State of the Industry Report 2000

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FIC

Financial Institutions Consulting, Inc.

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Preface

The Equipment Leasing and Finance Foundation focuses on future trends and their impact on the industry. To get beyond near-term performance numbers for the second year, the Foundation, selected Financial Institutions Consulting (FIC) to prepare its 2000 State of the Industry Report.

FIC is a management consulting firm with extensive experience in banking and commercial finance.

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. Therefore, the Report incorporates the Equipment Leasing Association's (ELA) 2000 Survey of Industry Activity (SIA) that tracks 1999 activity, FIC proprietary research and analysis as well as perspectives from industry experts. To acquire the industry perspectives, FIC recently conducted in-depth interviews with 16 industry experts, representing a cross-section of the major lessor types and ticket sizes, as well as vendors to the industry.

Our in-depth interviews focused on recent performance and the critical challenges facing the industry. The interviews emphasized assessing the implications of current challenges on the future path required for success. The individuals who lent their time and shared their opinions include:

Irv Beimler
David J. Connolly
Edward Dahlka
Raymond A. James
Charles Duggan
Daniel Larson
Charles Lee
Matthew Nicholas
Anthony Pacchiano
John Paris
Richard J. Remiker
Thomas R. Uehling
Mark Walters
Robert M. Wax
David S. Wiener
Edward S. Yocum

We thank these individuals for their generous commitment of time and candid insights into the intricacies of the leasing industry. Throughout this monograph, we include direct quotations from these interviews; however, to preserve confidentiality, we present quotes on an anonymous basis.

The lessor types analyzed are classified by the SIA as: captive leasing companies, independent lessors, and bank lessors. Financial advisor and other lessor types comprised only 5 percent of the pool of SIA respondents; their individual responses have not been included in this Report. Financial advisors and other lessor types are included in the averages calculated for the SIA and this Report. Additionally, the survey includes vendor finance as a lessor activity.

The ELA defines captive leasing companies as the finance subsidiaries of dealer or manufacturing companies. Independent lessors are typically finance companies offering leases directly to businesses and not affiliated with any particular manufacturer or dealer. A vendor is the seller or dealer of equipment to be leased.

Lease size segmentation, which was also captured in the SIA, divides into the following ticket sizes: micro ticket, up to $25,000; small ticket, from $25,000 to $250,000; middle market from $250,000 to $5 million; and large ticket, over $5 million.

Our Report begins with an overview of the leasing industry's recent overall performance and then discusses performance by type of lessor and ticket segment. The report goes on to focus on the key issues that senior managers are now addressing.

Finally, as management consultants to the leasing industry, we conclude this Report by providing readers with our firm's brief perspective on how the industry might address it's challenges and remain a formidable component of the overall corporate financing industry.

Charles B. Wendel
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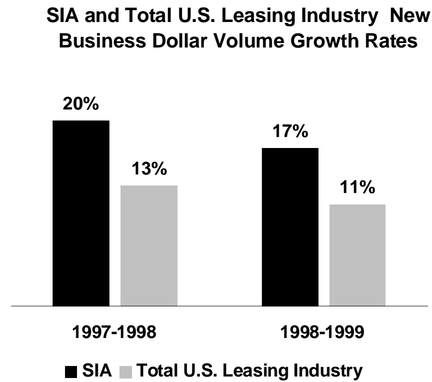
Introduction

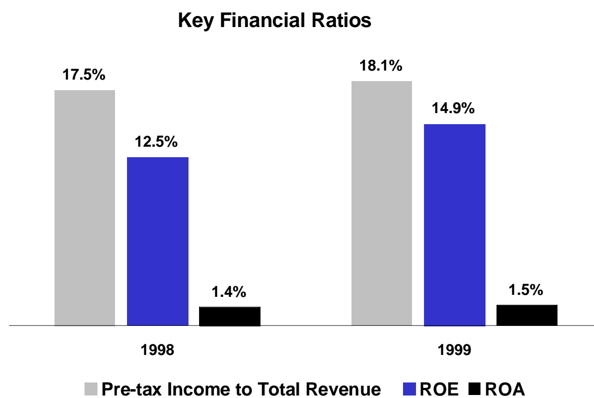
The equipment leasing industry remains solid while also finding itself in a challenging and changing position. As shown in Figures 1 and 2, growth and profitability have been strong: 17 percent year over year growth, 14.9 percent Return on Equity (ROE) and 1.5 percent Return on Assets (ROA) for fiscal year 1999. However, our interviews indicate that the market is showing signs of reaching a cyclical peak; the industry expects growth to continue but not at the same high rates; many believe that margin pressures will also impact profitability.



Source: ELA Survey of Industry Activity Report 1999-2000

Figure 1

Consolidation, proliferation of efficient delivery channels, and a general tightening of funding threaten to take their toll on traditional lessors. The general economic uncertainty pervading the industry exacerbates these challenges.



Source: ELA Survey of Industry Activity Report 1999-2000

Figure 2

In an Equipment Leasing Association (ELA) "Quick Poll" taken in August 2000, 151 respondents said that two words dominate their current business plans: "growth" (77 percent) and "profit" (74 percent). Taking the current environment into consideration, it will require a high level of proactive effort and

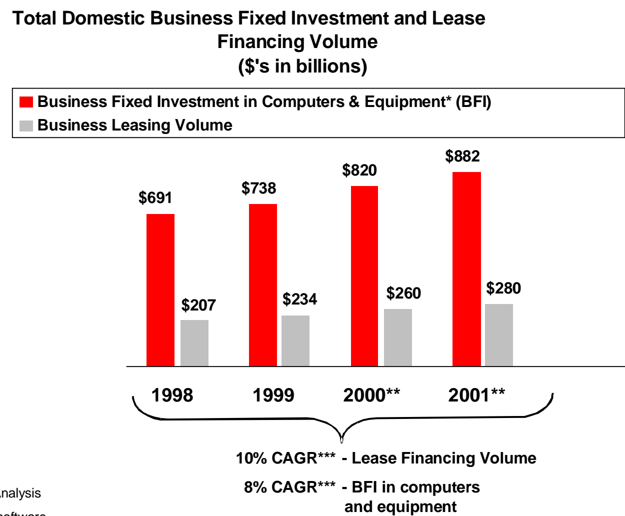
commitment going forward to achieve the industry's demanding growth and profit expectations. The industry must ask itself a fundamental question: *How can it maneuver through an increasingly competitive and rapidly changing business environment and continue to grow its markets while remaining profitable?*

This Report will examine the current state relying on the most recently available industry statistics of the leasing industry, focusing on new business volume, profitability, and productivity. Additionally, we will segment our analysis by type of lessor and ticket size.

This Report will focus, first, on evaluating current performance and then discuss ongoing challenges and a possible approach for the industry in the future.

Executive Summary

Thanks in part to a strong December 1999 finish, total new business dollar volume for the industry grew by approximately 13 percent over 1998 to $234 billion (Figure 3). This figure reflects only leases made for traditional business durable equipment, excluding software, and includes the entire market. The SIA's reported growth cited in Figure 1 reflects only those lessors participating in the survey. For 1999, business software purchases totaled $180 billion. Assuming a 30 percent average leasing penetration rate applied to software as well as equipment, this would add $54 billion to the 1999 industry volume total.



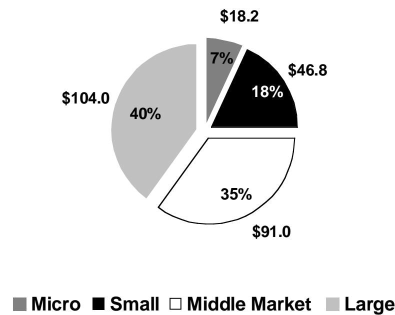
Source: ELA, FIC Analysis
* Does not include software
** Estimates
***Compounded Annual Growth Rate

Figure 3

New business dollar volume appears strong. Business fixed investment in equipment and software is growing at an annualized rate of 13.8 percent over 1999. Software and computers drive the growth with a 23.2 percent year on year increase. Business fixed investment in equipment sustains a more moderate 11.2 percent growth to $820 billion. At year-end 2000, the leasing industry will have generated approximately $260 billion in equipment leasing volume and an additional $50-$60 billion in software related leases.

Figure 4 illustrates FIC's estimates of the total 2000 market by ticket segment. However, with increased economic uncertainty on the rise, many leasing executives project that 2001 new business volume growth will decline. The overall investment in equipment by businesses drives the leasing industry. In recent years, double-digit increases in equipment investment has contributed to rapid growth in the leasing industry. However, many lessors project that growth will slow to less than 10 percent for 2001. Given that estimate, many lessors interviewed expect 2001 new business volume to be $280 billion, a 7+ percent increase.

2000 Projected Total New Business Volume by Ticket Segment ($'s in Billions)



Source: ELA Survey of Industry Activity Report 1999-2000, FIC analysis

Figure 4

Both ticket size and type of lessor appear to have different profit dynamics, with the clear advantage going to the lessor with the most efficient funding resources. In general, we have found that large and small ticket markets are both very profitable with middle market being less so.

