Industry Future Council Report 2008

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"Short-Term Concerns, Long-Term Optimism"

Last year's Industry Future Council (IFC) Report was titled, "Waiting for a Correction." By the time of this year's IFC meeting in January 2008, the economic correction, it seemed, had arrived. In the wake of the "sub-prime meltdown" and subsequent leveraged loan debacle several well-known banks and investment banks had revealed massive losses. Less than a week after the Equipment Leasing & Finance Foundation convened the meeting in Washington, DC, there would be an international stock sell-off, the Federal Reserve's dramatic rate cut and initial agreement in Congress on a $168 billion stimulus package to head off the threat of recession.

The diagnosis from one IFC member: "There was mis-assessment and mis-pricing of risk across business. Originators got it wrong, ratings agencies got it wrong, and now the whole model is up in the air."

Thus, the 2008 IFC met against a backdrop that one member called a "crisis of confidence." The questions then became, how long and how severe will this crisis of confidence be? And, more to the point for the IFC, what can equipment finance companies do to weather the crisis and be prepared to thrive when it's over?

Where We Are

What a difference 12 months can make. The 2007 IFC Report states, "None of the IFC members felt that capital is scarce—or even tight—today." This year, IFC members concluded that liquidity is—and will continue in the near term to be—the single most powerful differentiator between the "haves" and the "have-nots" in the market. In their assessments of the current state of their respective markets, nearly all, to one degree or another, focused on liquidity and the ability to fund new business as the most important factors affecting the overall market. As one participant from a large organization stated, "I've never seen anything like the attention being paid to liquidity right now." "Liquidity is king," said another, "and right now liquidity is hard to come by."

On the other hand, certain "pockets" of liquidity continue to exist, such as certain banks that rely on deposits for their primary capital (i.e community banks and small regional banks) and some private equity and hedge-fund players. Those players that can tap these pockets should have a significant advantage. While equity investment capital is more available (albeit at a price), the debt side of the equation will remain a scarce commodity.

According to the IFC members, the after-effects of the sub-prime (and leveraged lending) meltdown are keeping a significant amount of capital on the sidelines—particularly that of non-U.S. investors, who've become more cautious about putting their money here. While there has been evidence of sovereign funds flowing into some sub-prime-affected large banks, most new investors, say the IFC, will wait until we've "touched bottom" to commit capital in any significant amount. That's assuming that the credit crunch remains localized in the U.S., and doesn't spread internationally. However, some evidence of global liquidity challenges have been noted already.

This liquidity crunch is unfortunately occurring amid generally positive reports on demand for product. Most IFC members experienced strong volume and profitability performance during 2007 (some even saying "great")—at least through the first half; summer seems to have been a turning point in some markets, and few players described Q4 in glowing terms. (In fact, one used the term "nuclear winter" to describe Q4 and the current period.)

But there are deals out there, and as one participant said, "It's a great time to find business—it's a lousy time to fund it." Another was concerned about this mismatch of capital to opportunities. "If originations continue at the current pace, the money will run out." Furthermore, as described more fully below, the Council believed that this cycle of liquidity challenge will impact heretofore unaffected institutions—some very large players!

What else is characterizing the current equipment finance marketplace? One IFC member, a service provider, said his company is encountering an environment of "deferral and waiting." Credit quality has eroded some, but it is still generally healthy, and portfolios continue to perform ("overachieve" in the words of one IFC member). IFC members all agreed that a strong balance sheet is a "precious" commodity in this market, and expect the differentiation between balance-sheet-oriented players and those who rely on securitization or other closely matched funding to become more pronounced. While profitability remains an issue across most of the industry, and the IFC noted the classic pattern of funding costs rising more rapidly than prevailing pricing in the market, this inertia-driven squeeze on profitability is generally viewed as a near-term phenomenon. A general "flight to quality" and limited supply of capital will translate to more robust return expectations later in the year. In fact, some IFC members have seen spreads widen already.

Commoditization of lease and financing products continues, further reducing the differentiation between lease-like and loan-like structures. With the continuing trend toward more loan-like products (the IFC noted the findings from the recent U.S. Equipment Finance Market Study performed for the Foundation, showing a $1.3 trillion market for equipment/asset acquisition, with $600 billion of that being leased or financed, and about 12% of that amount being "true" or residual-oriented leasing), the relative importance of residual value setting, management and remarketing seems to be shifting. The key traditional drivers of the lease (tax, accounting, and residual risk) have continued to become less pronounced, furthering the trend toward loan-like structures.

