State of the Industry Report

Prepared By:

FIC
Financial Institutions Consulting, Inc.
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FOREWARD

During 1998, the equipment leasing and finance industry experienced tremendous growth and consolidation. The driving force behind growth and the business models used to convert new business volume into attractive returns varied dramatically among leasing segments. Leasing executives have been forced to envision the future of leasing and reevaluate their strategy in an effort to survive.

The Equipment Leasing and Finance Foundation commissioned Financial Institutions Consulting (FIC) to conduct a competitive analysis of the $200-plus billion leasing industry. FIC concluded its work by issuing this report, the 1999 State of the Industry, which addresses trends in the size, growth, and competitive issues occurring within the industry. The report is yet another resource provided by the Foundation in its ongoing efforts to improve the health and prosperity of the industry and its people.

As the leasing industry continues to evolve, the Foundation will diligently pursue its mandate to develop forward-thinking initiatives designed to provide insight into critical and emerging issues. The Foundation exists ultimately to develop and promote a body of knowledge that enhances recognition and understanding of lease financing among a variety of constituents, including the leasing industry, the business community, and the academic community.

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Preface

The Equipment Leasing and Finance Foundation is a forward-thinking organization, well aware that in today's emerging e-economy comfortable markets can change extremely rapidly. To get beyond the performance numbers–which do not always tell the whole story–the Foundation, therefore, selected Financial Institutions Consulting (FIC) to prepare this year's inaugural 1999 State of the Industry Report.

The FIC methodology for this analysis incorporates statistical data with in-depth personal interviews. Both FIC and the Foundation wanted to take advantage of the valuable human capital the industry has to offer. The Report, therefore, incorporates the 1999 Equipment Leasing Association's (ELA) Survey of Industry Activity (Survey), FIC proprietary research and analysis as well as perspectives from industry experts. In addition, FIC conducted in-depth interviews with 16 industry experts representing a cross-section of the major lessor types and ticket sizes.

These in-depth interviews with industry leaders focused on recent performance, key issues impacting the industry, and, in particular, future trends projected for the next two to three years. The individuals who lent their time and shared their opinions include:

Fred Costabile	Dougles Olson
Burt Feinberg	Paul Omohundro
Charles Kiser	Patricia Pegg
Robert Kopp	Paul Renner
Gary LoMonaco	Thomas Uehling
James Merrilees	James Walker

William Montgomery James Westley
Dennis Neumann William Zadrozny

We would like to thank these individuals, each of whom serves on an ELA Business Council, for their frankness and insight. Throughout this monograph, we include direct quotations from these interviews, recorded anonymously to preserve confidentiality of comments and opinions.

The lessor types analyzed in this Report are, as classified by the Survey, captive leasing companies, independent lessors, bank lessors, and financial advisors. Additionally, the Survey includes vendor leasing as an additional lessor type.

Lease size segmentation, which was also captured in the Survey, is based on the following ticket sizes: small ticket, up to $250,000; middle market from $250,000 to $5 million; and large ticket, over $5 million. The Survey further breaks out the small ticket segment into two sub-segments: up to $25,000 and $25,000-$250,000. Unless noted, however, we include both groups within the small ticket segment.

This monograph begins with an overview of the leasing industry's recent performance. We then move on to the key issues that senior managers are addressing. For the key industry segments identified by the Foundation– vendor finance, small ticket, middle market, and large ticket–we provide a summary of market performance and strategy.

Finally, as management consultants to the movers and shakers in the financial services industry, we know that foresight may be hard to gain, but it is well worth the analysis. Therefore, we have concluded this report by providing readers with our firm's views on some of the major trends for the equipment leasing and finance industry.

Charles B. Wendel
President
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Executive Summary

The leasing industry total new business volume for 1998 was $207 billion, up 15 percent from $179 billion in 1997. The total new business volume is expected to reach $233 billion by 2000. Industry returns, however, were not as impressive as new business volume growth and tell a story of aggressive competition as well as an increase in mean write-offs.

The penetration rate of leasing as a source of funding for business purchases of producers' durable equipment increased slightly to 30 percent in 1998, and it is likely to remain steady or increase marginally during the next two or three years.

Industry returns were not as impressive as growth in new business volume. ROE, as reported by Survey respondents, fell from 13.9 percent in 1997 to 12.5 percent in 1998. Aggressive price competition in most segments and an increase in mean write-offs contributed to the decline. Among the notable lessor types:

- Banks were the most profitable segment, reporting a 16.4 percent ROE and continuing to gain market share due to their focus on leasing as a core product.
- Captive lessors reported a 14.5 percent ROE which that resulted from the lower levels of competition existing within their market.
- Independents have encountered the most aggressive competitive environment with falling yields contributing to their 10.4 percent ROE.

Technology is changing the business model. Technology has transformed small ticket and vendor leasing and has begun to penetrate the larger ticket sizes. Internet technology, in particular, has spurred the growth of these markets and dramatically improved efficiency. In fact, technology has given many lessors a competitive advantage in their markets. The result, however, will likely be a commoditization of leasing product. Unless a niche market or brand identity is well established, this competitive advantage will almost certainly be lost. Non-leasing companies will enter the market as the Internet allows competitive bidding for leasing transactions.

Other issues abound. Mergers and acquisitions, pending regulatory changes, personnel shortages, and capital markets uncertainty will continue to be points of concern for managers.

Market Segments

Market segments have varied dramatically in their ability to generate new business volume and provide attractive returns. The defining characteristics beyond growth and return, however, fade as lessors cross the lines into other segments and introduce their business models. The segments performed as follows:

- Vendor financing is one of the fastest growing areas due to vendor demand and product and service sophistication.
- Small ticket leasing has grown in conjunction with and for many of the same reasons as vendor finance. Additionally, the less than $25,000 ticket segment is one of the most profitable markets with a 18.8 percent ROE and is beginning to attract outside, non-lessor competition.

- The middle market is the largest and most competitive segment. As a result of the lower than average yields and the higher than average expenses, the middle market segment reported an 11 percent ROE.
- Large ticket lessors have produced industry-leading returns with a 20 percent ROE but are faced with growth challenges. Cash rich customers are electing not to lease equipment, and acquisitions among customers has challenged credit exposure limits. Although margins were very tight in this segment, large ticket lessors managed to keep expenses at 73 percent of revenues

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Market Size, Growth, and Profitability

The leasing industry continues to compete against bonds, commercial mortgages, and commercial bank loans in financing producer's durable equipment sold in the US. The leasing industry, however, has maintained a consistent share of the producers' durable equipment financing as measured by the leasing penetration rate (defined as producers' durable equipment as reported by the US Bureau of Economic Analysis divided by total leasing volume) (Exhibit 1).

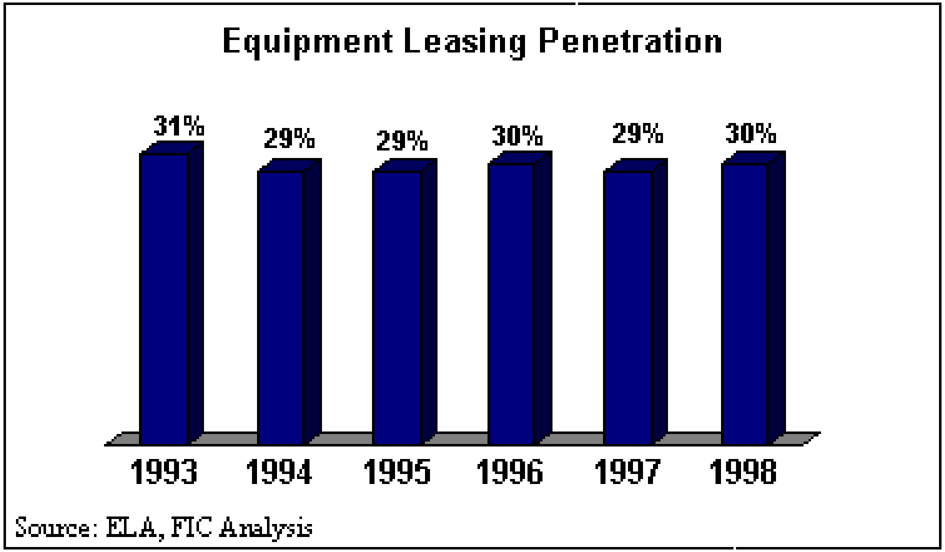

Exhibit 1

The nature of competing financing, however, has changed significantly over the past several years as flexibility and availability of funds through the capital markets has increased. The outlook for growth, therefore, is mixed and returns are down. The U.S. Bureau of Economic Analysis (BEA) estimated producers' durable equipment, the primary driver of the leasing industries total new business volume, as $691 billion in 1998. This represents an 11.4 percent growth rate over 1997's total of $621 billion.

Economists, however, are not expecting this level of growth to continue and are projecting growth rates of 6.8 and 3.4 percent in 1999 and 2000, respectively.

The outlook for market penetration is mixed. The leasing industry has faced many challenges and yet has consistently produced a penetration rate near 30 percent year after year (Exhibit 1). Nine of our 16 interviewees believe that leasing can capture more of the producers' durable equipment market. They believe that the technology equipment segment presents the greatest opportunity for increasing leasing penetration.

As technological equipment becomes obsolete at ever-increasing rates, we expect high-tech equipment, as a percentage of producers' durable equipment, to increase. Many believe that this rapid rate of obsolescence will encourage more companies to lease rather than purchase what may soon be outdated equipment.

Increasing commitment to the leasing industry by banks and the desire of vendors to provide turnkey solutions that incorporate financing and servicing should also help to increase the leasing industry's penetration rate. One bank lessor, for example, reported that over 50 percent of their leasing volume resulted from loan officer referrals. This stresses the importance banks are placing on leasing as a viable method of finance.

Slightly less than 50 percent of interviewees do not believe that the penetration rate will increase. They cite regulatory issues, economic growth, product maturity, and the historical consistency of the penetration rate.

The increase in the 1998 penetration rate is supported by the fact that new business volume, as indicated by the Survey and the Monitor 100, grew approximately 20 percent while the producers' durable equipment grew by only 11.4 percent (Exhibit 2). The difference in growth rates between the producer durable goods and the new business leasing volume indicates an increase in the leasing penetration rate. It also reflects the continued consolidation within the industry.