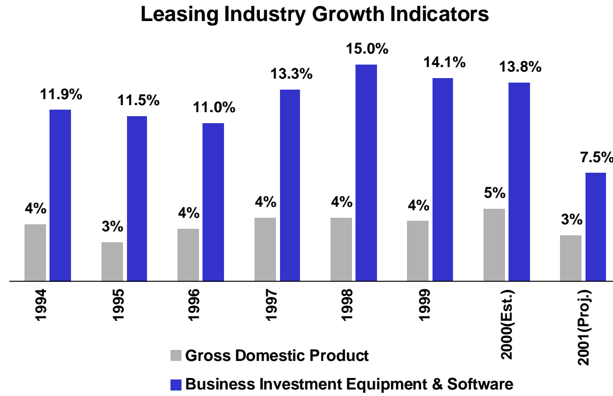
The leasing industry faces challenges on several fronts. New channels threaten the traditional way of conducting business. Merger and acquisition activity has led consolidation in the market and has created pricing pressure for the remaining players. The tight labor market continues to be a problem for the industry with high human capital costs eating away narrowing margins. And, lastly, the cost of funds continues to increase with rising interest rates and cooling capital markets threatening strong earnings.

Macroeconomics

Over the past six years the United States gross domestic product (GDP) has expanded by more than four percent annually. Double-digit increases in the demand for equipment and software have also occurred. Interest rates have been at their lowest in nearly two decades. However, many expect the positive macroeconomic environment to change.

Attempts by the Federal Reserve Board (FRB) to tame inflation by slowing the growth of the economy appear to be working. Interest rates have increased over the past year, and at the time this document is being written, some expect that the FRB will increase rates by another 25 basis points after the November 2000 elections. With these factors taken into account, the Mortgage Brokers Association forecasts the GDP to grow by approximately

3.5 percent in 2001, compared to the nearly 5 percent growth in 2000 (Figure 5). They



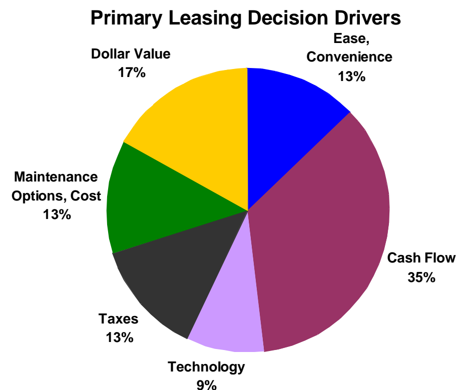
Source: BEA. MBAA. FIC.

Figure 5

expect business fixed investment growth to slow to less than 8 percent for 2001, compared with 13.8 percent (annualized) for the third quarter of 2000.

Equipment Leasing Industry Overview

Today, businesses face a myriad of financing options. With the total financing market for 2000 estimated to be approximately $1 trillion, leasing has become an increasingly popular choice for several reasons, including convenience and flexibility, increased cash flow, tax benefits, and opportunity to transfer the cost of upgrading equipment to the lessor (Figure 6). According to an interviewee,

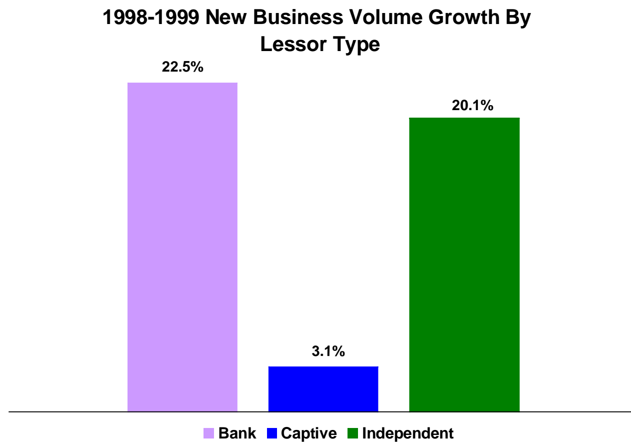


Source: ELA

Figure 6

"more favorable terms, growth in technology investment, and improved cash flow drive the customer to the industry. The challenge centers on who can offer the best added value to win the deal. It is a very competitive market."

Growth and profitability in the leasing industry vary both by type of lessor and by ticket segment. Bank lessors reported 22.5 percent growth, the highest rate in 1999. Given their leverage advantage, they dominate ROE with an average 15.4 percent. Captives report the lowest 1999 growth, 3.1 percent (Figure 7). On the other hand, captives maintain an ROA advantage, 2 percent. Company-subsidized cost of funds or operational support may positively impact a captives' performance number.



Source: ELA Survey of Industry Activity Report 1999-2000

Figure 7

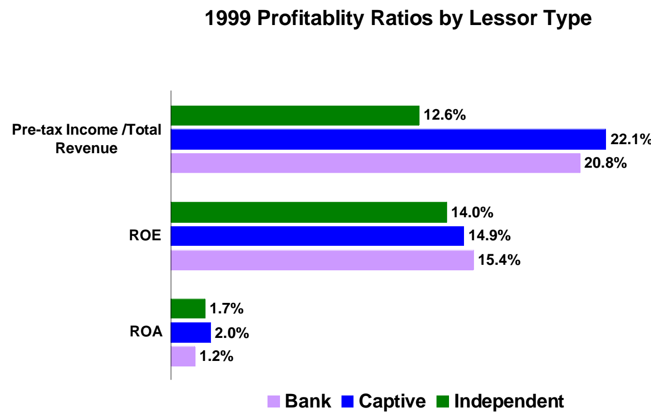
From a ticket segment growth perspective, large ticket dominated in both 1998 and 1999. Both the micro and large ticket segments outperform the small and middle market segments in ROE and ROA ratios. Interestingly, the middle market segment captures 44 percent of all new leasing volume but generates the lowest average ROA, ROE and pre-tax revenue.

Lessor profitability

Overall, ROE and ROA was strong. ROE increased from 12.5 percent in 1998 to 14.9 percent in 1999 (See Figure 2). ROA and pre-tax income to total revenue also increased from 1.4 percent and 17.5 percent, respectively, in 1998 to 1.5 percent and 18.1 percent, respectively, in 1999.

Although price competition and consolidation continued in1999, returns exceeded the prior year. Among specific lessor types:

- Banks were the most profitable segment, reporting a 15.4 percent ROE and a strong pre-tax income to total revenue of 20.8 percent (Figure 8). Driving bank lessor success, in part, is a low direct cost structure, existing customer relationships, and lower funding costs than other lessor types.



Source: ELA Survey of Industry Activity Report 1999 -2000 **Figure 8**

- Captive lessors command an ROA advantage over other lessors with a 2.0 percent ratio. This is an increase of 20 basis points over captive lessors reporting in 1998. Captives also drive the highest level of pre-tax income to total revenue at 22.1 percent. Both a low origination cost structure and a "captive" customer audience enable high returns.
- Independents faced the greatest industry challenges and returned the lowest profitability ratios. Both ROE and pre-tax income to total revenue were lowest among all lessor types at 14.0 percent and 12.6 percent, respectively. Threats to funding, increased competition, and higher costs drove ratios lower than other lessor types.

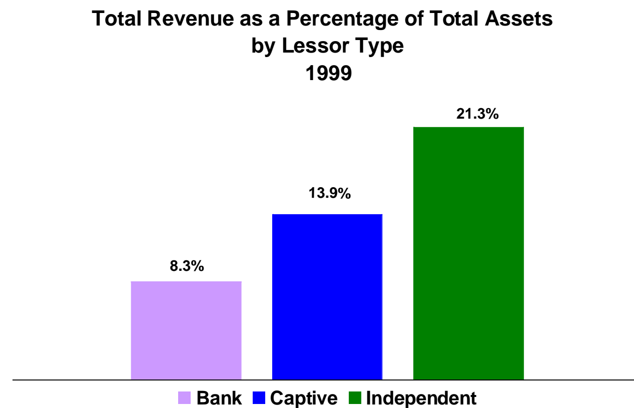
Banks

Leasing activities have gained more prominence with banks with their growth and earnings impact receiving more attention. Growth rates are well above the industry average and for most banks funding is not an issue. Deposits held in customer accounts make access to capital for the leasing subsidiary secure and cost effective. If debt or equity funding is necessary, the bank lessor can rely on the financial strength of its parent to obtain favorable rates. Several bank leasing executives revealed that their parent companies realize that the leasing subsidiaries often have stronger profitability measures than more traditional

lending business lines. As a result, banks continue directing capital to their leasing operations to support growth strategies.

Bank-owned lessors see customer relationship as a major competitive advantage. Many bank lessors feel that this advantage does not result in a pricing premium but instead enables bank lessors to win high credit quality business. Where once it was presumed that the only relationship a leasing company had to its existing customers was through repeat business, now a bank operated lessor has a potential relationship with its parent's customers as well.

Some bank lessors believe that many customers are more comfortable obtaining a lease from their bank, since they have a certain inherent trust in the banking institution. The banks' other business lines are also aware of the leasing operation and sometimes – although not frequently enough - promote it to customers.



Source: ELA Survey of Industry Activity Report 1999-2000, FIC analysis

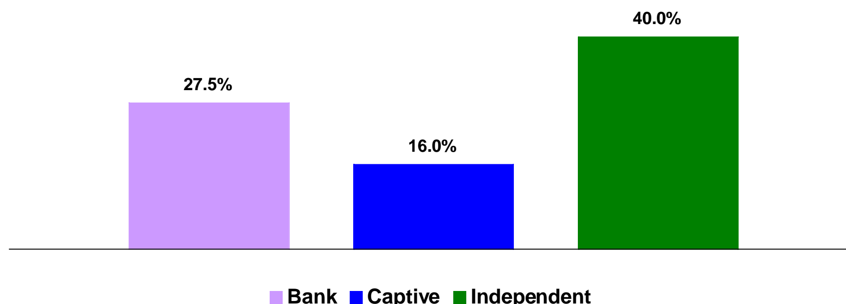
Figure 9

The most successful bank leasing operation is connected to overall corporate objectives, creating synergies with the existing banking relationships, thus creating a major challenge for independents. For example, at one major bank, 35 to 40 percent of all leasing customers overlap with traditional banking customers.