However, as with any trend, an underlying shift in attitudes often creates new opportunities for those who can exploit a contrarian view. Thus the IFC developed a consensus that the general movement away from residual risk will create opportunities for those who can make residual risk-taking, and the associated cash-flow patterns, a part of their business plan.

Where Does Our Company Stand?—*Ask yourself these questions regarding your company's position in the current environment.*

- Do we have enough cash and cash flow to weather an extended downturn?
- Are our customers taking a "wait and see" approach to capital expenditure? If so, to what extent?
- How efficient is our business in the current market?
- What is our current measure of success (Turnover? Market share? Risk-adjusted return on capital? Spreads?) What should it be in this environment?
- Does our pricing adequately reflect our cost of capital?

Looking Ahead

The Market

As noted at the beginning of this Report, the current correction phase of the business cycle has been expected for at least a year. While no one would hazard a guess as to its duration or severity (One member said, "We don't know whether we're in the second inning or the seventh inning of this particular game.") nobody seemed to feel that the end of the correction is imminent.

In the short term, volume will probably fall as capital expenditure slows and "the business sorts itself out." But over the long term, the IFC predicts that equipment financing will grow as a percentage of all capital expenditure, improving its share of the market.

The Council discussed the possibility of a categorical asset de-valuation as market conditions force some end-user companies to cancel equipment acquisitions and thus forfeit their deposits to the manufacturers. While this phenomenon may initially be limited to capital assets with long construction lead times (aircraft, maritime, rail), the Council discussed the potential ripple effect of the trend. With the deposits already in hand, the manufacturers can then market the equipment for a lower price, driving down the price of assets in both the primary and secondary markets.

"Plain vanilla," has become the preferred flavor of the finance transaction, as investors' distrust of complex structures deepens. This suits some IFC members. "A lot of us were getting creative because we were getting beaten down on margins," observed one executive. "Now, we're going back to basics."

Liquidity is—and will continue in the near term to be—the single most powerful differentiator between the "haves" and the "have-nots" in the market.

"Back to basics" will also characterize many firms' approach to their portfolios. The flight to quality will likely leave the higher-risk end of the market underserved. That vacuum, members predicted, will eventually be filled as companies recognize the opportunity.

It is important to stress that, although the 2008 IFC is clearly concerned about the immediate future, the long-term outlook for the equipment leasing and finance business is good. One member predicted that, whenever this difficult period has run its course, "it will be the best of times," because the correction will have washed out the unhealthy practices from the market.

Survival Checklist—*Questions every company should be asking itself.*

- When will it be safe to get out of our foxholes? What signs will I be looking for to know when that time is?
- What is our appetite for residual risk? Credit risk?
- Have we boosted our reserves for potential losses?
- Do I have an appropriate risk management team and plan to navigate the current market?
- Does our pricing fairly reflect real risk?
- What is our organization's value proposition? Do we need to change it based on the changing economic environment?

The Players

We are entering a period in which the market will be divided into "haves and have-nots," in terms of liquidity. Unlike previous cycles, however, the "haves" may not be the usual suspects—large independents and large banks. Those organizations are subject to Basel II capital adequacy requirements, which becomes a dominant factor as they decide where in their businesses they allocate their capital, and adopt risk-adjusted pricing. The traditional assumptions regarding the identity of the well-funded players therefore may be challenged during this cycle, and other players such as regional banks and non-conventional financiers may actually have a near-term competitive advantage.

The Council also felt that the market will become more clearly defined between those who focus on credit risk versus those who focus on the underlying asset risk Some IFC members believe this trend, coupled with the pressure of Basel II requirements, will encourage some banks to question their continuing involvement in this business. "When they're no longer getting value from lease renewals, they'll say forget it and pull out," predicted one Council member. Compared with some other competitors in the same market, many banks simply lack equipment expertise and the ability to hold assets over the long-term. And some of those banks may have had an unrealistic understanding of equipment financing in the first place, according to another IFC member: "They've used leasing as a loss leader. But it should be a premium product."