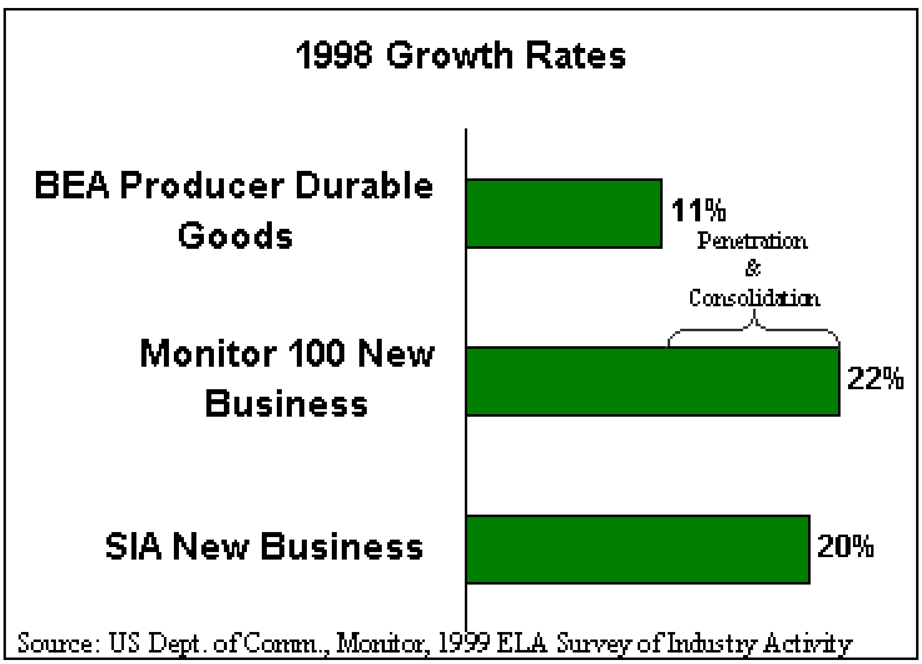

Exhibit 2

FIC expects the penetration rate to increase slightly in 1999 and 2000. The growth in vendor programs, increasing bank sales, and new delivery channels provided by the Internet will improve the leasing industry's ability to reach new customers. An increasing interest rate environment will also help to encourage companies to lease versus buy, as capital becomes more expensive.

For 1998, volume increased by 15 percent. The estimated total market new business volume was $179 billion in 1997 and $207 billion in 1998 (Exhibit 3). FIC has derived these growth estimates from a number of market sources, including the producers' durable equipment index, the Monitor 100 new business volume growth rate, and the Survey new business volume growth rate.

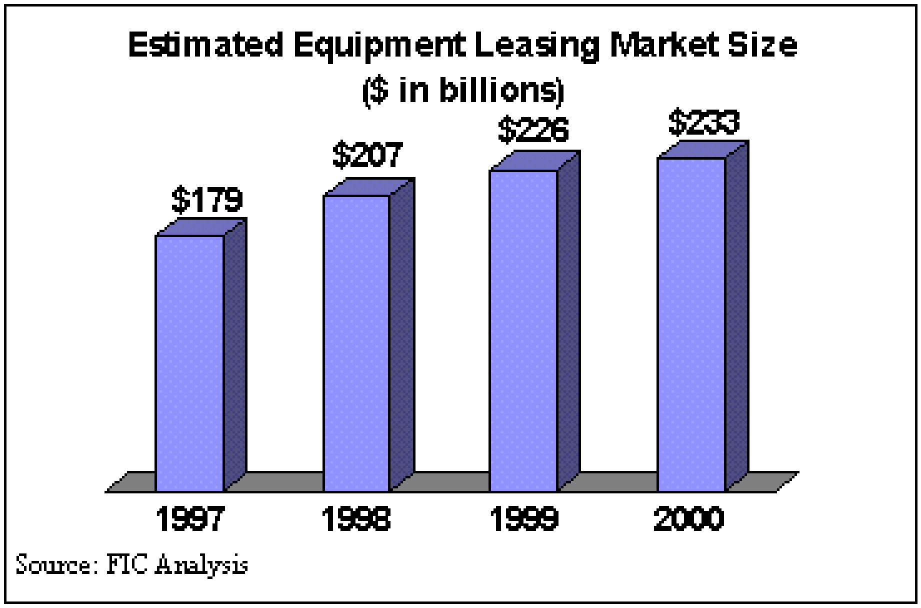

Exhibit 3

Based on the total market size estimate and the ticket segment distribution of the respondents in this year's Survey, we have estimated the market size for each ticket segment (Exhibit 4). Of the new business volume reported by the 142 respondents, 37 percent was categorized as middle market ($250,000 to $5 million), 33 percent was categorized as large ticket (over $5 million), and 30 percent was categorized as small ticket (up to $250,000). Applying these segmentation percentages to the total estimated new business volume of US leasing companies results in a $77 billion middle market segment size, a $68 billion large ticket segment size, and a $62 billion small ticket segment size, respectively.

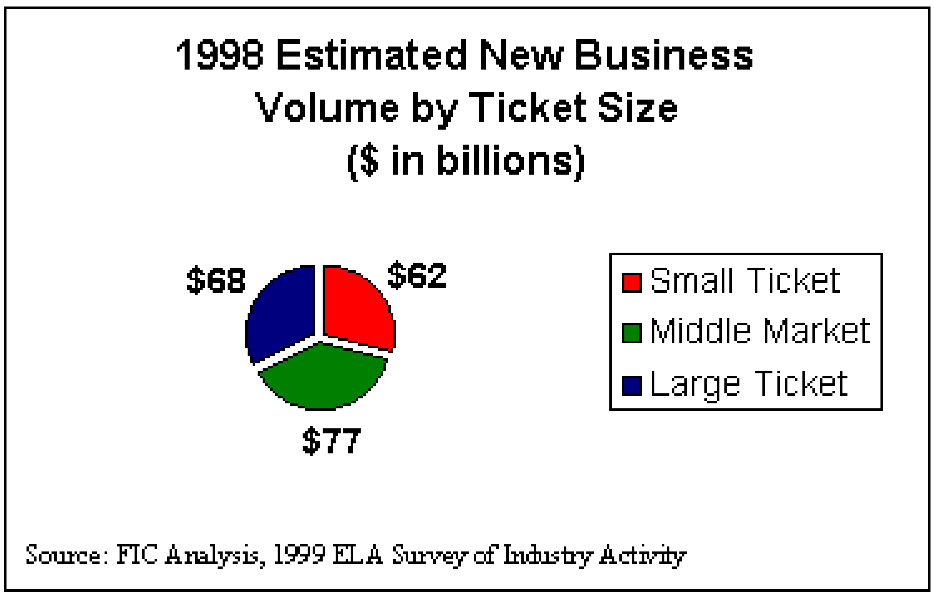

Exhibit 4

Going forward, new business volume growth rates of 20 percent will be more difficult to attain. Regulatory issues, economic conditions, equipment obsolescence, international markets, and end customer perceptions about leasing will collectively impact growth of the equipment finance and leasing industry in 1999 and the new millennium.

In addition to providing the greatest opportunity for leasing penetration, the technology segment also provides the greatest opportunity for volume growth. As indicated in Exhibit 5, computer equipment has demonstrated remarkable growth among Survey respondents. Although a portion of this growth is attributable to "Y2K" replacements and upgrades, the estimated growth rates exceed the industry average.

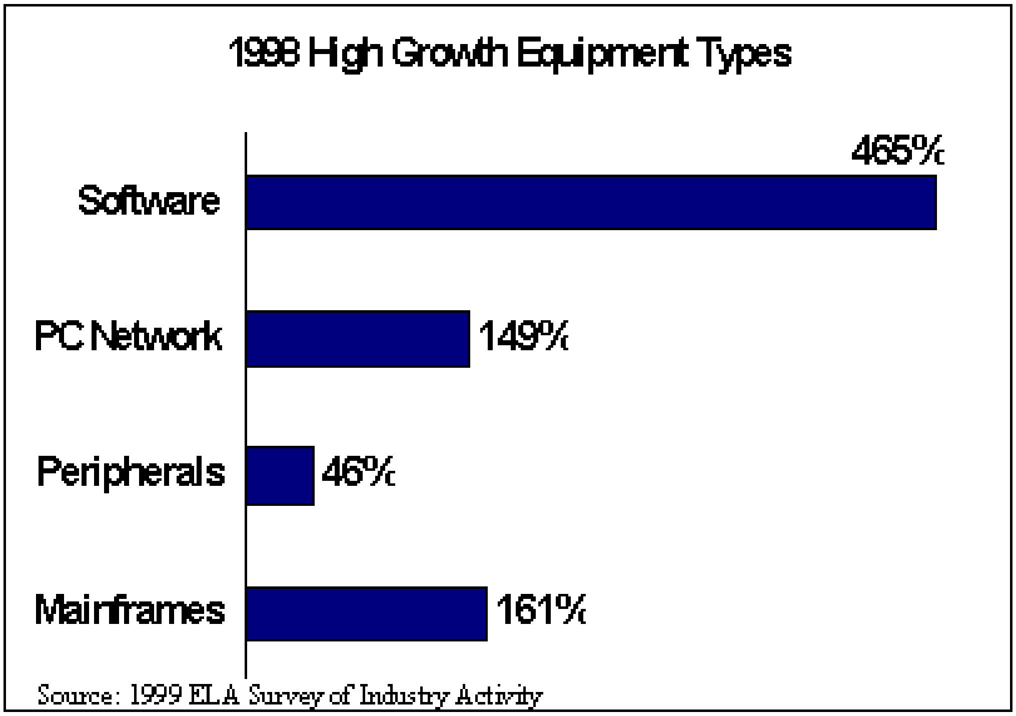

Exhibit 5

Although new business volume grew significantly, returns did not. The respondent average return on assets (ROA) fell slightly from 1.5 percent to 1.4 percent in 1998 and return on equity (ROE) dropped from 13.9 percent to a mediocre 12.5 percent (Exhibit 6). These figures also indicate a reduction in the leverage ratio from 9.2 to 8.9. Write-offs, as a median percentage of full year average net lease receivables balance, have remained constant at 0.4 percent while write-offs as a mean percentage have increased from 0.3 percent to 0.8 percent.

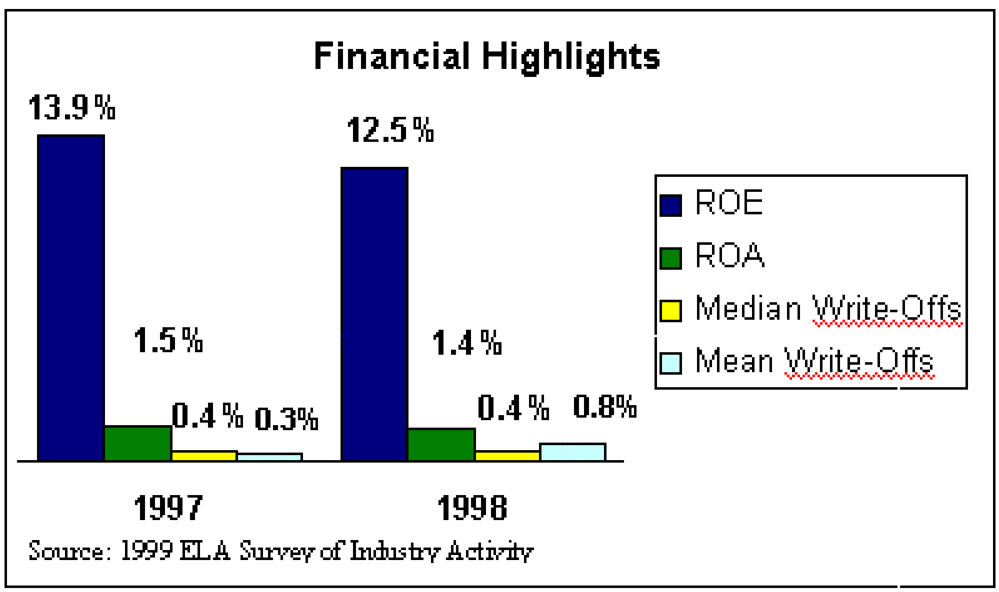

Exhibit 6

According to FIC interviews and analysis, aggressive competition has negatively influenced yields. Price was cited as the primary competitive factor in most segments, and the strong desire to build volume has caused the decline in spreads (Exhibit 7).

