STATE OF THE INDUSTRY REPORT 2002

consolidation

ACCOUNTING

downsizing

securitization

merger

ROE

credit

ROA

balance sheet

residual values

EQUIPMENT LEASING AND FINANCE FOUNDATION

Equipment Leasing and Finance Foundation

The Equipment Leasing and Finance Foundation is a 501 (c) 3 non-profit organization established by the Equipment Leasing association of America in 1989.

Strategic Objective

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

The Foundation's strategic objectives are:

- 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.

The Mission

To promote the growth and effectiveness of equipment leasing and finance through programs that:

- Identify, study, and report on critical issues affecting equipment leasing and finance, and
- Develop the body of knowledge of equipment leasing and finance for use by the equipment leasing and finance business, academic, and public policy communities.

All products and services development by the Equipment Leasing and Finance Foundation are FREE! The Foundation relies on your generous support to conduct research to increase the industry's body of knowledge and to provide products to you. Please consider a tax deductible contribution today.

Equipment Leasing and Finance Foundation
4301 N. Fairfax Drive, Suite 550
Arlington, VA 22203
www.leasefoundation.org
703-527-8655
Lisa A. Levine, Executive Director

The Equipment Leasing and Finance Foundation

wishes to express appreciation to the following company

for providing sponsorship funds and for preparing this year's

State of the Industry Report:

PRICEWATERHOUSECOOPERS PwC

EQUIPMENT LEASING AND FINANCE FOUNDATION

2002 STATE OF THE INDUSTRY REPORT

PREPARED BY:

PRICEWATERHOUSECOOPERS

OCTOBER 2002

STATE OF THE INDUSTRY REPORT 2002

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EQUIPMENT LEASING AND FINANCE FOUNDATION

The premier developer and disseminator of the industry's body of knowledge.

October 2002

It is with special pride that I introduce the Equipment Leasing & Finance Foundation's 2002 State of the Industry Report. Given the challenging times the industry now faces, we at the Foundation believe this comprehensive analysis of recent trends and market conditions is more valuable than ever to lessors in the field.

As in the past, the report is based in part on ELA's annual Survey of Industry Activity (SIA) results. This year, however, the consulting arm of the company that provides the statistical analysis of SIA results, PricewaterhouseCoopers LLP, took on all the other components of the State of the Industry report—conducting interviews, gathering independent economic data and synthesizing all into a cohesive narrative. Combined with PWC's generous sponsorship of the report, this unification of the work involved produced a more seamless product.

This year's report gives us a portrait of an industry "repairing and rebuilding" from the storms of 2001. Demand for leased equipment remains sluggish in 2002, and lessors are working to streamline processes and increase efficiency. The downturn forced many companies to shore up their credit practices with a return to fundamentals. In all, leasing companies are positioning themselves to take maximum advantage of the opportunities 2003 and a recovery will bring.

When that recovery comes, The Foundation will be there with the information relevant to the times. Our mission, to expand the body of leasing-related knowledge and to provide lessors with timely research and analysis, is ongoing. I hope that you find the 2002 State of the Industry Report valuable in strategic planning, or simply in increasing your understanding of these turbulent times for equipment leasing.

Sincerely,

Thomas C. Wajnert
Chairman
Equipment Leasing and Finance Foundation

4301 North Fairfax Drive • Suite 550 • Arlington, Virginia 22203-1627
(703) 527-8655 • Fax: (703) 465-7488 • www.leasefoundation.org

ABOUT THIS REPORT

The mission of the Equipment Leasing and Finance Foundation (the Foundation) is to identify and evaluate business and economic trends and their impact on the leasing industry. This report, presented by the Foundation in conjunction with PricewaterhouseCoopers LLP, analyzes and interprets the performance of equipment leasing and finance companies, as presented in the Equipment Leasing Association (ELA) 2002 Survey of Industry Activity (Survey). Using Survey findings, personal interviews and independent economic data, this report discusses key challenges and issues facing the leasing industry and their implications for the future.

The Survey presents financial and operational information on 134 equipment-leasing and finance organizations that are also members of the ELA. Survey participants included seven of the Monitor Top 10 and 33 of the Monitor Top 50 leasing/finance companies. Respondents are classified both by lessor type (Banks, Captives and Independents) and by market segment (Micro-Ticket, Small-Ticket, Middle-Market, and Large-Ticket).

Survey data generally reflects domestic leasing activities in calendar 2001, although in some instances, global business data was included. Most of the data is based on calendar year-end reporting. Because participants in the Survey vary from one year to the next, year-to-year comparisons could only be made when respondents provided both current and prior-year information. Unless otherwise indicated, statistical data cited in this report is from the Survey.

The performance statistics presented in the Survey tell only part of the story about the current state of the leasing industry. To provide a more current and in-depth assessment of the industry, PricewaterhouseCoopers LLP conducted extensive interviews with 32 industry leaders and subject-matter experts and considered other meaningful information.