As complexity continues to be suspect, companies with residual setting skills and who can do the "blocking and tackling" of equipment leasing and finance will benefit from the back-to-basics environment. In particular, the IFC sees a future for small independents that hold portfolios. These players enjoy the advantages of less regulation, less emphasis on patterned increases in reported income, and less pressure to demonstrate period-over-period growth. They have positive yields that enable them to fund their business through a variety of means, and they've got differentiators ("secret sauce" one IFC member them) that some large players just don't have—specialized skill sets such as origination or asset management, industry-specific focus or expertise (especially seen in corporate organizational structures), or asset-specific knowledge and skills as found most prominently among captives. The differentiator may even lie in establishing and maintaining customer intimacy through personal contact and heightened service levels. "Price is always a factor," admitted one IFC member, "but just knowing people's names can be a differentiator."

A general "flight to quality" and limited supply of capital will translate to more robust return expectations later in the year.

If the flight to quality mentioned above pushes pricing and yields up to a level at which this business becomes attractive again, a few new players may try to enter the market. However, they will face significant hurdles in funding and the same tough decisions about residual/credit risk as current players.

Survival Checklist—*Questions every company should be asking itself*

- Who are the "marginal" players in our segment? Are we in a position to benefit if they pull back?
- Can we benefit from the current market by acquiring competitors or complimentary businesses at distressed prices?
- In what areas can we simplify our products (get back to basics) without sacrificing market share?

Opportunities

De-emphasis of residual risk-taking in current financing products continues. But the demand for residual risk-taking hasn't disappeared. Therefore, the IFC believes there are significant opportunities for companies who will do traditional equipment leasing—who have equipment expertise and the ability to provide tax-oriented products. Much of this opportunity lies in business that might be considered below investment grade in the sense that banks and those who employ true risk-adjusted pricing will be challenged to generate adequate returns on higher levels of allocated capital. However, these players should be able to earn a premium for such products and transactions.

IFC members felt that the present economic situation would spur renewals, and that companies will be well-served by an ability to rewrite and extend leases and maintain their portfolios. This may, in turn, lead to an increase in M&A activity, as those with liquidity see the potential upside contained in existing portfolios.

Again, liquidity will be the key to seizing opportunities. In an environment of slowed capital expenditure, volume will be difficult to maintain. But companies with ready access to capital can grow through expanded originations and through acquiring portfolios from those less able to meet continuing re-funding and capital requirements.

While everyone else is primarily concerned with survival, companies with liquidity also have the opportunity to improve their operations, streamline and make processes more efficient. As Fortune 500 management guru Ram Charan wrote recently in Fortune, "When the top line looks shaky and the bottom line looks worse, the temptation is to go after discretionary spending. Fine—but do not consider product development, innovation and brand building optional. Sacrificing your future for a slightly more comfortable present is not worth it."

In terms of market opportunities, IFC members agreed that alternative energy and "green technologies" hold promise that is yet to be clearly defined, but those sectors are well positioned for more rapid growth. The creativity and adaptability for which this industry has been recognized for the last half century may be best suited to address the growth opportunities in these sectors—opportunity reborn.

> *"We don't know whether we're in the second inning or the seventh inning of this particular game."*

Survival Checklist—*Questions every company should be asking itself*

- Are there opportunities in your markets to benefit from the knowledge and resources of a joint venture partner where the relationship could be mutually beneficial such as funding, tax base, residual risk capacity, ect.
- How can I incorporate new technologies to improve the management of my business or improve the delivery of service or value to our customers?
- If we have liquidity, can we really afford to invest now in people, systems, operational efficiencies, new markets? Can we afford not to?
- Do we need to develop more competencies? Will the organization's historical strengths be sufficient to deal with the future?

Challenges

"If you don't find a way to fund yourself, you're out," said one Council member, summing up the number one challenge most companies will face over the next couple of years. "We need to realize that some of these means of funding won't come back—and neither will the companies that relied on them," said another. A quick look at the usual means by which companies fund themselves:

Corporate Notes and Commercial Paper Facilities are "pretty grim" according to one IFC member. These facilities may still be providing liquidity under current commitments, but have tightened monitoring and oversight. For those whom are looking for this type of financing, it might be difficult to obtain a new facility. Pricing will be increasing for any renewals and if CP can't be sold, banks will put these assets on their balance sheets and charge more for this type of senior capital.