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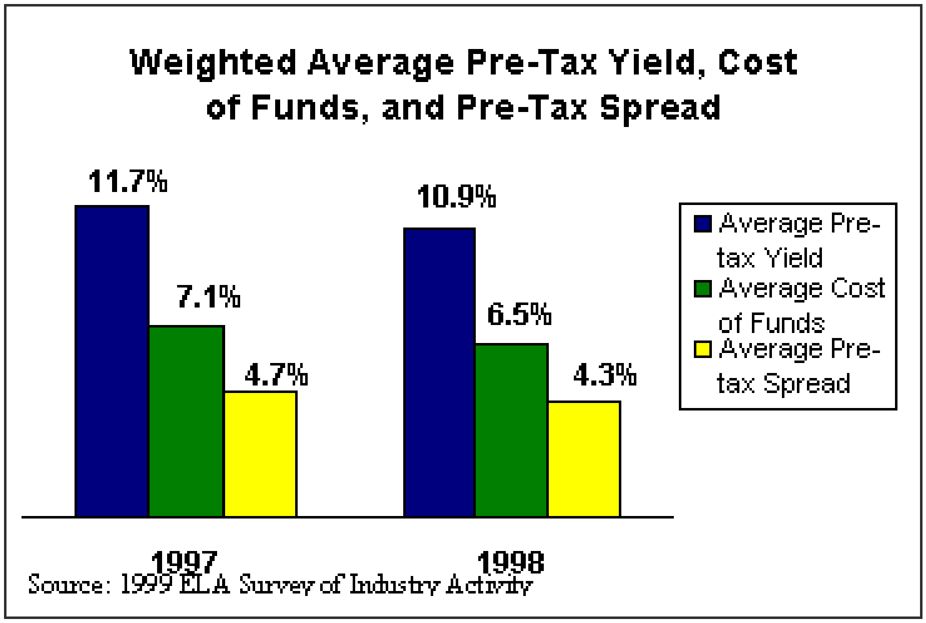

Exhibit 7

The Competitive Arena

Although the leasing industry is definitely growing, segment performance is uneven. Four major lessor types make up the competitive arena: independents, banks, captives, and financial advisors. Although each one of these competitors face the same industry challenges, the markets they target and the competitive advantages they offer result in a unique situation for each lessor type.

Growth rates among various lessor types were distinctly different. For example, Survey bank respondents held a competitive advantage as evidenced by their ability to increase total new business volume by 35.8 percent while generating a 16.4 percent ROE (Exhibit 8). Although independent respondents generated the largest total volume of new business, their ROE, in contrast, was the lowest at 10.4 percent.

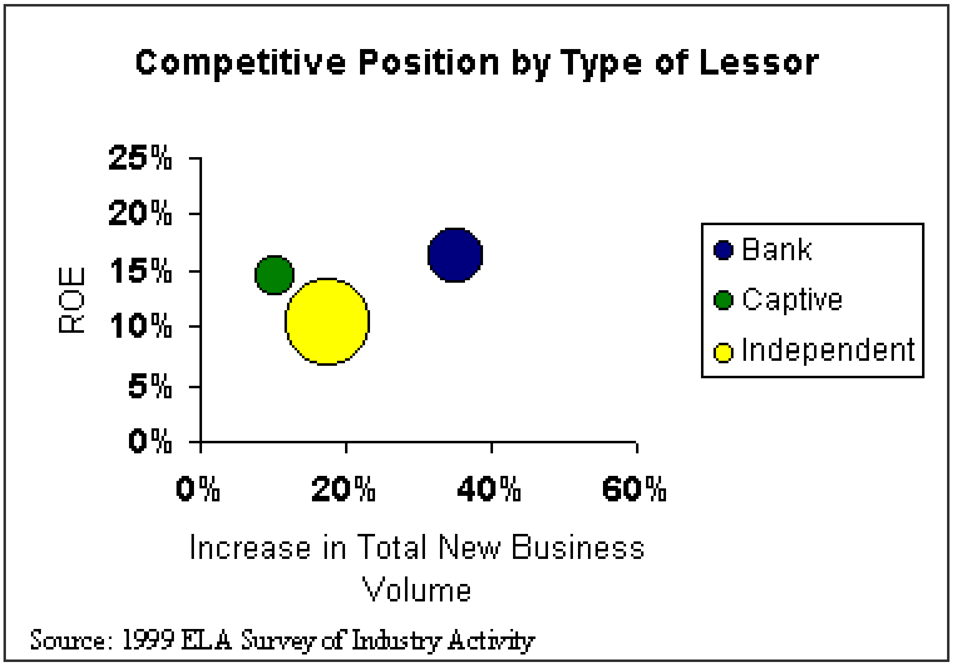

Exhibit 8

Another example of this diversity is annual volume. Neither banks nor captives have more than 40 percent of the companies in any single volume category. (Exhibit 9) Financial advisors, although not reporting in three of the eight detailed volume segments, did appear to be concentrated in the $50 million to $250 million annual volume category. Additionally, over 40 percent of independent respondents generated less than $50 million annually which reflects the fragmented and entrepreneurial nature of this group.

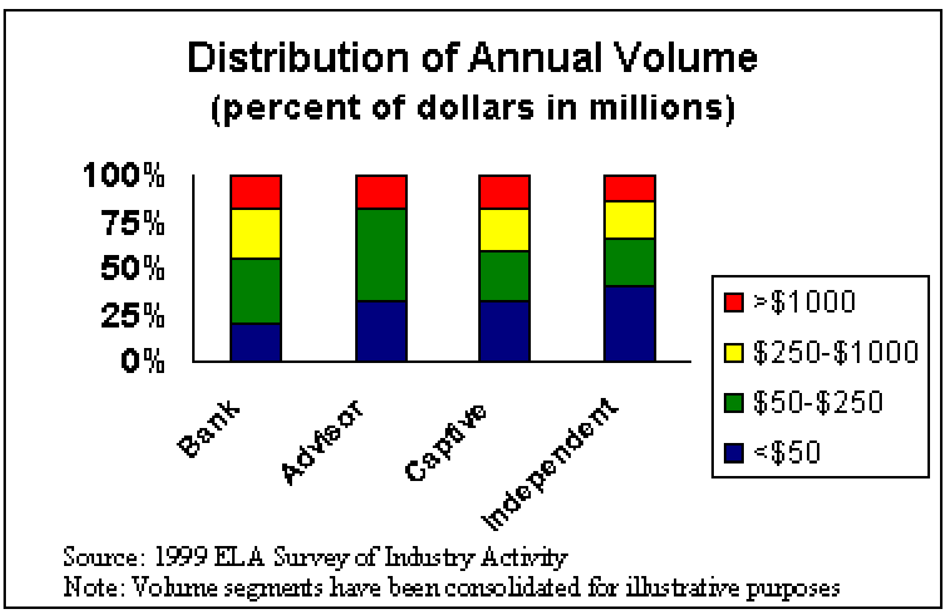

Exhibit 9

The profitability measures by lessor type are a direct result of their competitiveness within each industry segment. The Survey data on applications submitted, approved, and booked demonstrates the ability of lessor types to win desired transactions. On average, lessors approved 65 percent of applications and booked 69 percent of the approvals. The ability of a lessor to book approved transactions, referred to in this Report as "pull through effectiveness," indicates their competitive strength and marketing focus within their chosen segments.

Captives operate in the least competitive environment. Given the manufacturers' ability to combine a lease with an equipment purchase, captive lessors book almost 98 percent of their approved applications (Exhibit 10). Although many manufacturers and vendors use their captive finance arms as loss leaders, the captive lessors still maintain an above average ROE at 14.5 percent. The ability to capture a large percentage of their approved applications and to avoid aggressive price competition has provided captives with a unique position within the leasing industry. Even this segment, however, has begun to encounter additional pressure as banks and independents market customers prior to their purchases using offers such as pre-approved lease lines of credit.

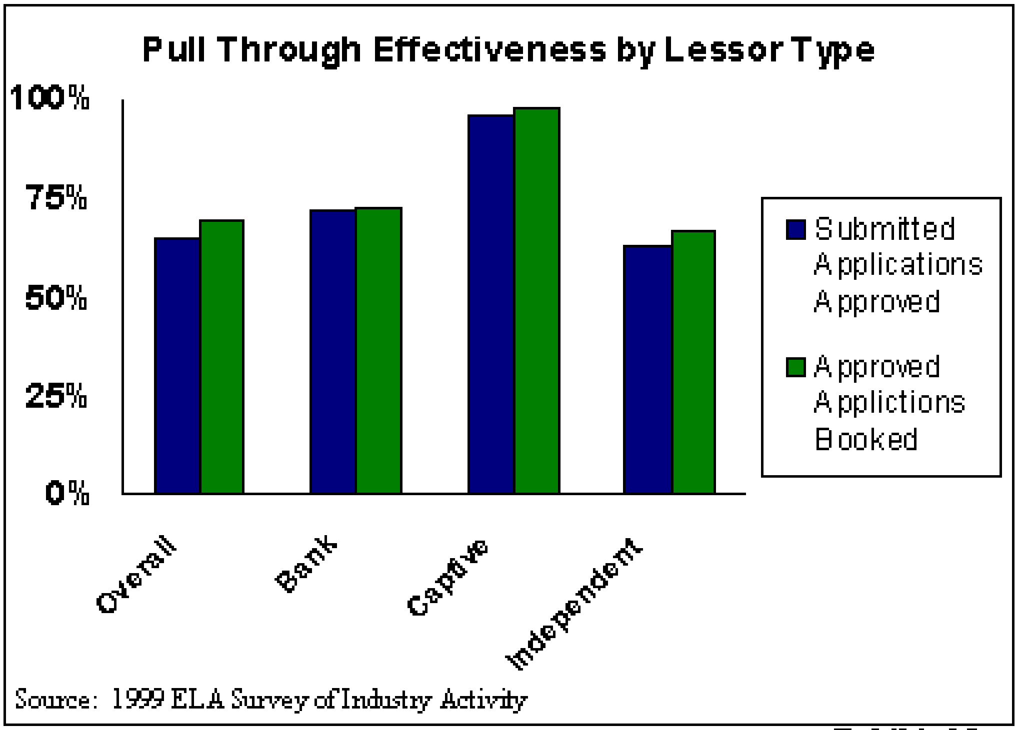

Exhibit 10

Independents, however, do not enjoy the same level of pull through effectiveness. In contrast to captives, independents approve 63 percent of applications but only 67 percent are eventually booked. The inability to book approved transactions indicates the high level of competition within the market and undoubtedly contributes to their below average ROE of 10.4 percent.