SIA Bank respondents reported 22.5 percent growth in 1999. Median bank leasing company growth for the same period was 28 percent. Bank leasing companies report an average ROA of 1.2 percent, the lowest of all lessor types. Bank ROA is low in part because they generate lower revenue relative to assets than other lessor types (Figure 9). Bank lessors describe their propensity to take high credit quality customers as well as relationship-based pricing as possible reasons for the low ratio.

At 15.4 percent, bank ROE is the strongest among all lessor types. This is not surprising as banks also report the highest leverage, 12.2 percent. Using interest expense to net earning assets, banks have a low ratio of 4.11 percent compared to independents with the high of 5.7 percent. Furthermore, the total expenses net of interest, depreciation, and provision to total revenue is 27.5 percent for bank lessors versus 40 percent for independent lessors. This ratio indicates a lower bank lessor operating cost structure (Figure 10).

Operating Expenses* as a Percentage of Total Revenue
by Lessor Type
1999

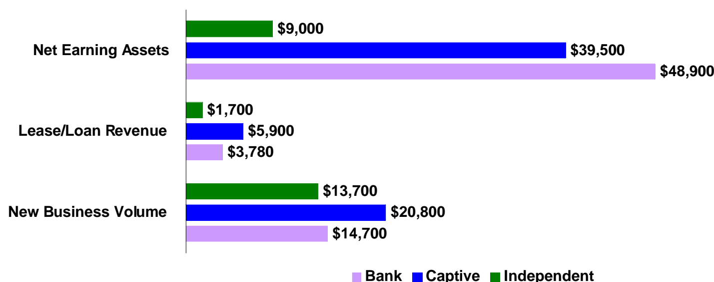


Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis
*Operating expenses include 2000 SIA income statement categories: Sales and Marketing, Operating, and Other

Figure 10

Some non bank lessors believe the reason why they generate stronger ROE than other lessors has more to do with the parent company than the operating performance of the bank. For example, leasing companies that are owned by a bank but operate as a subsidiary have the autonomy to focus on the leasing side of the business and need not worry about funding the business. This allows the bank lessor to fine-tune its core competencies. Furthermore, the parent company subsidizes a portion of the bank lessor's costs in the form of lower overhead allocations. Many executives surveyed for this Report, including bankers, feel that if bank lessors managed all costs themselves, their balance sheets would look less attractive.

Productivity per Employee* (000's)
by Lessor Type
1999

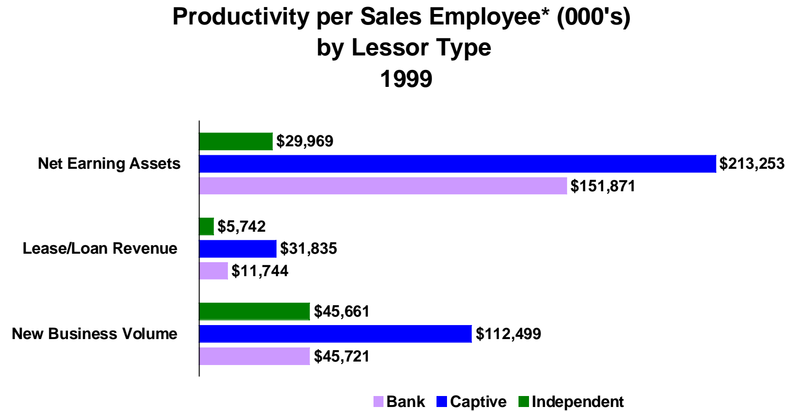


Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis
*Median total employees

Figure 11

Banks also score high in overall productivity (Figure 11-12). Banks have the highest average value for net earning assets per total employee at $48.9 million as well as a high lease/loan revenue per employee at $3.78 million. New business volume per sales employee is also strong at $45.7 million, but banks perform at a distant

second to captives with $112.4 million per sales employee.



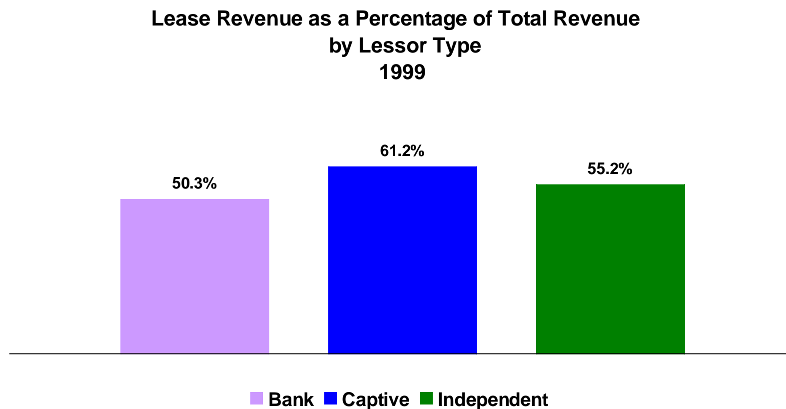
Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

*Sales employees include median inside and outside sales

Figure 12

Captives

Captives are profitable and continue to grow, albeit slower than other lessor types, as their equipment sales expand. Captive leasing success centers on the sale of the product, not the sale of the lease. Captives have a clear advantage over both a bank and an independent through their ability to make adjustments to rates and residuals due to their extensive and proprietary knowledge of the underlying asset and the true cost to deliver. As one captive said, "We are a success if we sell our equipment versus letting the competition win the sale. The financing is a great bonus. It gives us the latitude to price our equipment differently and offer large subsidies on the financing side of the deal."

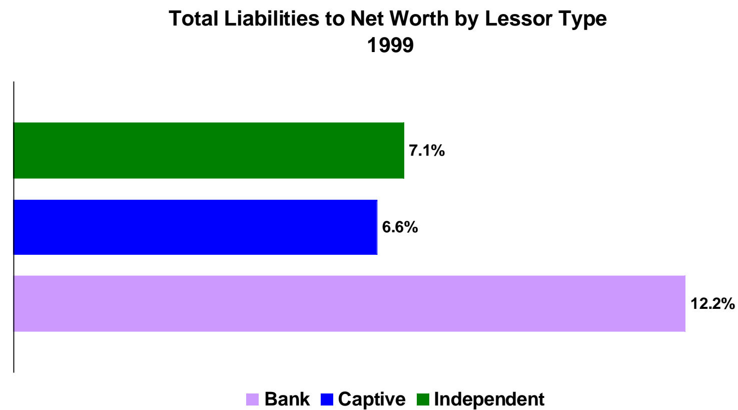


Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 13

Captives finance the majority of their equipment through

leases versus loans. Although, the percentage of lease revenue to total revenue has slightly declined since 1998, captives have the highest percentage of lease revenue to total revenue, 61.2 percent in 1999 compared to other lessor types (Figure 13). They also hold the highest increase in the volume of operating leases at 30 percent.



Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 14

From a profit perspective, captives are high performers. At 2 percent, their ROA is the highest. They rank second in ROE and number one in pre-tax income as a percentage of total revenue, 22 percent. Using interest expense to net earning assets as a proxy for cost of funds, captives return the lowest ratio, 3.9 percent. Furthermore, they demonstrate the lowest level of total liabilities to net worth of 6.6 percent (Figure 14) and a higher use of short term funding as a percentage of total assets, 37 percent.

Captives were highly productive and efficient in 1999. On a per sales employee basis, captives report the highest new business dollar volume, lease/loan revenue, average dollar value of assets ($112.4 million, $31.8 million, and $213.2 million, respectively). The lower number of originators drives origination effectiveness of captive lessors, with this low number resulting from most sales being generated on the product side or by vendors. Captives are also highly successful at turning applications submitted into leases booked. On average, captives fund 85 percent of all application they approve, representing 48 percent of all dollar requests submitted.

Success has prompted captives to reach into new markets by extending beyond their existing focus. Captive lessors interviewed report a strong desire to provide holistic solutions versus single transaction financing. To accomplish this, captive lessors will finance both proprietary and non-proprietary equipment. Leveragability of current knowledge to new products may provide a source of competitive differentiation.

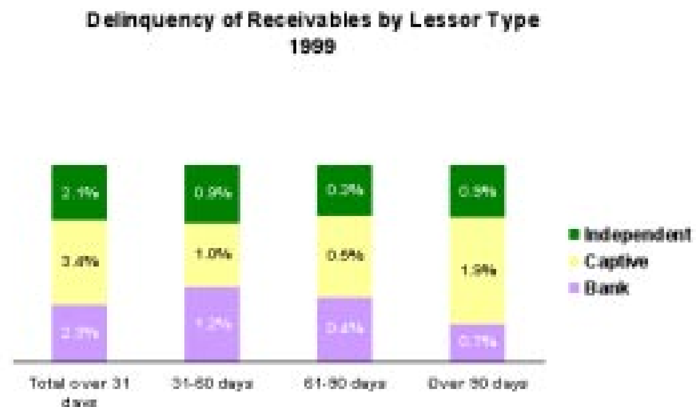
Captive lessors view the threat to their continued success to be ticket segment specific. For example, they believe that small to mid-size businesses are less likely to shop financing whereas larger companies will and often times do shop. As a result, competition intensifies at the larger middle market and large ticket segments. A downturn in the

economic health of the country will impact smaller businesses first and most likely severely curtail their spending. This will hurt the captive on two fronts: product sale and lease financing.

Industry concentration and type of equipment financed will also impact captives in a negative economic climate. Residual values and the product market vary according to industry and equipment financed. A lessor of durable, high residual equipment will fare better than, say, a lessor of computer software, which one respondent categorizes as "unsecured lending" due to its low residual values. Industries classified as counter-cyclical will also weather negative economic change better than those reliant upon non-essential spending.