Term Securitization has slowed dramatically, and is expected to remain difficult to effect. The term markets are closed in the short term, and will be difficult through the remainder of the year. Only the top tier will have access to this type of product.

Insurance Companies such as MBIA, AMBAC are suffering from the sub-prime meltdown and might make it difficult and costly to insure lease assets for the term markets.

Deposits continue to be a reliable source of funds for those who rely on them as a primary capital source—especially small to medium-sized community and regional banks. Deposits have, however, become significantly more expensive as banks compete for these funds.

Portfolio earnings are of course dependent on quality of receivables and residual value realization.

Income and Hedge Funds may find the equipment markets more interesting with higher yields and the ability to fund deeper into the structures. One member of the Council also commented on the ability of these Funds to assume residuals on longer-term assets and take larger positions than the traditional funding sources.

Managed funds may have access to capital, but where and when will returns become attractive enough to entice them into the market?

Regulation and legislation will continue to challenge companies in this industry. Basel II is already changing the way banks and large independents do business. Banks are undergoing a period of intense regulatory oversight and, while opportunity may lie in the credit-challenged end of the market, those subject to more intense oversight will likely migrate further toward the lower-risk end of the spectrum.

While everyone else is primarily concerned with survival, companies with liquidity also have the opportunity to improve their operations, streamline and make process more efficient.

Survival Checklist—*Questions every company should be asking itself*

- Do we have enough sources and diversity of capital?
- Are we confident in our parent company's short and mid-term liquidity?
- How will our equipment financing division react if our parent company or the general market suddenly restricts our liquidity?

The Human Challenge

As it has over the last few years, the IFC discussed "human capital" at length. Most Council members agreed that the quality of youthful resources in their companies is generally good, but they worry about their experience level and the "transfer of intellectual capital." Many of today's senior executives, who will be leaving the industry soon, have been in leadership positions from a young age. This is less-so for those who will immediately succeed them, and even more remote for those in the industry's next generation. "Not many people in this business have even been through a real recession," one IFC member pointed out.

Conversely, "I'm much more optimistic about the human capital situation than I was three or four years ago," said one executive. "I think the steps ELFA has taken and that we have taken in our own companies have helped a great deal." The IFC focused especially on the continuing emphasis on diversity and on creating excitement—tapping the "cool factor"—to attract a new generation of creative, talented individuals. One member observed, "There is diversity in our companies, but those people are not at the executive level yet."

As for the cool factor, IFC members agree that equipment finance should have appeal to young people. "You can be creative, and it incorporates all these different skill sets," said one. "It's a lot more fun than approving loans in a bank." But the industry needs to get its story out, and to reach out to college and business school students to ensure a flow of talent into the business There was general speculation that it may take more than five years before that diversity was more fully reflected in the industry's leadership.

In this correction, human capital may be every bit as valuable as money—all the more so because a company in a position to thrive when the environment improves must have the talent to execute. In the Fortune article cited above, Ram Charan writes:

It may seem counterintuitive to pay bonuses when profits are falling, but sometimes it's the right thing to do, particularly if a specific unit is creaming the competition…In fact, a downturn can be an excellent time to poach; people who might have stuck with a company because of vested options or other monetary incentives may be more willing to join your company when those vanish.

So if your company is one of the fortunate ones with access to capital, consider whether you're paying enough attention to, and investing enough in, your human capital.

Survival Checklist—*Questions every company should be asking itself*

- Are we committed to implement diversity in our workforce?
- What are we doing to prepare our younger people to lead?
- Do we have a succession plan?
- Do we have the right talent on board to drive our business plan?
- Are there opportunities to upgrade our human capital resources during the current downturn?

Companies with residual setting skills and who can do the "blocking and tackling" of equipment leasing and finance will benefit from the back-to-basics environment.

The equipment leasing and finance market, like the larger economy, is experiencing a correction. Liquidity, so plentiful for the last few years, has suddenly dried up except for certain discrete "puddles." Nevertheless, the industry is fundamentally sound, and there will continue to be demand for financing. Companies that use this correction phase to hone their competencies and improve the efficiency of their operations should be well-placed to thrive when the "best of times" arrive.

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