Banks have a high percentage of approved transactions. Due to their larger transaction size and high level of bank referrals, banks have a higher percentage of approved applications than independents. This is also a result of pre-qualifying transactions before a lease application is made. During 1998 banks approved 72 percent of their applications and were able to book 73 percent of those approved.

It is noteworthy that the equipment leasing industry views banks as an increasingly important player. Of the industry experts interviewed by FIC, 78 percent believe that banks will continue to increase their market share (Exhibit 11). Banks have also made inroads and commitments in various leasing segments that have contributed to their over all competitive threat.

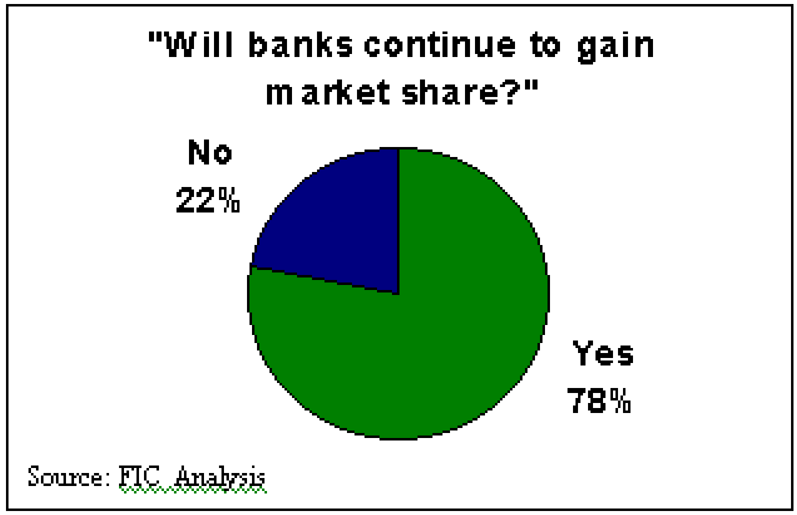

Exhibit 11

By capitalizing on their customer base and focusing on cross-selling, banks have begun to build share in both the small and middle market business segments. Many banks began their small ticket leasing activity by private labeling leases that are approved and monitored by third-parties such as GE Capital and DeLage Landen Financial Services. This initial approach of outsourcing small ticket transactions allowed banks to offer a lease product without making a significant capital investment in process technology. Recently banks have become more comfortable and knowledgeable about the small ticket segment. One bank has even brought its operations in-house.

The cooperation between loan officers and leasing officers within banks has increased with the mutual goal of capturing the existing leasing business of current customers. At one bank we interviewed, relationship managers are compensated similarly whether they sell a lease or a loan. This practice encourages a solution-approach to customer problems.

Within the large ticket segment, banks have established a competitive advantage by their size and relationship history. Although the growth of this segment has slowed, large banks have been able to fund profitable transactions that are beyond the capabilities of all but a handful of leasing companies.

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Technology & The Internet: Changing the Business Model

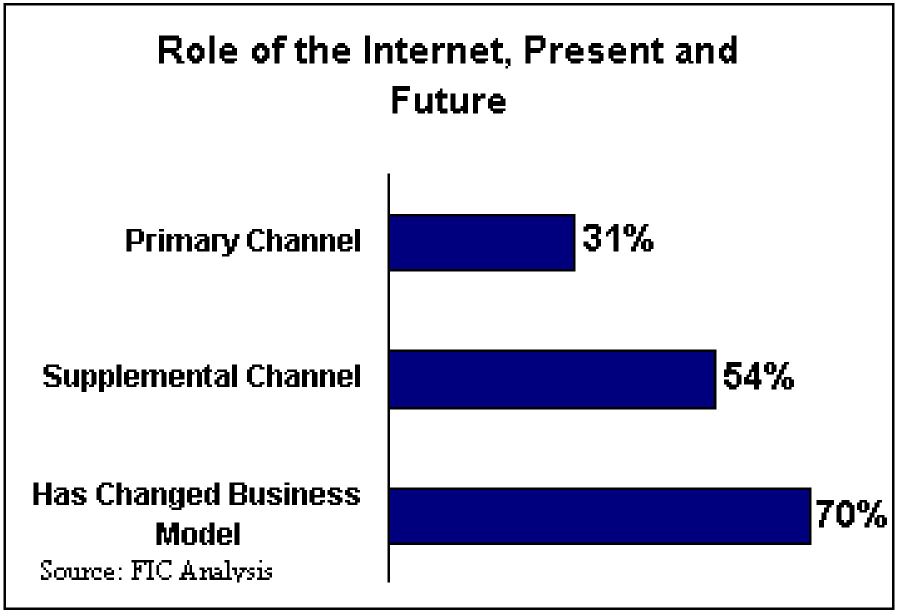

Exhibit 12

"Few deny that the Internet has changed the American economy, but the leasing industry has yet to fully embrace the Internet as an alternative delivery channel."

Industry experts believe that technology will continue to have a profound effect on the leasing industry. Of the lessors interviewed by FIC, most believe that the Internet has already changed their business model (Exhibit 12). Interviewees view the Internet as a faster, more efficient method for both internal and external communication. One interviewee noted, "The result of these technologies is that sales staff out in the field operate the same as they would if they were in the office." But, while the Internet is perceived to increase efficiency, from improved inter-office communication to a reduction in the sales force, only 31 percent of interviewees believe that the Internet will become the primary delivery channel for lease origination and servicing.

Growth of Internet use within the leasing industry varies dramatically. Generally, the small ticket firms have been more aggressive while the larger ticket companies have been hesitant to follow (Exhibit 13). Those companies that have yet to embrace the Internet view it principally as a means of internal communication, document transfer and processing, and customer communication. However, re-marketing of equipment on the Internet has grown rapidly as lessors expand their network of used equipment outlets.

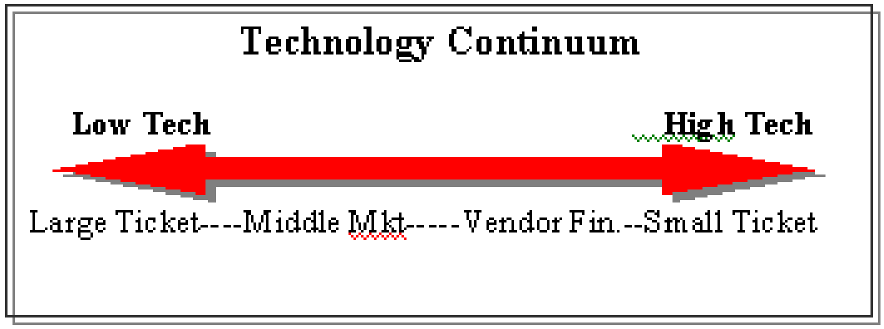

Exhibit 13

More Internet-savvy firms have used the technology to develop functionality such as, online applications, underwriting, processing, signature, and funding. One interviewee told us, "All of our new business thoughts have the Internet in mind." High transaction volumes and product standardization have promoted Internet use in the small ticket segment. FIC believes this will ultimately result in a more efficient process, but it will also force lenders to emphasize their brand in an attempt to differentiate their product and avoid commoditization.

> "Small ticket lessors have embraced the Internet faster than other segments of the leasing industry."

The small ticket segment has been the most aggressive pursuer of technology. Online applications, credit scoring, and account access have gone beyond efficiency improvements to help increase penetration and provide day-to-day management tools. With these improvements, transactions and accounts can be monitored in real time so that the lessor and the customer know exactly where a transaction is in the approval process. The status of a transaction can be tracked as it moves from application to funding, and existing accounts can be queried to determine payment or balance status. Automation also improves back office tasks and portfolio management functions. Leasing habits and end-of-lease terms can be evaluated and communicated to the appropriate staff for improved sales management and marketing.

For middle market lessors the Internet may become the primary and exclusive delivery channel for master leases and vendor programs. The elimination of paper documents and original signatures will assist lessors in moving toward a total e-commerce product. The small ticket segment has paved the way for these middle market lessors to move towards an Internet-based business model. The sophisticated level of processing and service required by small ticket, as well as vendor leasing, has been served well by the Internet's ability to increase turnaround, provide prompt payments, and establish a cost-effective processing and delivery channel. This level of sophistication has spread to middle market lessors.

> "In small ticket, technology has been vendor-driven but as these small ticket lenders begin to deal in middle market, demand has evolved as they bring their technology

On average, however, middle market lessors have been slow to apply the Internet to their business model. The majority of middle market lessors have developed web sites displaying company and product information and use the Internet to communicate internally and with clients. While some middle market lessors believe that the Internet has potential as an alternative delivery channel, others feel that their business is too complex to employ the Internet as part of their sales process. Of the middle market lessors interviewed by FIC, 80 percent with them."

believe that the Internet will be a supplemental delivery channel in their market while only 20 percent felt that the Internet will become the primary delivery channel. In contrast, many banks are currently using the Internet to exchange documentation and coordinate syndications for loans up to $1 million.

"Treasurers and purchasing agents want to talk to a human being when they are making career-limiting million dollar decisions."

The perception is that middle market leases, in particular operating leases, are not conducive to the standardization required for Internet delivery. The view that the leasing business is still very much a "people business" also permeates the middle market. Middle market lessors strongly support the value of personal selling, creative deal structuring, and human credit decisioning.

The Internet has not significantly penetrated the large ticket segment. This segment believes that clients prefer more traditional delivery channels and that complex negotiation points prohibit the use of electronic delivery channels used for small or middle market transactions. The level of customization required for large ticket transactions is, therefore, the biggest hurdle to increased Internet use.

In general, views on the Internet range widely from enthusiastic acceptance of the Internet as a way to change the business model fundamentally to befuddlement and denial. We believe that online application of small leases will become the norm. Internet-only competitors will also soon emerge, in particular on the low-end. It is also very possible that an Internet auction-style leasing site will be available in the next few months. Financial services institutions have begun to prepare for what they envision as an "e-bay for leasing".

Today, leading lease companies are putting priority on strategizing about how to incorporate the Internet into their business, focusing both on Intranets, Extranets, as well as the Internet. Successfully addressing these strategic issues will be critical in separating value-added lessors from also-rans.

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Branding Building: The Next Challenge

As the grand old era of equipment leasing dissolves into the brave new world of e-commerce, leasing companies must search for the competitive key to building and holding onto customer relationships. There is no doubt about the challenge or the solution. The online buzz is loud and clear—the competitive key is the brand.

Internet access calls for new brands. Electronic access is not only changing the basic business model for leasing but also making it necessary to create and promote an

e-commerce brand for marketing. Without establishing a distinction in the minds of customers, equipment leasing companies may find it impossible to build and keep customer loyalty. What leasing companies stood for— an alternative to outright purchase and loan financing of durable equipment— has forever been changed by the speed of electronic transactions. For example,

- Banks are offering pre-qualified leases
- Credit card companies are offering card-based solutions
- Manufacturers are taking a solutions approach to vendor finance
- An Internet auction site to help companies find the best possible terms for a lease is supposedly in development.

In effect, the financing market for durable equipment has been leveled, and the leasing product is fast becoming a commodity.

Research conducted by Financial Institutions Consulting shows that despite the e-commerce barrage of advertising and proliferation of web sites, financial services customers still respect the "reputation" of selected financial services brands. Customers believe these companies when they "promise" unique benefits and express awareness and appreciation of their "experience" when they deal with the company— both online and off-line.