Like independents, captives depend upon funding to continue their business. According to one interviewee, corporate track record and not simply size determine funding cost. Even a small company that has a good banking relationship and a proven ability to manage its receivables can access the debt market with favorable rates. However, a number of large corporations exist that have not handled their debt very well and face difficulty in the capital markets.

Credit quality may be a looming issue. Captives demonstrate the highest overall delinquency rate of 3.4 percent. 1.9 percent of the receivables are older than 90 days (Figure 15), the highest among lessor types. During interviews, captive lessors discussed the tendency of captives to write deals that banks and independents may not be willing to do. As one executive described, "The success of this higher risk strategy will be seen in a down market. Profits on the sale of product are greater than the potential for profit on financing, so there is a push to finance sales, sometimes even at the expense of credit quality."



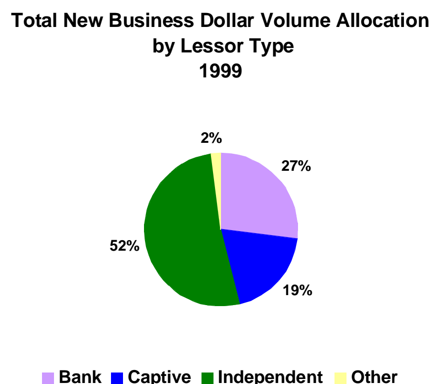
Source: ELA Survey of Industry Activity Report 1999-2000

Figure 15

Independents

In 1999, independents generated 52 percent of all new business dollar volume (Figure 16). Although independents as a whole have enjoyed a rapid rate of growth in the past, most interviewees anticipate slower future growth.

Interviews with independent lessors centered on lengthy discussions concerning higher costs both in funding and general operating expenses. Large independents may be generating the best results. While the total volume contribution of independent lessors grew by 20 percent in 1999, the median and the mean were significantly lower at negative 4.3 percent and 9 percent, respectively.



Source: ELA Survey of Industry Activity Report 1999 -2000

Figure 16

Profits seem most at risk for independents versus other types of lessors. In total they generated the both the lowest ROE, 14 percent and the lowest percentage of pre-tax income to total revenue, 12.6 percent. On a more positive note, independents generate an ROA of 1.7 percent, due to pricing advantage. This performance is second only to the captive's ROA of 2.0 percent.

Interviews with independent industry executives point to low leverage and higher cost of funds to explain the differences. They mention that a bank's ability to maintain a higher level of debt to equity is a major driver in the higher average ROE reported in the SIA.

Independents fare much better on the revenue side of the profit equation. As one executive stated, "A better comparative profit measure for the leasing industry is ROA. This is where you can see the pricing advantage that the independents have." To explain the higher ROA of an independent versus a bank's higher ROE and pre-tax income as a percentage of total revenue, we need to break apart the ratios. Through this we find that as a percentage of total assets, independents generate more revenue than banks. Independents may be pricing higher either due to deal complexity or added risk. The higher price results

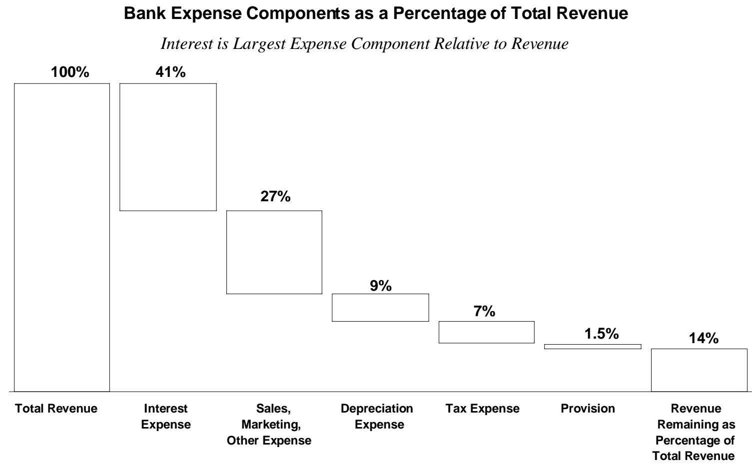


Figure 17

in higher revenue and, ultimately, higher ROA. But, with less debt and more equity and not enough compensating revenue, the ROE for the independent is lower.

Furthermore, while the revenue is higher for an independent, so too is the operating expense versus a bank (Figures 17-18). Customer acquisition costs are much higher for independents as they are constantly generating new clients. Therefore, as a percentage of revenue, their pre-tax income is lower. According to the productivity reported in the SIA, an average independent requires 241 percent more people versus a bank lessor while generating only 151 percent more volume. This underscores the inherent value of being able to leverage a bank customer relationship

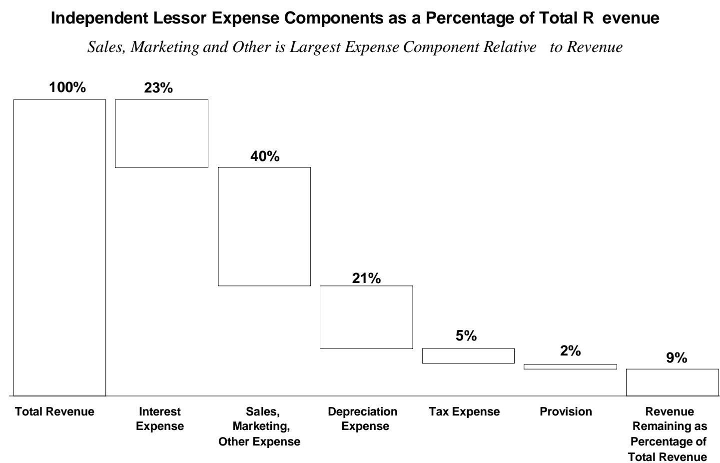


Figure 18

These cost factors point toward increased consolidation of the independents. Many industry executives fear that debt and operating costs will eventually become too high and

difficult to manage, forcing them into a sale situation. But the path differs for independents based on their size and strength.

Large, well-established and highly rated companies will continue to grow. Middle and small tier firms bear the burden of the risks. Negative press, high profile losses, and lower credit quality threaten their continued viability. Banks and large independents view this as opportunity to either acquire additional assets or to buy (rather than build) capabilities.

Independents demonstrate lower average productivity versus banks and captives. For new business volume, the average sales employee generated $45.6 million in new business dollar volume. Independents also generate the fewest revenue dollars per sales employee with $5.7 million. In addition, they demonstrate a weaker ability to turn applications into booked leases with only 47 percent of total new application units submitted being booked. However, independent lessors book the highest percentage of application dollars submitted, 53 percent (Figure 19). They may be more successful booking larger rather than smaller applications.

Generally, independents tend to have a greater appetite for risk than their bank counterparts. This gives them the pricing and volume advantages but obviously places additional risk on the company in the event of an economic downturn.

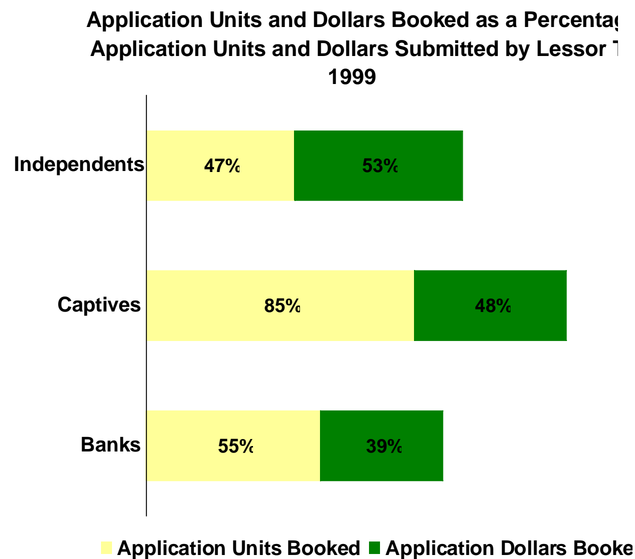


Figure 19

The good news is that credit quality currently appears to be holding. 98 percent of their receivables are paying within 30 days. This is the highest percentage of all lessor types. The allocation of the remaining 2 percent of delinquencies predominately in the 31-60 and greater than 90 days categories may be a longer-term credit quality issue.

Vendor Finance

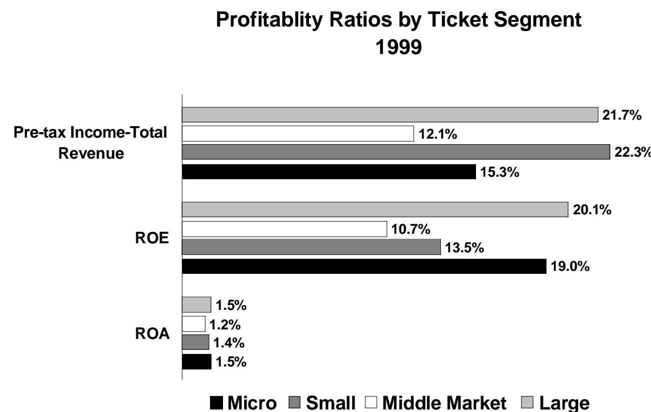
Vendors finance has become an increasingly important part of the leasing industry. According to the SIA, the small and micro ticket segments depend on vendor relationships and drive over half of its new business volume. The small ticket segment alone generates

37 percent of total vendor new volume dollars. These programs provide lessors with the opportunity to compete efficiently in the small ticket and lower middle ticket segments. Manufacturers use this as a competitive advantage in the marketplace. All interviewees participating in programs cite the importance of the Internet in both originating and managing these programs.

