IFC member called this the "new normal," and explained that he now looks at "every credit, every quarter."

Q. Have we used the downturn to cull our portfolio?

Q. How tight have our credit standards become?

Q. How are we prepared to maintain new credit standards through better times?

Documentation and Financial Reporting – The cost of doing business, in a future focused on compliance and document integrity, continues to grow.

Documentation has become more complicated and expensive. Different states want different information, and the widely anticipated adoption of "E-sign" technology hasn't really occurred.

Financial reporting is more burdensome than ever. In the words of one council member, "Sarbanes Oxley rippled out to companies too small to be directly affected by the bill's original design. It increases the costs to everyone."

People Power – Should we be proactive or reactive in our hiring?

"Jobs are another devalued asset class," according to a lessor. For an equipment finance company in expansion mode, these would be high times. "The cream of the crop is out there now," said one IFC member. And that's because there are few if any companies in expansion mode. There's a healthy supply of qualified, experienced equipment finance professionals on the market right now, victims of downsizing and firms exiting the market outright.

Meanwhile, most of the companies around the IFC table no longer have formal training programs. And while that may be troubling, there may be an upside for the industry. Just a few years ago, industry veterans worried about the "cool factor" – the inability of the industry to attract young people who were wooed by investment banking and other careers. "This industry has always been a place where creativity and personal initiative have thrived, and it will continue to provide such opportunity where hard assets intersect with high finance." Since young people in the industry now have seen bad times, "they're experiencing things we didn't," said one industry veteran. "This environment is teaching them, and they'll be ready to lead that much sooner."`

Q. What training and education mechanisms do we have in place for young employees?

Q. Are we positioned to snap up some of the excellent, experienced people currently in the job market?

CONCLUSION

The equipment finance industry, along with much of the rest of the economy, is in a state of suspended animation. Until they see improvement in consumer spending and unemployment, executives will remain in a reactive posture, distrustful of what bright spots there are and the fundamental underpinnings of the economy. Their caution is compounded by the unprecedented threats and rhetoric coming from Washington, D.C.

IFC was optimistic about the long term. Equipment finance is better positioned than other finance sectors, and companies with adequate funding should be in an excellent position to pick up market share. Firms that "stuck to their knitting" and weren't overly aggressive in the pursuit of growth have strong portfolios. Barring unforeseen calamities, and provided that legislation and regulation doesn't impose unprecedented handicaps on the sector, the "Great Recession" will fade, just as recessions past have. And there will be equipment finance providers to fund the recovery. This industry is nothing if not resilient.

But … resilience must be coupled with adaptability. Unlike past downturns, there will be no "back to the future" after this. The fundamentals – everything we thought we knew – have been called into question. The economic landscape, the markets and the nature of finance have changed and will keep changing. Success in that new environment may require seeing and seizing opportunity instantly.

It's impossible to know what the future will look like when we finally get there. But we do know it's going to look nothing like the past.

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