Almost any brand manager will tell their executive that 'a brand is a promise.' But, in today's interactive and converging marketplace, a brand has to be more than a pledge for future performance. A brand that can succeed in a 'clicks and mortar' environment must be the sum of its promise, the individual customer experience, and the company's reputation.

Essentially this definition suggests that leasing companies must redefine their traditional relationships with customers and concentrate on the transaction experience. **Back to State of the Industry home**

M&A: The Fastest Path to Growth

Mergers and acquisition activities continue to be a major focus of the equipment leasing industry. Several factors, including the high valuation of financial services firms in the stock market, strategic moves in and out of leasing, and the need to achieve economies of scale have all contributed to a staggering year of mergers and acquisitions.

In 1998, aggressive pursuit of this strategy resulted in approximately 104 M&A transactions, up from 44 in 1997, according to Hovde Financial, Inc. Although 1999 will not likely reach the 1998 totals, our interviews suggest that acquisitions remain a key part of management strategy.

Several large M&A transactions involving banks worked to consolidate the industry in 1998. Deals included: NationsBank and Bank of America, Banc One and First Chicago and NBD, and US Bancorp and First Bank, and Wells Fargo and Norwest.

Outside of banking, leasing companies continued to pursue acquisition candidates. Targets have been chosen to add market share and/or facilitate entry into a niche segment. Some of the larger deals have included: Newcourt and AT&T Capital, GE Capital and Met Life Capital, GE Capital and Colonial Pacific, and Associated First Capital and Avco Financial.

Companies are using various acquisition strategies in their pursuit of growth. GE Capital for example completed ten transactions in 1998 and First Sierra completed nine transactions. Another model has been unicapital's roll-up strategy. UniCapital made 16 acquisitions in various market segments and plans to provide the benefits of a large finance company in the form of funding and technology to each one of its niche oriented operating units.

For 1999, several major transactions are in process. Sanwa, Chrysler, BancBoston, Newcourt, and Tokai have become some of the year's top stories. As of October 1999, the total number of merger and acquisition transactions had reached 40.

Of the industry insiders we interviewed, one-third have been involved in a merger or acquisition during the past two years; and two-thirds anticipate a merger or acquisition for their firms within the next two years. Those that do not anticipate a future merger or acquisition cited the need to "digest" a recent merger or acquisition before pursuing additional transactions. **Back to State of the Industry home**

Who Would Want a Negative Economy?

As in other industries, many managers within equipment leasing are anxiously anticipating an economic recession. Many, in fact, believe that one is long overdue. The source of anticipation, however, isn't fear as might be expected. It is competitive pressure.

> In light of strong competitive pressures and low margins, a recession would be a welcome event for the leasing industry."

The leasing industry expects a downturn to improve the competitive position of "true leasing companies." As one interviewee said, "We need adversity in this business!" The question is whether or not the economic conditions necessary to "shake-out the pretenders" in the industry will also create further price pressures as competitors chase fewer quality transactions. Many insiders believe a recession would be beneficial for two reasons.

> Leasing will get back to its essence, asset-driven, not financing driven like it has been for past 4-5 years."

First, some argue that second tier players will retreat. These top players envision a scenario where second tier players, which in some cases they believe include banks, will retreat from the equipment leasing industry as a declining economy leads to increasing lessor risk. They see the second tier players becoming apprehensive as delinquencies rise, residual risks increase, and the industry reverts to an asset-driven approach, as opposed to a finance-driven approach.

In contrast to this view, FIC's perspective is that in a recession, industry dropouts will be limited and relatively unimportant. Many institutions, including banks, have become increasingly dependent on revenue sources such as leasing and would find it hard to walk away from the business. As one interviewee said, "Leasing is now part of the core product set of many banks."

Second, some argue that a recession would improve leasing penetration. Although durable equipment purchases may slow, companies will be more prone to choose leasing versus buying. In essence, leasing would capture "a larger piece of a smaller pie." Additionally, sale and lease back transactions and lease renewals would help support leasing volumes. It is worth noting, however, that historically a decrease in the sale of durable equipment has led to lower total leasing volumes.

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Regulatory Issues

> "Tax sensitive equipment finance has a role in corporate America."

Many industry leaders view the primary threat to the leasing industry's penetration rate as regulatory change. The effective elimination of LILO transactions in the spring of 1999 pushed large ticket lessors back into the U.S. market and reminded the industry of pending regulatory uncertainty. In addition, the ELA recently quoted FASB member John "Neel" Foster as saying that he believed a new standard of accounting for leases would be adopted and implemented by January 1, 2004.

This proposed new standard of using an asset/liability methodology of accounting for leases was presented in 1996 in a special FASB report commonly referred to as the "McGregor Report." A change from the current risk/reward model to the McGregor model would require the capitalization of all non-cancelable leases with an initial duration of greater than, or equal to, one year.

Although the impact of such a change has yet to be fully quantified, many believe it is certain that a material and permanent decline in the demand for certain lease products would occur. This decline would result from the elimination of a factor distinguishing a lease versus a bank facility— the ability to keep leases off the balance sheet.

> "Companies will continue to require equipment financing and lessors will continue to find ways to fulfill that need."

Although many of those interviewed by FIC agree that there will be a definite negative impact, they also believe that the leasing industry is capable of adjusting to negative regulatory changes. The regulatory changes in the past have, arguably, not been as dramatic as the changes suggested by the "McGregor Report" but still, leasing executives seem confident about the resiliency and ability of the industry to respond effectively.

The industry expects that the possible elimination of off-balance sheet leases will cause a decrease in leasing volumes, particularly the volume generated by leveraged leases and structured transactions. However, if a negative ruling is made and takes effect in three to five years, industry experts predict lessors will adjust well in advance of the effective dates, minimizing its negative impact. **Back to State of the Industry home**

Human Capital

One interviewee described the personnel challenges of the equipment leasing industry in the context of "the aging of…the industry."

> "The credit models AND the people have not been tested in a bad economy."

Leasing companies have had difficulty attracting new talent to the industry. Hiring personnel away from competitors continues to be the major source for new hires. However, beyond the fallout from a merger or a re-organization, hiring away the top performers is both difficult and expensive. At the same time, very few companies have made the financial commitment to invest heavily in training and hire from outside the industry. As a defensive measure, some companies have implemented a team-based profit sharing program in an effort to retain experienced personnel.

While managers comment on the difficulty of bringing in new blood, they also worry about the limited experience of current leasing employees. Many marketing and credit officers have not experienced an economic downturn and, therefore, may not be prepared to anticipate or address credit problems effectively. In our interviews, several companies described a lack of "bench strength"— the inability to promote from within for key positions and develop a succession plan at the executive level— as their major challenge.

The industry has, however, begun to address these personnel challenges and several companies are devoting significant resources to correct the problem. One interviewee described how senior management is personally involved in training staff. The employees are required to attend eight hours of training per month. Four hours are paid by the company, and four are on the employees' time. **Back to State of the Industry home**

Securitization and Funding

Securitization of lease assets passed through a turbulent period in the fall of 1998. The flight to quality and the ensuing tightening of credit left many lessors without funding. Securitization, however, continues to be the major funding source for many lessors. In particular, entrepreneurial companies that have survived on securitizations continue to use the market as their primary funding source.

Despite concerns surrounding securitizations, the market volume did not slow in 1998. Survey respondents reported $10.2 billion in total securitized assets, most of which were securitized as commercial paper (Exhibit 14). FIC believes that securitization will continue to be an important financing option. Nonetheless, its future growth may be more controlled and provide lower profitability for those who rely on it. The volatility in capital markets pricing will certainly continue as investors and issuers attempt to manage risk and volume more closely.

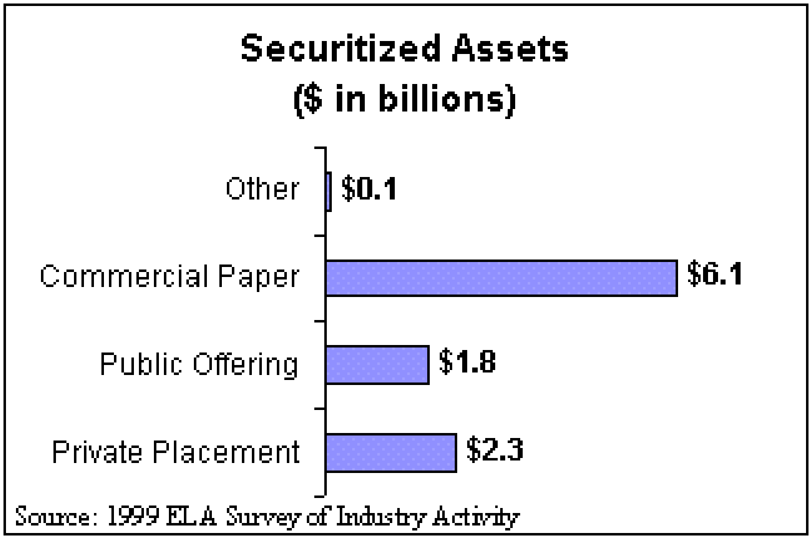


Exhibit 14

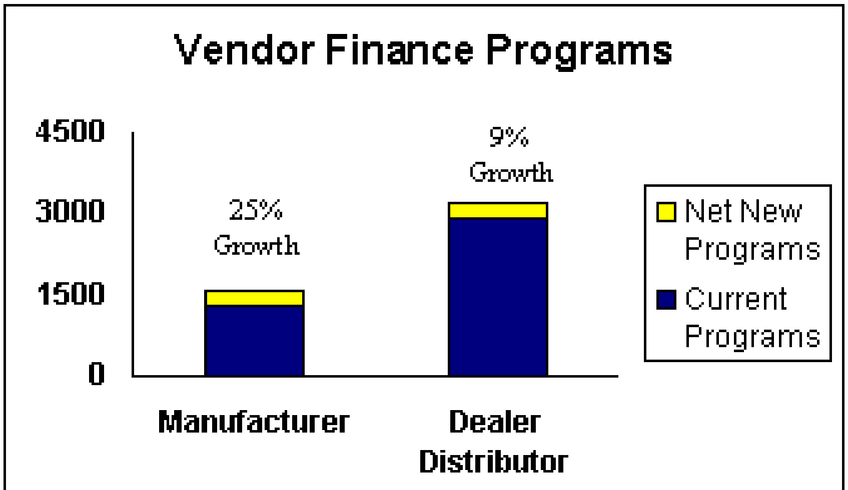
[Back to State of the Industry home]

Key Industry Segments

The competitive landscape in each of the key industry segments is dramatically different. Small ticket and vendor financing are providing substantial growth and healthy margins. The middle market segment is extremely competitive and has the highest expense ratio among the segments. The large ticket segment has achieved strong efficiency and returns yet continued growth for the segment will be difficult to achieve.

Although these segments are dramatically different, the lines between them are becoming less clear as companies increasingly cross over segment lines in search of additional volume and yields. New competitors from outside leasing may also begin to enter as the commoditization of credit becomes more common.