According to lessors providing vendor financing, price is no longer a differentiating factor. These leases have become commodities, thus, the most effective way to sustain a competitive advantage in the vendor/manufacturer market is to help drive the vendor/manufacturer's business. Lessors can do this through application of technology to facilitate the vendor's sales force, streamline the application and approval process or create electronic interfaces between the vendor/manufacturer and the lessor to service the lease, market new products, and retain existing lessees.

Market segment profitability

Ticket size focus rather than lessor type seems to determine lease profit potential (Figure 20). While in 1998 the large ticket segment dominated leasing industry profitability, 1999 high profit performers cuts across several segments. Large ticket generates the strongest ROE at 20.1 percent and is tied with the micro segment for ROA high performance, both



Source: ELA Survey of Industry Activity Report 1999-2000

Figure 20

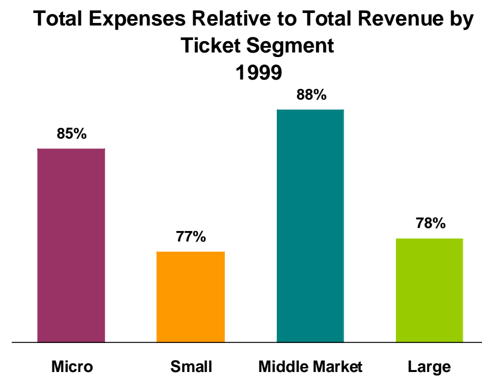
reporting a 1.5 percent return. Small ticket commands the strongest pre-tax income to total revenue with 22.3 percent.

To understand the returns requires going beyond the numbers and understanding the characteristics of each segment. Defining characteristics include:

- Large ticket leasing generates high revenue with relatively few resources when compared to other lessor types.
- Middle market profitability has decreased since 1998. High origination costs, lower transaction sizes, low barriers of entry, and increased competition characterize the current environment.
- Small and micro segments command strong returns. High tech/low touch is the buzz. Vendor finance drives new business dollar volume.

Large ticket

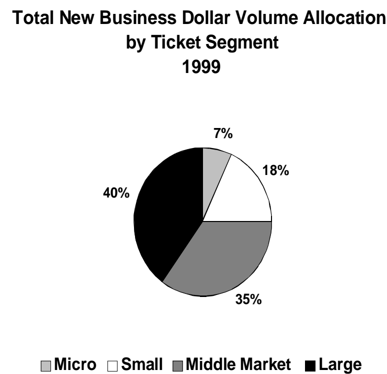
Large ticket leasing is a very attractive segment of the overall market. Relative to the revenue generated, costs are among the lowest of all ticket segments (Figure 21). But, high barriers to entry characterize participation in this market. Barriers are not technology-related but instead involve structuring and credit expertise, access to funding and tax appetite for housing equipment assets on the balance sheet.



Source: ELA Survey of Industry Activity Report 1999-2000

Figure 21

Commanding 40 percent of all new leasing business volume (Figure 22) and only 8.5 percent of all new applications submitted, large ticket leasing clearly focuses on transaction size. Furthermore, the transportation industry (including rail, air, trucking, water, and bus) is the dominant end-user lessee with 44 percent of all transactions supporting these end-users (Figure 23).

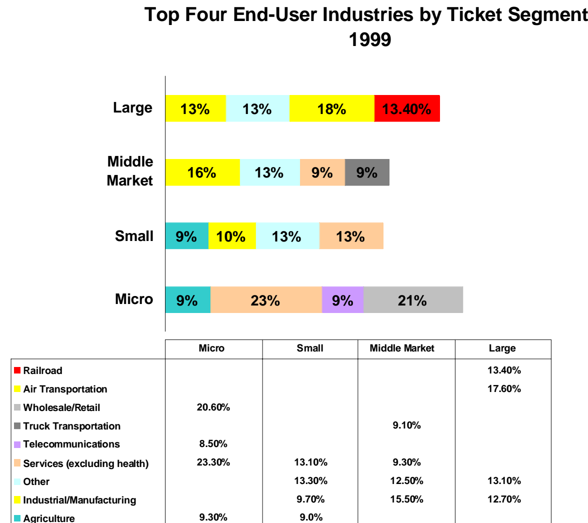


Source: ELA Survey of Industry Activity Report 1999-2000

Figure 22

The large ticket segment produces high ROA, ROE, and pre-tax income to total revenue. The profitability of this segment is

higher than the middle market. First, higher leverage reduces the equity and results in a



	Micro	Small	Middle Market	Large
Railroad				13.40%
Air Transportation				17.60%
Wholesale/Retail	20.60%			
Truck Transportation			9.10%	
Telecommunications	8.50%			
Services (excluding health)	23.30%	13.10%	9.30%	
Other		13.30%	12.50%	13.10%
Industrial/Manufacturing		9.70%	15.50%	12.70%
Agriculture	9.30%	9.0%		

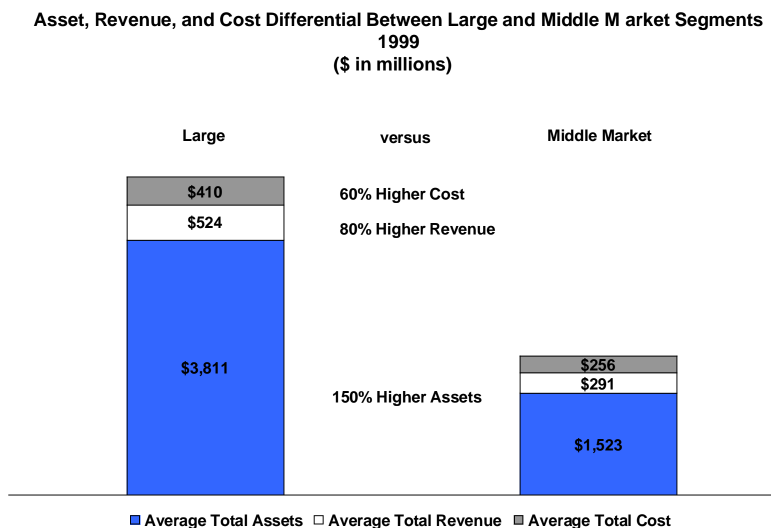
Source: ELA Survey of Industry Activity Report 1999-2000

Figure 23

higher ROE than for the middle market. Second, pre-tax spreads in both businesses are similar (2.8 percent). Accounted for by

differences in asset size, the large ticket segment generates 80 percent more revenue than the average middle ticket segment. But, on the expense side, it generates only 60 percent more expense dollars (Figure 24). Therefore, the middle market segment maintains a higher cost structure relative to its revenue thereby enabling the large ticket segment to dominate both the ROA and pre-tax income to total revenue profitability measures.

Some industry experts interviewed expressed surprise that the large ticket segment produces such a high ROE. In today's market they feet that the pre-tax ROE range for the large ticket is about 9 to 10 percent and 6 to 7 percent after-tax. In fact, many



Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

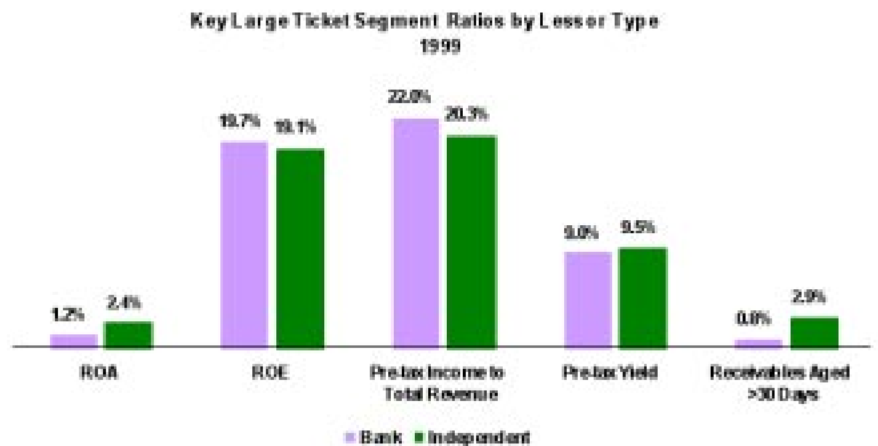
Figure 24

interviewees felt that middle ticket is generally a more profitable market than large. To explain the discrepancy between impression and reality, one interviewee stated, "The equity investment that (we) put in these (large) deals gets leveraged which produces a higher ROE."

Banks are the most formidable competitors in the large ticket market. Several independent lessors described a preference for participating with banks in larger deals versus directly competing with them. One independent lessor mentioned that many of the deals won by independents in the large ticket center around structuring – especially tax and legal structuring. When the deals are simple, a leasing company linked to a bank relationship is likely to win. Also, banks tend to shy away from operating leases or cross-border deals (foreign-exposure issues) due to their regulatory environment. Generally, the more complex the deal, the easier it is for non-bank lessors to win deals.

When a deal is straightforward, many competitors would prefer not to compete against a bank. In a conversation with an independent lessor, he stated, "Banks play in the big ticket very strongly. Every time, I am up against a bank, I feel like I am at a disadvantage. Banks are banks. They have been providing capital to industry for years. They have got chairmen that sit on boards; they have got relationship managers that have been building a business base."