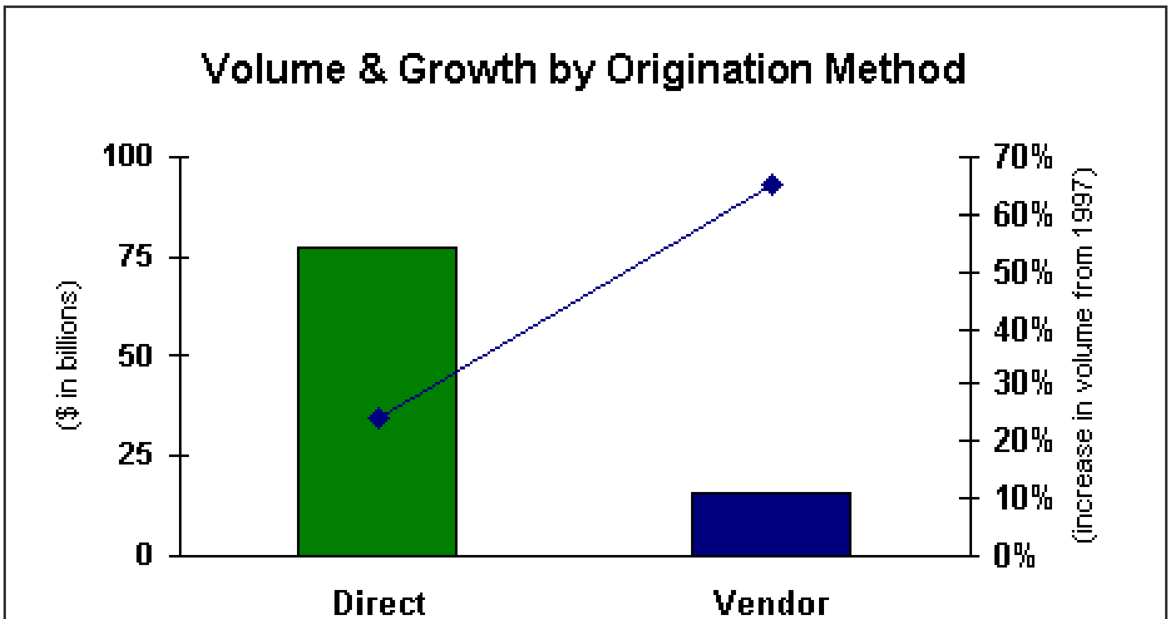
Vendor financing, particularly within manufacturer programs, continues to be the fastest growing segment for many lessors. Based on Survey results, the total number of programs with national manufacturers and dealer distributors grew by 25 percent and 9 percent respectively (Exhibit 15).



Source: 1999 ELA Survey of Industry Activity

Exhibit 15

Program growth has subsequently contributed to an increase in vendor-originated volume. Although volume increased from 1997 to 1998 for direct and vendor origination methods, the vendor-originated volume had the largest increase at 65 percent (Exhibit 16). Direct origination increased by 24 percent.



Source: 1999 ELA Survey of Industry Activity

Exhibit 16

Vendor leasing is increasingly prevalent in smaller ticket segments. For transactions less than $250,000, vendor finance origination of reported total new business exceeds direct origination. Conversely, direct origination of reported new business volume dominates the over $250,000 transactions.

The demand for vendor leasing has increased for several reasons. As consolidation takes place in almost every industry and as product distribution channels converge, vendors have found themselves financing larger transactions. Falling equipment prices and the need to increase revenue have encouraged vendors to package service and maintenance contracts with equipment sales. As these products become more sophisticated and comprehensive, vendors are increasingly searching for turnkey solutions to facilitate the sale and financing of packaged products.

Many lessors have responded to this demand by investing large amounts of capital in systems and Internet technology to fulfill the needs of the vendor. As one interviewee said, "most vendors will tell you that if you don't have a web-based system, don't talk to us." This relationship also allows lessors to take advantage of the timing and ease-of-use factor associated with providing leasing at the point of sale. The level of sophistication has grown dramatically as turnaround time, ability to customize leasing programs, prompt payment, and process and manage high transaction volumes have become critical service components. Lessors who have committed the resources necessary to enter the market segment have subsequently enjoyed an annuity-like volume from established relationships.

Ironically, some vendor lessors fear that the technology that has helped to capture this market may also one day be the technology that leads to the deterioration of the vendor finance market. Industry experts raise the possibility of new approaches to leasing, particularly with respect to origination.

For example, in the vendor segment in particular, Internet transactions may ultimately lead to a competitive auction scenario. As the vendor receives an equipment order, customer information would be transmitted to several leasing companies that would respond with preliminary commitments, approvals, or declinations. Another scenario involves an online broker who would establish a clearing house for leasing transactions. Some of the interviewees believe that non-leasing companies are soon to be new competitors in the "electronic" leasing markets.

Small ticket leasing has been characterized by many industry experts as one of the fastest growing segments of the industry. The market has expanded rapidly as falling equipment prices and a strong economy have spurred demand. Technology has allowed small ticket lessors to handle large application and processing volumes with great efficiency. "In many ways, small ticket lessors are the frontiersman of the leasing industry," one interviewee said.

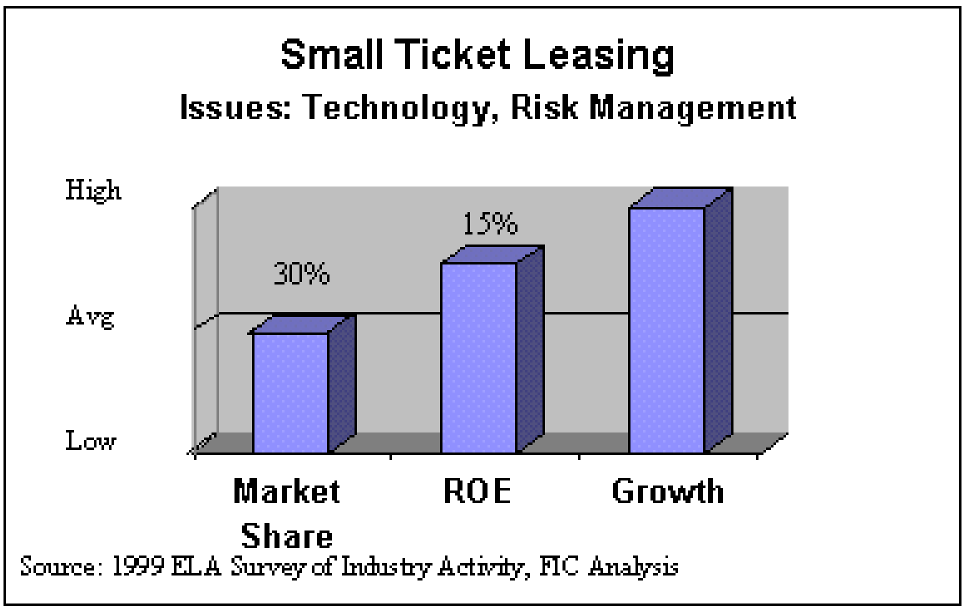


Exhibit 17

Although credit and residual risks have increased, the returns have remained healthy. The segment produced a 15 percent ROE for 1998, exceeding the respondent average of 12.5 percent. (Exhibit 17)

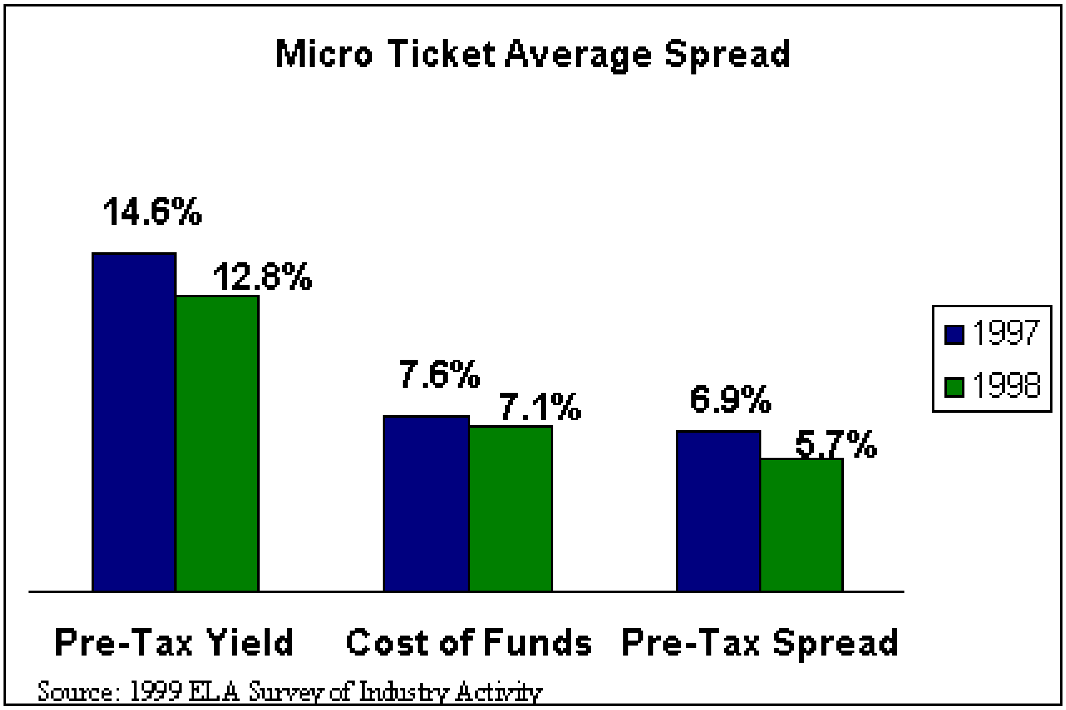


Exhibit 18

The micro ticket segment is producing attractive results. While the collective small ticket segment exceeds the industry average profitability and expected growth, the micro ticket portion (less than $25,000) has produced results that are even more attractive. The pre-tax spread of 5.7 percent for this segment was the highest among Survey respondents. (Exhibit 18) The combination of a 2 percent ROA and an industry high 8.6 leverage ratio have produced an 18.8 ROE for the micro ticket segment that far exceeds the respondent average of 12.5 percent.

The small ticket leasing segment includes a variety of customer types. The predominant end users of micro ticket leases by SIC code are Other, Other Services Excluding Health, Industrial/Manufacturing, Wholesale/Retail, and Truck Transportation. Within the small ticket segment of $25,000 to $250,000, Other, Other Services Excluding Health , Industrial/Manufacturing, Agriculture/Forestry/Fishing, and Health Services were the predominate lessees.

Not surprisingly, to achieve profitability, small ticket leasing runs like a well-oiled, high volume machine."

Small ticket lessors are serving their customers by providing heavy amounts of office and transportation equipment. The assets that are financed by the micro ticket segment are largely Office Machines, Medical, Computers - Total, Industrial Manufacturing, and Other. Office Machines dominate this ticket size segment, accounting for 60 percent of total annual volume. Within the $25,000 to $250,000 portion of small ticket, the equipment types are less concentrated. Transportation - Total, Computers - Total, Office Machines, Agriculture, and Industrial Manufacturing fill the top five equipment types.

Although pricing of leases for this equipment has become much more competitive, new competitors are continually entering. Banks for example, have recently begun to enter the small ticket segment convinced of the necessity to offer their small business customers a product. Outsourcing has been the method of choice to deliver the product because banks have not had the required expertise and systems necessary to compete. The clear advantage for banks is the ability to cross sell the small business customer base and collect a fee. This opportunity is significant for independents that provide small ticket processing for banks.

In addition to the new entrant threat posed by commercial banks, American Express offers a card-based equipment finance product that while not a lease, effectively replaces the lease with a term loan. Other credit card companies are evaluating similar card-based lease offerings.

"In instances where the small ticket lessor is part of a bank organization, the leasing division relies heavily on its interaction with other parts of the bank."

"With increasingly small residuals, the fate of equipment at end of lease term has significant impact on the small ticket lessor."

The high level of credit risk provides the best defense against new entrants. Respondents of the 1999 Survey recorded a 1.7 percent mean full year loss in 1998. This was an increase from the prior year's loss of 1.4 percent. The level of current receivables, however, did improve from 94.6 percent in 1997 to 95.2 percent in 1998. Credit risk has been mitigated to some extent by credit scoring usage and the amount of creditor information currently available in electronic form. Small ticket lessors with strong portfolios have kept their balance sheets clean by continuing to call on experienced human decision makers in the underwriting process.

Increasing amounts of risk have been taken by small ticket lessors in an effort to boost profitability. Lessors have assumed greater residual risk, which may prove to be a difficult situation if equipment prices continue to fall.

Middle market leasing is the largest segment among Survey respondents, representing 37 percent of total new business volume (Exhibit 19). This segment is one of the most challenging and competitive segments in which to operate. Banks have a strong position within the segment, and FIC believes that they will continue to have significant opportunities to expand volume. Additionally, any tightening in capital availability could negatively affect small to mid size lessors.

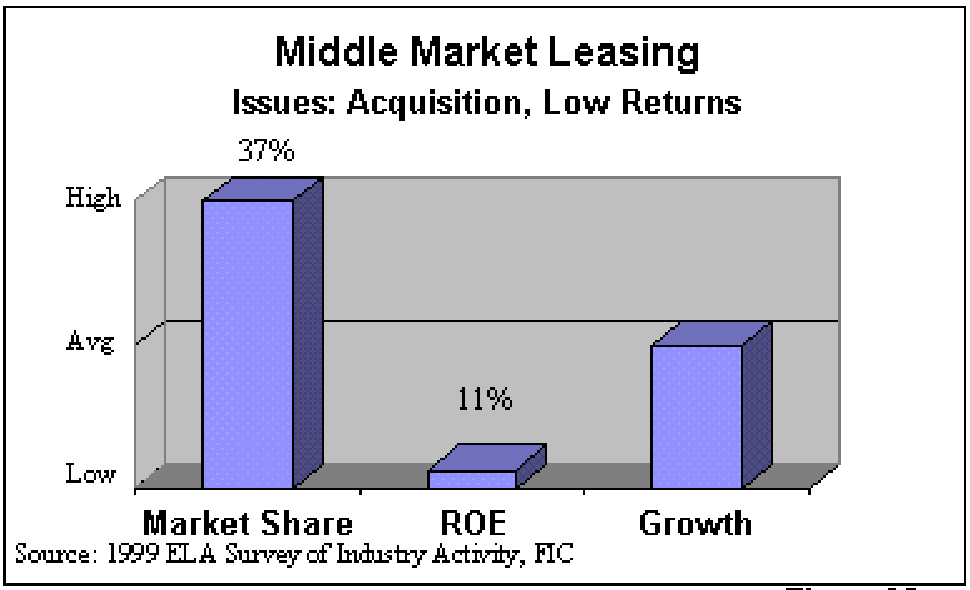


Figure 19

The middle market respondents reported the lowest segment ROE among all the ticket segments . Their 11 percent ROE is attributable to lower than average yields and higher than average expenses. Total expenses, as a percentage of revenue were 86 percent. The depreciation expenses that reached 24 percent of revenue drove this high level of expense. Pre-tax yield for 1998 was 9.5 percent, which was 1.4 percent lower than the respondent average. The yield has been the victim of excess capital, a healthy economy, and aggressive competition from banks that are able to compete with lower cost of funds (Exhibit 20).

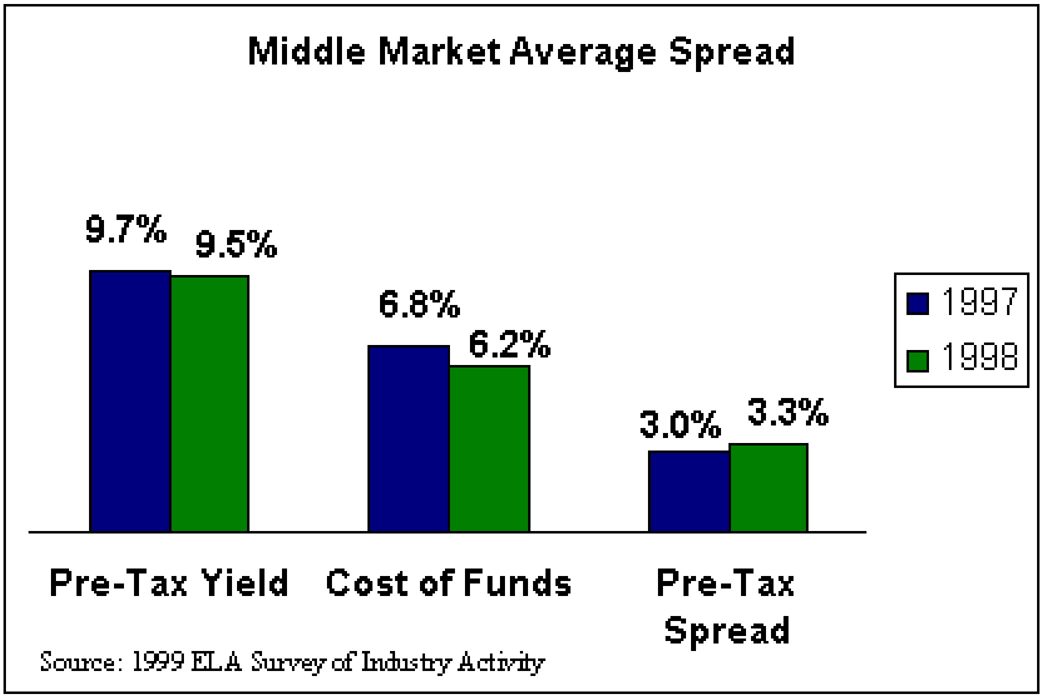


Exhibit 20

The aggressive level of competition is apparent in the lower pull through rates. As seen in Exhibit 21, middle market lessors funded only 67 percent of approved applications. This is the lowest pull through rate of the respondent segments. Compare this with the large ticket segment that funds 88 percent of approved applications.

Just as competition for new business volume has affected the middle market segment so has competition for transaction funding. The middle market segment is the largest securitizer of assets within the respondent segments. The segment accounted for 50 percent of total securitization volume although it accounts for only 37 percent of the total new business volume. Securitizations have driven down yields as investors squeeze returns out of the securitization process.

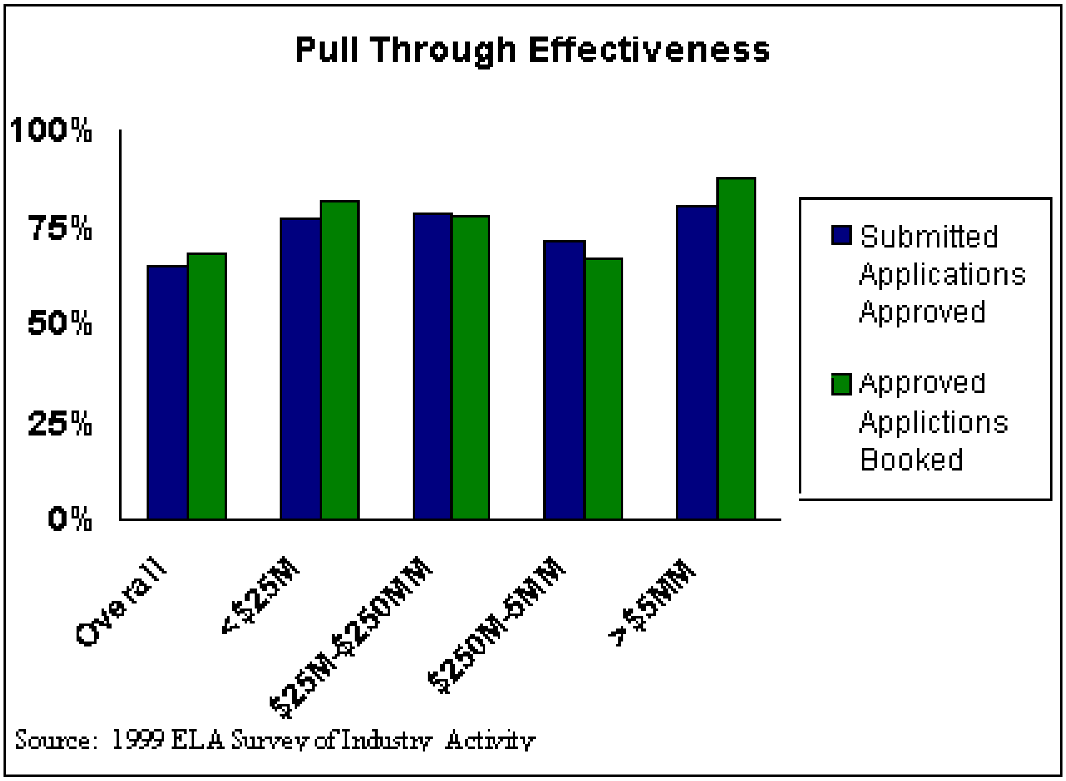


Exhibit 21

The middle market segment is beginning to realize the negative impact of asset securitization as many other industries have. The securitization of residential mortgages, for example, eroded the profitability of many small to medium size mortgage companies as they sold off assets at narrow margins in the secondary market. After the assets were sold, the companies merely became originators and servicing shops of a commodity product.

Although securitization requires a measure of standardization of product and customer, the middle market end-users are the most diverse of any of the ticket segments. Industrial Manufacturing, Truck Transportation, Other, Other Services Excluding Heath, and Air Transportation comprise the top five SIC codes. These customers tend to be larger in size than those within the smaller transaction size segments and require a higher level of product sophistication. The equipment in this segment also requires a higher level specialization than that required for small ticket leases. The predominate equipment types within the middle ticket segment are Transportation - Total, Computers - Total, Construction, Other, and Industrial Manufacturing.

Structured deals that provide economic value to this diverse client segment will continue to be a defining characteristic of a successful middle market leasing company. An integrated solutions approach will be the key success factor, while flexibility, pricing, and market penetration will be the required skill set for the direct middle market lessor.

Both traditional and non-traditional competitors have begun to target this segment. Many lessors view the middle market segment as an expansion-via-acquisition opportunity. Unfortunately for middle market lessors, there are no significant barriers to entry into their market.