Banks operate at a ROE advantage compared to independent lessors (Figure 25). According to the SIA, bank lessors (54 percent of large ticket volume) participating in the large ticket market dominate both ROE and pre-tax income as percentage of total revenue. Banks are also much more highly leveraged (15.5 to 1 versus 6.9 to 1). However, independents demonstrate their risk or expertise premium through higher average pre-tax yields of 9.5 percent versus 9.0 percent for banks. Median yields a more dramatic difference, 9.6 percent for independents versus 8.7 percent for banks. Premium pricing drives the independent lessor ROA to a high 2.4 percent versus the bank ROA of 1.2 percent.



Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 25

Origination methods also differ between banks and independents. Volume generated directly, through vendors, and through third parties totals 67 percent, 25 percent, and 8

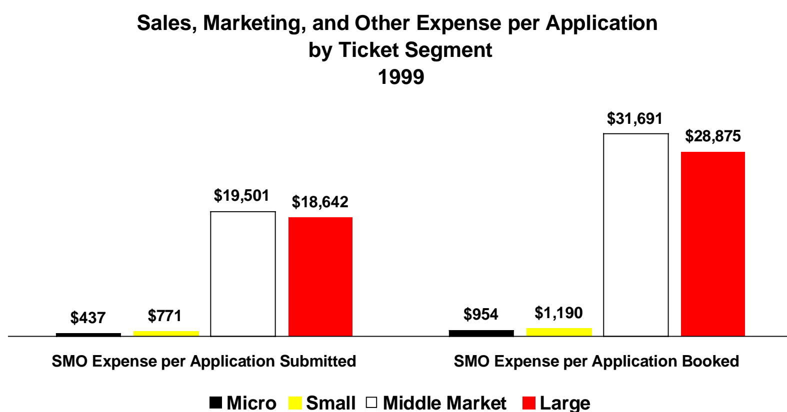
percent, respectively, for banks and 65 percent, 11 percent, and 24 percent, respectively, for independents. The third party portfolios may represent the independent lessors' participations with bank lessors.

Middle market

While the middle market segment generates 35 percent of all new leasing dollar volume, it may face an even larger proportion of threats and challenges to be addressed. These include: high market penetration, growing competitive intensity, and high infrastructure costs. As a middle ticket lessor stated, "There are a lot of people in the middle ticket segment. You've got small ticket lessors that are creeping into the lower end and nibbling at the heels of the middle market and then you have large ticket lessors who are playing in the upper end of the same market."

Comparatively, the middle market segment does not perform well. Middle market generates the lowest average ROA, ROE, and pre-tax income as a percentage of total revenue (1.2 percent, 10.7 percent, 12.1 percent, respectively) versus other ticket segments. With total liabilities to net worth of 7.7 percent, middle ticket lessors have low leverage, driving down the average ROE.

With pre-tax yields similar to those in the large ticket segment, leverage and expenses negatively impact profitability. Compared to other ticket segments, middle market leasing operates with the largest percentage of expenses relative to revenue. Small, large, and middle market segments reflect 77 percent, 78 percent, and 88 percent, respectively. Demonstrating the higher expense structure of middle market leasing, the middle market segment lease applications are the most expensive to originate and book.



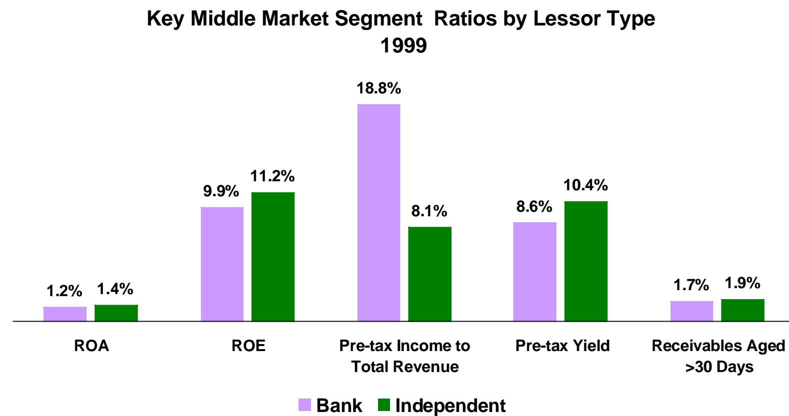
Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 26

According to the 2000 SIA, the average middle market application requires $19,501 in sales, marketing, and operating expense (Figure 26). An average single large ticket application requires $18,642. This difference is exacerbated when comparing the cost of applications

booked. A higher percentage of applications submitted become leases in the large ticket arena. This results in the average cost of a booked application increasing by 55 percent compared to a 63 percent increase in cost for middle market. This leads many lessors to chase the larger deals. According to one industry leader, “We would rather spend our time doing fewer large deals than a lot of smaller ones. It just makes more economical sense.”

Middle market leasing provides another example of the bank versus independent profitability battle (Figure 27). In this case, debt and total liabilities to net worth are similar for both players; independents better in ROE performance with an average of 11.2 percent.



Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 27

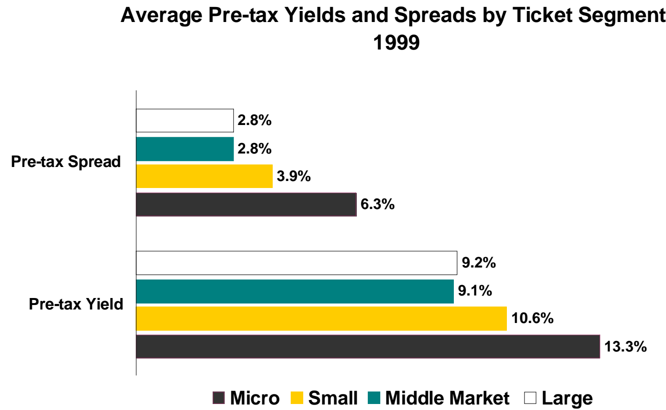
Independents also command a significant price premium compared to their bank competitors. For example, on average bank middle market leasing has a pre-tax yield of 8.6 percent while independents report 10.4 percent. While the median is closer at 8.8 percent and 9.2 percent for banks and independents, respectively, the 75th percentile rank produces a 9.3 percent pre-tax bank yield versus a 16.2 percent for independents.

Independents in the middle ticket again reflect a larger expense base relative to revenue, as demonstrated by their significantly lower pre-tax income to total revenue ratio. Independents on average report an 8.1 percent ratio while banks report an 18.8 percent. Many interviewees feel that this can be explained by bank allocation methodology that does not necessarily reflect all costs that banks would incur as a stand-alone business.

Small ticket

The small ticket segment appears both profitable and attractive to many players. Representing 18 percent of all new 1999 business volume, the ROE for the average small ticket lease is 13.5 percent. ROA for the same period equaled 1.4 percent and pre-tax income as a percentage of total revenue totaled 22 percent. Average pre-tax spreads have dropped since 1998 but remain higher than for the middle market and large ticket

segments. Driving the higher spread is an average pre-tax yield of 10.6 percent, nearly 150



Source: ELA Survey of Industry Activity Report 1999-2000

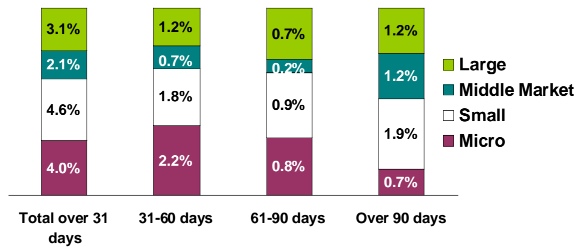
Figure 28

basis points higher than that of middle market and large ticket segments (Figure 28).

Significant barriers face lessors considering entry to this market. With the $44,692 average size of a small ticket application submitted versus $437,762 in the middle market segment, lower per transaction revenue demands high tech/ low touch processing. Once the infrastructure is built, the challenge is then to continuously develop partnerships with manufacturers, vendors or distribution channels that can provide ‘flow’. This leads to the need to achieve economies of scale, driven by standardization of documentation and structure.

The small ticket segment is similar to micro ticket in two ways: first, use of vendor programs to gain volume, thereby, reducing the origination costs and, second, higher than average portfolio credit risks. On average, the vendor channel generates 46 percent of all new volume. Total new volume originated by vendors increased in 1999 by 52 percent, making it second only to large ticket leasing vendor program in growth (90 percent increase).

Delinquency of Receivables by Ticket Segment
1999



Source: ELA Survey of Industry Activity Report 1999 -2000

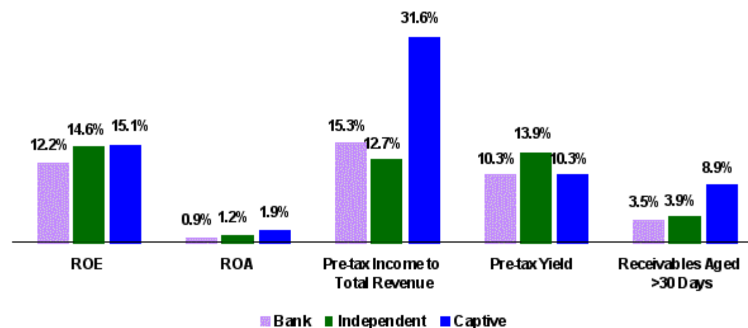
Figure 29

Losses are also an issue. According to small ticket segment interviewees, these deals are typically done with small companies where turnover and capital demands are high. On average, small ticket leasing results in 4.6 percent of the total portfolio receivables classified as older than 30 days (Figure 29). Furthermore, respondents report 1.4 percent of the total receivables balance being charged-off.