Small ticket lessors, for example, have created the demand for technology within the middle market, particularly within vendor leasing, as they slowly begin to penetrate higher ticket segments. Small ticket lessors have managed to leverage their technology and delivery skills as a method of penetration into the middle market segment.

Large ticket lessors, faced with limited growth opportunities and the issues related to LILOs, realize that moving into the top end of direct middle market may augment lost volume in their core market. Captive lessors have expanded beyond their proprietary products as well, moving into the middle market segment.

Large ticket leasing faces what are arguably the most significant challenges in the leasing industry, yet they continue to generate exceptional returns (Exhibit 22).

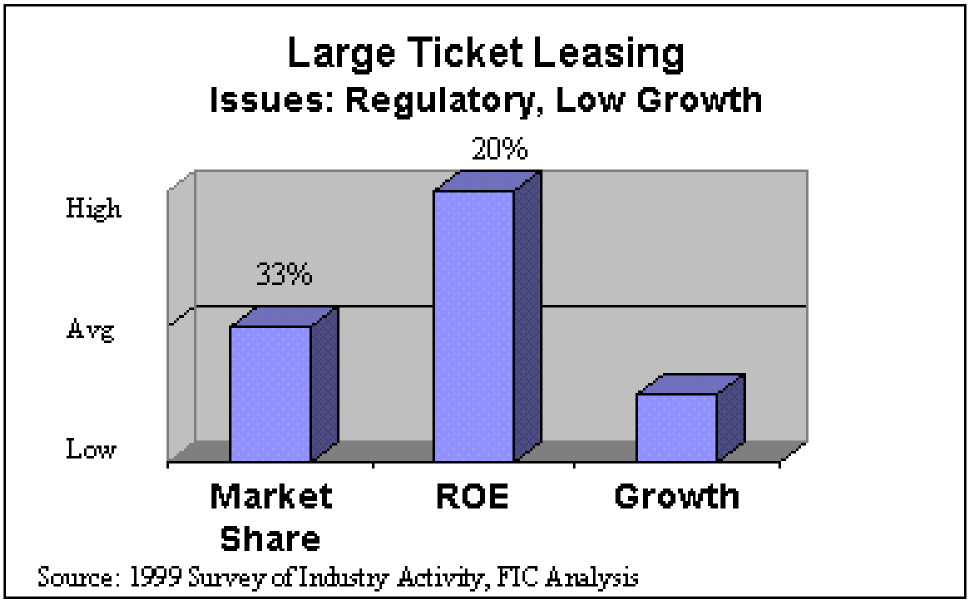


Exhibit 22

Large ticket leasing reported the highest ROE among the SIA respondent segments at 20 percent. Although the abundance of capital available to lessees from both the capital markets and the credit markets has kept rates low, consolidation and product specialization have created several niche opportunities.

Large ticket lessors have achieved these higher returns because of low expenses measured as a percentage of revenues. Below average depreciation, provisions, sales and marketing, and combined operating expenses (operating expense plus other) resulted in the lowest total expense ratio among ticket segments at 73.3 percent (Exhibit 23).

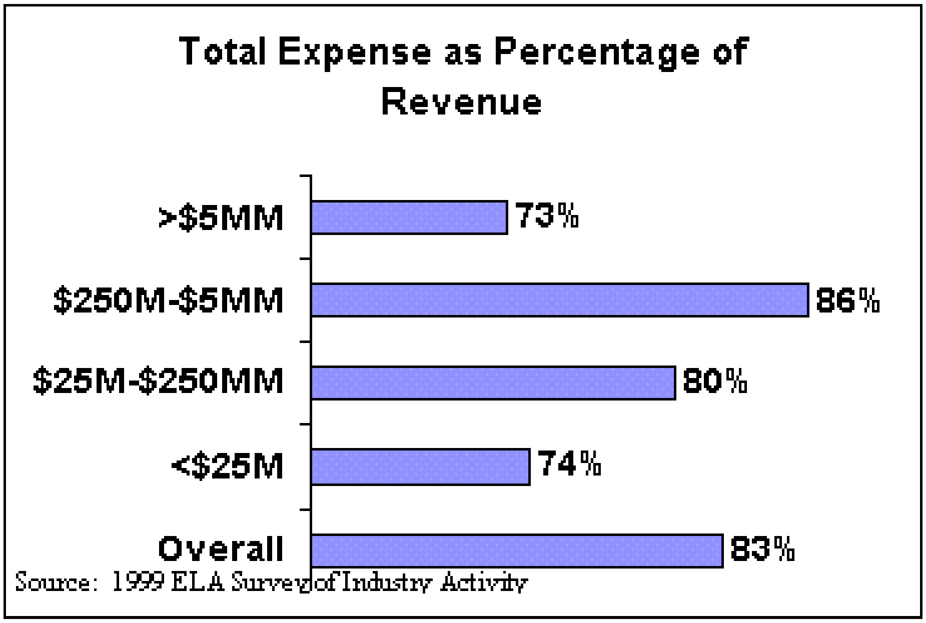


Exhibit 23

The large ticket segment is also the most efficient originator among the Survey respondents (Exhibit 24). The segment reported a median origination full time equivalents (FTE) total of 15.8 per company, each of which produced 168 applications on average. Although the number of applications pales in comparison to that of the micro ticket segment with over 2500 applications per FTE, the average dollars originated per large ticket FTE – $106 million – far exceed six other segments.

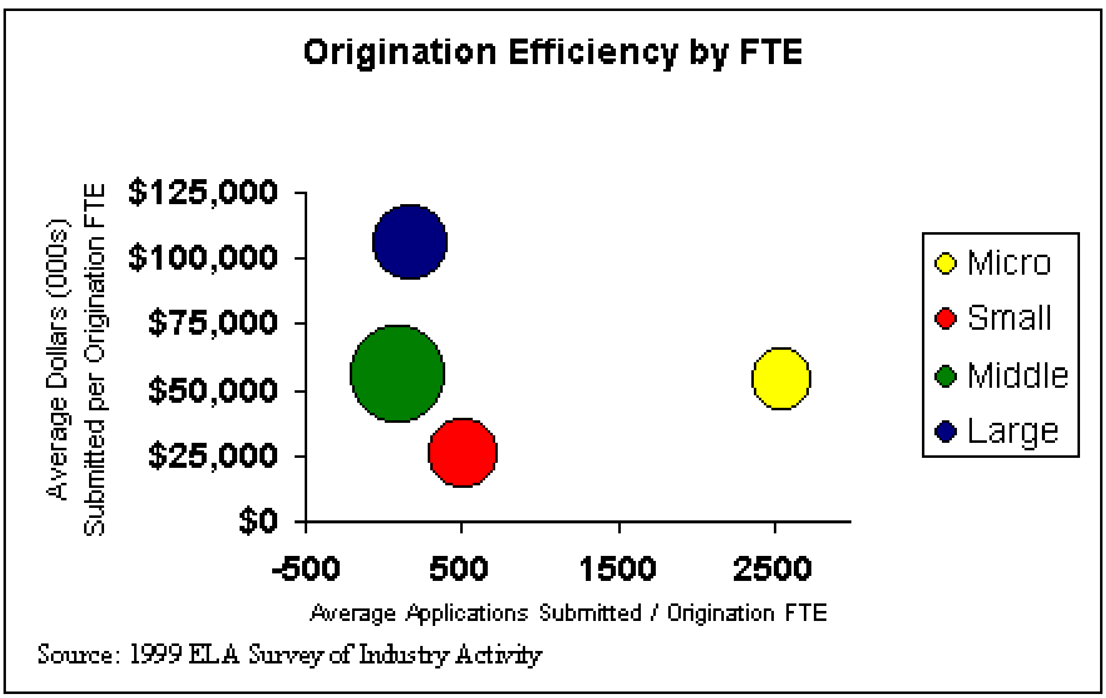


Exhibit 24

Growth, however, has eluded the large ticket segment. Due to a growing economy, the low cost of capital and cash rich balance sheets of corporate America has placed leasing at a disadvantage. For example, approximately 50 percent of US airlines are buying their airplanes and only two of the four major railroads are currently leasing. Until interest rates rise, the lease-versus-buy decision for the major transportation industries will continue to disappoint large ticket lessors.

Regulatory changes have contributed to the concerns about new business growth because both LILO and structured finance deals are in jeopardy. Many large ticket lessors have responded to the regulatory changes and threats by increasing their operating and portfolio risks. The move away from leveraged leases and into operating leases has created risk levels that are not welcomed by Wall Street analysts. This strategy has severely affected banks that have assumed additional residual risks.

Consolidations have also limited growth within existing customer segments. The consolidations taking place within the utility industry, for example, have typified the challenges facing large ticket lessors. Consolidations have created additional credit risk because lessors are dealing with a shrinking pool of customers. Many lessors have chosen to walk away from new deals generated by current customers due to the limits of their credit exposure policies. Moving down market to lower grade credits can only provide lessors with marginal opportunities as the pool of investment grade credits dwindle.

The large ticket segment does, however, have niche opportunities in addition to its traditional focus of product innovation. Although LILO transactions have been effectively eliminated, the leasing penetration rates overseas and in South America provide abundant opportunity. US companies continue to expand their equipment distribution around the globe and desire partners that will help reduce their risk and provide financing sources for equipment sales. The international market will, therefore, continue to be a significant opportunity for lessors.

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Implications for the Industry

Similar to most financial service industries, the equipment leasing and finance industry is at a crossroads. A rapidly consolidating market is introducing new competitive pressures to improve efficiency and increase volume. The e-commerce world of the Internet has also changed customer expectations and implications for the leasing industry.

Consolidation will continue. Slower growth and pressure to meet shareholder expectations will encourage the continued consolidation of the industry. As this occurs, top-tier players will increase their competitive advantage using economies of scale and funding advantages to buy volume. The aggressive pricing made possible by these tactics will continue to pressure yield spreads for all segments.

The challenge for independent leasing companies. Independent lessors will face increasing competition in the leasing industry as banks continue to recognize leasing as a core product. The ability to increase market share by leveraging current customer relationships and penetrating new market segments makes banks formidable competitors. Independent leasing companies will need to develop product sets and identify segments that banks are apprehensive to serve to remain competitive.

The disappearing middle market. Middle market lessors face the most dramatic challenge as the market realigns and lessors from segments above and below "poach" the middle market segment. Both small and large ticket lessors, in the form of vendor and bank lessors, will continue to enter the market in search of new business volume. Middle market lessors will be required to defend market share by developing specific market niches and customer friendly technological capabilities. Companies must position and defend their brands to build customer loyalty. Lessors without a niche market, who choose not to keep pace, will eventually be forced out of the market or acquired.

Technology is rebuilding the business model. Technology is still in its infancy in the leasing industry. For some lessors, technology has provided incremental efficiency gains. For other lessors, technology has substantially redefined their current business model and will drive future strategy. Outside of leasing, the Internet has already created an environment were e-products are commoditized. Consumer selections in the web environment are based on ease-of-use, efficiency of delivery, and lower costs. In the near future, it is likely that competitors will enter the leasing industry by using an Internet platform and begin to capture market share electronically. **Back to State of the Industry home**

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