These losses underscore the biggest small ticket segment risk, an economic downturn. A downturn will represent the first major test of the credit scoring models employed to facilitate and sometimes automate the underwriting process. According to a small ticket interviewee, “One of the biggest risks we face in an economic downturn is poor credit quality due to over use of credit scoring”

Captives dominate the small ticket segment (including micro ticket) and lead in profitability with ROE, ROA, and pre-tax income to total revenue of 15.1 percent, 1.9 percent, and 31.6 percent, respectively (Figure 30). With no direct origination sales force to support, captives have a lower cost base. This allows captives to realize significant profits even if the portfolios are held for a short period and securitized. Furthermore, insiders and competitors talk about the difficulty competing with rate subsidies granted to the captive finance divisions from parent manufacturers. The captive truly has a “captive customer audience.”

Key Micro/Small Ticket Segment Ratios by Lessor Type
1999



Source: ELA Survey of Industry Activity Report 1999-2000, FIC Analysis

Figure 30

Another threat to the entire small ticket leasing industry may involve credit cards. By virtue of the ease of the transaction, they have become a preferred payment method for a growing number of small businesses. According to FIC's 1999 Annual Small Business customer survey, 76 percent of businesses surveyed use credit cards or credit lines versus 42 percent who use equipment leasing. As one SIA interviewee stated, "If interest rates were competitive then it would be easier for the customer to just swipe and pay rather than deal with a book of lease documents and get the new equipment later."

Micro ticket

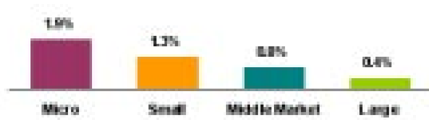
With average ROE and ROA of 19 percent and 1.5 percent, respectively, Micro ticket leasing is highly attractive. The micro ticket segment reports the highest percentages for average pre-tax yield (13.3 percent) and average pre-tax spread (6.3 percent). Clearly, lessors participating in this segment try to obtain high compensation for deals with a higher perceived risk.

Average aging receivables and losses for the micro segment reflect the added risk. In 1999, 4 percent of the micro ticket lessor's receivables were older than 30 days. The majority of these agings were classified as aged between 31 and 60 days (2.2 percent). This was the highest reported percentage in the category across all segments. Actual full year losses as a percentage of net receivables were also highest for micro ticket leasing at 1.5 percent.

Vendor programs drive productivity in the micro ticket segment, with 66 percent of new business volume generated through these relationships. Micro ticket lessors use vendor relationships to minimize origination costs. In 1999, lessors demonstrated a 41 percent increase in micro ticket volume generated through the vendor channel. Micro ticket leasing uses the greatest number of dealer programs across all ticket segments (60 percent of the total). The majority of these programs are both non-exclusive and without recourse.

Like small ticket leasing, but perhaps even more exaggerated in micro ticket, technology and efficiency move hand in hand. On average, the micro ticket segment spends a higher percentage of its total revenue on IT related investments (1.9 percent) than other ticket segment (Figure 31). Conversely, in 1999 large and middle ticket lessors spent an average of .5 percent and .8 percent, respectively, of their total revenues on IT.

New Information Technology Investment Relative to Total Revenue by Ticket Segment
1999



Source: ELA Survey of Industry Activity Report 1999-2000, FIC analysis

Figure 31

Industry challenges

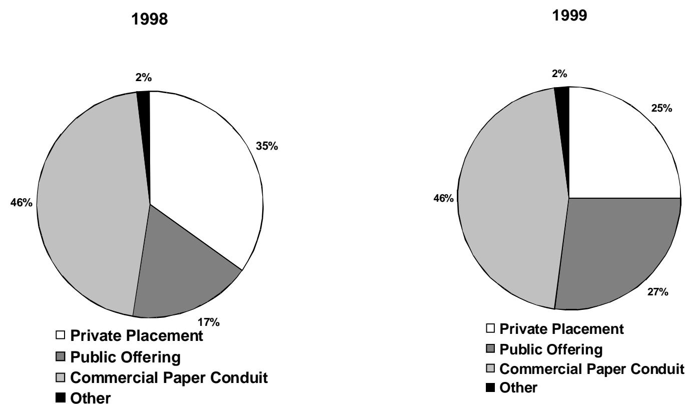
Although industry profitability measures remain strong, creating an attractive current environment, the future state of the equipment leasing industry remains unclear. Even in the face of a strong year, there are forces at work threatening the industry. Among those requiring focus:

- *Access to funding* is becoming increasingly difficult and shifting the current balance the power between lessors
- *New delivery channels* are changing current business model and highlighting the need to participate
- *Operational efficiency* is a primary business focus helping to control growing margin pressures
- *Continued consolidation* activity is further reducing the number of market players and increasing the market control of those remaining
- *Quality employees* are more difficult to find, more expensive to acquire, and more demanding of their employers
- *Proposed reporting changes* to operating leases threatens a valuable product

Access to funding

According to the 2000 SIA, total assets securitized rose 16 percent from 1998. Both small and large ticket leasing experienced the largest year over year growth, 52 percent and 55 percent, respectively. While commercial paper conduits remain the primary securitization vehicle (46 percent of 1999 and 1998 securitization volume), public offerings surpassed private placements as the second vehicle (Figure 32). From a ticket segment perspective, both the large and middle market segments rely heavily on commercial paper conduits while the micro and small ticket segments tend to favor public offerings.

Total Dollar Volume of Securitized Assets by Type



For many of the top tier players in the leasing industry, funding is not a daily source of concern. Strong debt

ratings enable them to secure funding when and how they need it. A lessor representing a major industry player told us, “When you look at a company like ours, we are able to raise capital through a number of vehicles. Being able to raise funds has not been an issue. Generally, I do not think that companies that are fairly well diversified have the funding issues.”

But access to funding remains a critical topic for the majority of players. Company size seems to be a key determinant in access to the funding process. Smaller firms do not have the securitization volume of a larger firm and, therefore, have a more difficult time getting with the investment community. Analysts do not know them and have less confidence in what they are doing. One lessor commenting on the situation stated, “If you end up going to the market only sporadically, the market does not get to know you, and it becomes more difficult to make a niche in your business. You never have the opportunity to achieve critical mass.”

To further understand the funding challenge, lessors must be segmented by type. Issues differ for each type of lessor. Bank lessors typically rely on the parent company to provide funding. While transfer pricing exists through the Treasury department, the actual cost to acquire funds is typically lower than for other players. Deposits kept in the bank by both businesses and consumers provide a funding source unique to a bank.

Conversely, independents and captive finance companies that depend upon their size and overall credit rating may face significant challenges. A captive lessor described today’s securitization market as “fickle.” He went on to describe an environment that has changed over the past year. In the past, conduits were more willing to provide funding for longer time periods and at higher dollar amounts. Today, a conduit’s changing funding stance requires that a prudent lessor has access to other types of financing as well.

Many lessors consider the current funding situation and its related implications to be very serious. A lessor discussing the situation elaborated, “If you look at some of the consolidation going on and some of the companies going out of business it indicates the seriousness.” In very candid conversations, independent and captive lessors talked about their continued viability and the potential of strategic alternatives that include selling their business to companies with a more favorable funding environment.

New delivery channels: E-Business

Product delivery-related discussions with industry executives frequently led to lengthy conversations about the Internet. Generally, many respondents consider the Internet to be an unprofitable as a delivery channel and feel its use will not generate the business volumes needed to sustain profitability. Many anticipate that within a year or two Internet-only companies will either cease operations or will participate in a very different way. Nonetheless, most major lessors have developed Internet strategies in order to keep current with industry trends.

Industry experts speculate that lessors are uncomfortable with the Internet as a delivery channel because they see the Internet as removing them from the customer.

Some lessors believe that the model may better suit a different purpose. The model is considered more conducive to large transactions that cannot be handled by a single lessor. Providers such as LENDX and PureMarkets package and syndicate these types of transactions. Industry executives generally see value in seeking buyers or sellers of deals via the Internet. This business model is much less threatening and considered higher value by those interviewed. One lessor, described a current syndication environment in which the originating lessee copies hundreds of pages of material to be sent to prospective participants. Using the Internet, the paperwork reduced considerably creating a more efficient process environment.

While receptivity on the part of the traditional leasing industry to the new delivery channel has been tentative, all acknowledge that the Internet is both a permanent factor and a driver of the internal focus on efficiency. In some cases, particularly small and micro ticket leasing, lessors are developing online origination capabilities. In other cases, lessors are joining origination sites with customer targets similar to theirs. As a lessor assuming this approach describes, “We are waiting to see what happens.” Waiting, as opposed to trying various approaches proactively, may be a dangerous strategy to pursue.

The Equipment Leasing and Finance Foundation is committed to helping lessors maneuver through the maze of technology. For more information on the impact of E-commerce, the Equipment Leasing and Finance Foundation recently completed an extensive study on "Net Readiness of the Equipment Leasing and Finance Industry," which is available by contacting the Foundation, or visiting the website http://leasefoundation.org.

Operational efficiency

“Process efficiency is the biggest industry challenge no matter what ticket market you are in” described a lessor interviewed. Leasing companies continue to control costs through aggressive process reengineering and continuous improvement programs. Interviewees are quick to point out, however, that they must pay attention to the probability of diminishing returns and employee backlashes when making efficiency-related changes. Many see service as a differentiating competitive factor and stress the need to avoid engineering quality service out of the process.

This appears particularly true in the middle market segment. At a time when profitability is at great risk, middle market lessors have fewer options for improving profits within their direct control. Some view process reengineering as one such option. According to a middle market lessor, “While processes must continuously be evaluated and improved, reengineering must look at the customer’s expectations and align strategy with those expectations to change the process with a solution driven framework. The lessor must differentiate based on operational cost and service.”

Process reengineering to reduce costs creates the need for an increased use of technology. The technology opportunity includes: scoring models to automate the underwriting process; servicing platforms to enable on-line customer access to lease information; on-line application engines; and, sophisticated tracking systems to facilitate the workflow of an application throughout the decisioning process. Within the middle market segment, technology supplements a process to make it more efficient. Full automation is not a viable option, but automating where it makes sense is highly effective. In the small and micro ticket segments, technology dramatically reduces inefficiency by decreasing turn-around times and reducing the number of people required to process an application.

Many industry executives feel the leasing industry does not have to move at the same fast pace of other industries to keep up with technology. They do feel, however, that updating the back-end and front-end processing applications of the firm through technology has become a necessity. One lessor interviewed spoke to the competitive nature of technology saying, "The first company that can get to market with something that can improve the cost side of the business will have the competitive advantage."

In the past, leasing companies built proprietary systems to help automate the decisioning and servicing processes. Today, many are moving away from propriety systems and outsourcing the entire IT process. The applications offered make the entire leasing process faster, more seamless, and, generally, more efficient. While such systems originally cater to the back end requirements of the leasing business, the last five to six years has seen a surge in demand for front-end support as well. The ultimate benefit of the service is an efficient accounting system for the leasing company. This benefit is no longer a luxury but rather a necessity for success.

Investments in technology by the small and micro ticket sectors of the industry have started to pay off. In the 2000 SIA, small and micro ticket leasing combined, reported an average application decision turnaround time of 16 hours, a 7.5 percent decrease from 1998's time of 17.3 hours. These results demonstrate an increase in operating efficiency. In 1999 there was a per small/micro ticket lessor annual average of 20, 449 applications decisioned. At an average of 16 hours per application, this process took 327, 184 hours to complete. Assuming the same volume for 1998, a similar process would have taken 353,678 hours to complete. The difference, 26,584 hours represents an average of 16 full time equivalents.

The savings of human capital in the process is not necessarily eliminated but redirected to higher value activities. According to an interviewee, "Rather than replace people altogether with technology, professionals are redeployed into areas where need for human capital exists." For many lessors, new business origination is the place.

Consolidation activity

Consolidation threatens to reduce the total pool of available financing and increase the competitive control of those lessors remaining in the market. One lessor described a hypothetical situation in which two lessors, each currently providing $500 million in

annual leasing volume, merge and collectively offer $750 million in leasing volume to the market. In effect, this reduces funds available by 33 percent. Such a situation could have adverse long-term effects on both the industry participants and the markets served.

While there have been a number of acquisitions in the equipment leasing industry this year, mergers and acquisitions activity has cooled off significantly since 1999. The ELA reported 68 mergers or acquisitions in 1999 compared with only 41 through the end of September 2000. According to industry sources, rising interest rates and falling stock prices contributed to the decline in the number of M&A deals this year.

For 2000, banks seem to be buying versus building leasing capabilities. Nearly 30 percent of this year's leasing-related deals consist of a bank purchasing a leasing or finance company. Citigroup and Copelco Capital, Wells Fargo and Charter Financial, Inc., and U.S. Bancorp and Lyon Financial Services provide a clear indication of bank interest to the leasing industry. For example, Citigroup's purchase helps it to realize its strategy to grow the equipment leasing business by increasing its leased assets by 50 percent.

Other industry deals highlight the difficulty smaller, undercapitalized finance companies face in this market. An independent lessor expressing concern about the longevity of small independents said, "Consolidation is an issue from a planning and execution point of view." Smaller leasing companies must proactively manage not only their future growth but also their future viability as an independent. Many lessors of all types felt that while it is infrequently discussed, lack of funding is the real driver behind many recent finance and leasing company acquisitions.

Going forward, M&A activity will continue to allow companies to expand into new markets, acquire capabilities, or create economies of scale. Assuming volume growth rates depictive, successful acquirers will increase their selectivity and act quickly to exploit consolidation benefits.

Employee acquisition

Recruiting newcomers and retaining experienced professionals in the equipment leasing industry remains a major industry issue. A lack of training, fear of industry consolidation, and "dot.com" fever are among the elements creating this problem. According to many lessors interviewed, "The best way to attract new hires has been to build a fast-track training program and offer good incentives."

A shortage of talented people has existed over the past five to seven years. First, the recession of the early nineties caused many leasing companies to eliminate training programs reducing the qualified pool of internal job candidates. In addition, industry consolidation has shrunk the total trained labor pool. Many industry sales personnel, fearing consolidation or move out of leasing into what they perceive as more stable industries. Third, many of the industry's most experienced people often receive huge potential financial rewards to move to the dot com world. In fact, losses to dot coms may turn out to be a short-term phenomenon.

As such, the best alternative available to the industry may require leveraging people with skills that are transferable from other industries. Industry leaders believe that the best industries from which to recruit may include: accounting, law, and general banking. The skills highest in demand include experience in tax and asset finance or with lessee transaction experience.

Employees generally change companies for one of three reasons: culture, professional growth opportunities, and, related to growth, opportunities to earn more money. Some insiders view industry consolidation as restricting intra-company advancement. People can no longer move from one company to another with the expectation of working on larger transactions and earning more money. People are also less loyal to their firms as a result of industry consolidation.

Managers view one hiring approach as involving recruiting people from less attractive industries who view leasing as an attractive environment. It may be easier to move people from rating agencies and banks, rather than the investment and securities markets.

Regulation and taxation

Recently, the regulatory and tax leasing environment has been relatively quiet. Even so, rulings about Lease-in/Lease-out vehicles, Section 467 treatment of revenue and expense and definitions of operating and financing leases are important issues for the industry.

In 1999, the Internal Revenue Service (I.R.S.) ruled that Lease-in/Lease-out (LILO) vehicles that have no economic benefit other than tax deferral or avoidance are invalid, and deductions cannot be taken for expenses related to such arrangements. These deals usually involve a multi-national corporation that enters a large ticket lease on an offshore property then immediately leases it back to the original owner. Payments are transferred and loans arranged in a circular fashion such that there is no real economic risk for either entity, and the original owner of the asset still has defacto use of the asset. The impetus for the transaction was to defer taxes by creating expenses where none actually existed.

In 1999, the I.R.S. also changed the differential treatment, under Section 467, between leases with payments and considerations of less than $2 million and leases with payments and considerations of more than $2 million. (Leases with payments and considerations of less than $250,000 are unchanged by this ruling.) The differentiation originally existed to make regulations easier for small business; however, the I.R.S. has determined that the potential for abuse outweighs the need for simplification. This means that application of constant rental accrual will receive identical treatment under both large and middle ticket lease arrangements. Ultimately, this change requires that the middle market lessors do additional document customization to provide customers with the same tax benefits.

Operating leases, representing 11 percent of total 1999 new business volume reported by SIA respondents, face increased scrutiny today. A 2000 ELA Quick Poll reflects the potential negative impact of a change in off-balance sheet leasing. 47 percent of the 67

respondents said their business would be greatly affected. As an interviewee emphatically explained, “What I would say is the greatest advantage we have today is not the tax benefits but the off balance sheet treatment of leasing. Unfortunately, it is also our greatest risk.”

Currently proposed changes to accounting regulations that would standardize the treatment and definition of operating leases versus financing leases threaten the industry. Essentially, the proposed changes would tighten the definition of operating leases and force the inclusion of more assets onto the books of the lessee. The argument for this change is that it will cause the lessee to more accurately reflect on its balance sheet its financial position, particularly with respect to lease liabilities and assets. The proposed new standard will also impact the income statement of the lessee with respect to treatment of lease payments. The imposition of the proposed new accounting standard may affect the lease/buy decision and could make it less attractive, in some circumstances, to lease rather than to buy.

A path to continued success

While each interview conducted for this Report had a different emphasis, our interviewees consistently described a dynamic operating environment for the leasing industry. Whether it is funding sources, delivery channels, use of the Internet, staffing, regulations, credit quality, or human resources, the commonality cutting across each centers on the continued change that all anticipate. Decisions made today with regard to managing through that change will impact performance for the next several years. Clearly, much is at stake.

Top performing lessors demonstrate that no single right solution exists for keeping the pieces together and successfully maneuvering through the rigorous course ahead. They need to maintain a rigorous set of principles designed to guide their ongoing success. While the premise to achieve success may be similar for all involved, the optimal path taken must match an individual lessor’s desired near and long term position in the industry, coupled with an objective assessment of its current and expected future capabilities.

FIC thinks the success path includes at least three elements. Independently, each of the points is important and characterizes a high performing organization. Collectively, the points may define long-term success

Become flexible. An organization ready and able to adapt to changing economy, markets, customer needs will soon surpass those that are not. For example, if customers are willing to use the Internet for both origination and servicing, those lessors able to react quickly with an optimal approach will gain growth momentum. The ability to change quickly should not only focus on processing capability but also on organizational mindset. Critical going forward: organizational flexibility and the willingness of an organization to try different initiatives without undue career risk to their leaders.

Embrace technology warily. Both internally, and externally, high tech has become synonymous with high value. Whether to improve efficiency, acquire new customers, or simply maintain pace with competitors, technology is a requirement. Most lessors must focus on seeking the selected use of strong external partners to provide the tech capabilities.

Back to basics: Set strategy and specific tactics. Understanding the total customer market, creating segments and specific value propositions for each, and developing segment specific processes to support products and propositions remain critical elements of success. Increasingly, lessors must 'pick their spots' offering selected products to selected

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The Foundation develops and promotes the body of knowledge to enhance recognition and understanding of lease financing.

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- To maximize the role that equipment leasing plays in the world economy, and;
- To be the prime developer and disseminator of a body of knowledge of the leasing industry.

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