Our thanks go out to the many professionals who assisted in the preparation of this report. We are particularly grateful to the following executives who generously gave their time to share their experiences and insights:

James S. Beard	Robert J. Knapp	Matthew D. Shieman
John H. Bella, Jr.	Ken Keyes	Gary R. Shivers
Laird M. Boulden	Theodore W. Krug	Richard Specker
Donald P. Campbell	Paul A. Larkins	Paul Summa
Fred Costabile	John McCue, III	Jeffrey J. Van Cleve
Adam David	Paul J. Menzel, CLP	Phil Walker
Crit DeMent	James K. Merrilees	Albert L. Weiss
Michael Evans	Douglas L. Nielsen	David S. Wiener
Tony Golobic	James R. Renner	Frederick E. Wolfert
Larry Hartmann	Robert P. Rinek	William Zadrozny
Robert Hunter	Irving H. Rothman	Paul Zediker

Throughout this monograph, we include quotations from our interviews; these are presented on an anonymous basis for the sake of confidentiality.

This report begins with an overview of the leasing industry's recent performance and projections of future industry growth and activity. It then discusses ongoing challenges and key opportunities by type of lessor and market segment. It goes on to discuss the major issues that senior managers are now addressing.

September 30, 2002

EXECUTIVE SUMMARY

Leasing continues to play a critical role supporting the U.S. economy, and the analysis of industry results, trends, developments and perspectives provides insight useful to many constituencies. The overriding intent of this report is to help answer the question "what is the current state of the industry?" and to thoughtfully consider what the future may hold.

The Economy

During 2001, the economy and the investment in business equipment slowed. Investment in business equipment in 2001 was expected to be $780 billion, but in the final analysis turned out to be closer to $700 billion. As new lease volumes are dependent upon the level of investment in business equipment, last year's lower-than-expected business spending profoundly affected many companies. Unfortunately, the investment in business equipment in 2002 is expected to decline relative to 2001. Financial Institutions Consulting, Inc. (FIC) estimates that 2002 investment in business equipment will be approximately $655 billion, of which $204 billion will be financed through leasing. 2003 is expected to show only marginal improvement. FIC projects that the 2003 investment in business equipment will be $668 billion, of which $208 billion will be leased, a small recovery over 2002, but still well below the heydays of 2000. Depressed business spending and lower leasing volumes will translate into a reduced asset-earning base. Consequently, 2002 and 2003 are shaping up to be challenging years for the industry.

The immediate and perhaps most dramatic effect of the sluggish economy has been lessee defaults. Like many others, some lessors were caught by the euphoria of the 1990s technology boom and entered into transactions that, in retrospect, seem unwise. Without a doubt, many of those deals have come home to roost and the fundamentals of high return/high risk ring true. The problem, however, is deeper. During the past 18 months, there have been declining profits, business failures and corporate reorganizations in key industries served by leasing companies; most notably, the airline, telecommunications, and commercial construction sectors. Bad debt write-offs and declining used equipment values caused by overcapacity have adversely affected the bottom line for many lessors.

On the positive side, most, if not all, lessors have placed renewed emphasis on writing high quality transactions and ensuring that contract documentation is robust. Tomorrow's portfolios should reap the benefits of the hard lessons learned in 2001 and 2002.

Funding

Interest rates are at record lows and for many in the industry, profitability has increased or held at prior-year levels because the decrease in the cost of funds has outpaced the decline in lease rates and the provision for bad debts. Many, however, consider lower interest rates to be a short-term benefit as lease rates will eventually reflect the lower cost of funds. No doubt interest rates will eventually rise and lessors will face the challenge of passing the increased cost of funds on to lessees.

Adequate funding has been available to many, but not all, in the industry. The segment that has had the most difficulties in obtaining funds is the smaller independents. Some lessors that previously financed independents have significantly cut back or even stopped the funding. Given the reduced availability of high-quality deals in the marketplace, it makes no sense to fund the competition. The securitization market has also been a difficult place for smaller independents.

Regulatory Matters

In response to Enron, WorldCom and other monumental business failures, regulators are making fundamental changes that will significantly affect many businesses.

Responding to accounting concerns, the Financial Accounting Standards Board has proposed new rules relating to special purpose entities. The proposal is currently being studied and debated. There is no doubt that the accounting rules will be changed, but what form the changes will take is not yet known. The uncertainty has caused a paralysis in the Large-Ticket segment that most likely will not be resolved before 2003. Furthermore, once the rule changes are known, it's unclear, given current investor sentiments, whether or when companies will want to pursue highly structured transactions.

To restore confidence in corporate America, the U.S. Congress passed and the President signed into law the Sarbanes-Oxley Act. The Act could be the most significant reform of U.S. securities laws since those laws were enacted in the 1930s. While the implications of Sarbanes-Oxley are not yet fully understood, it is clear that the boards and management of public companies have expanded corporate governance responsibilities and obligations. New financial statement certification requirements and expanded criminal penalties relating to financial reporting may also lessen interest in complex transactions.

The IRS continues to aggressively challenge certain tax strategies and the companies that employ them. Some of those tax strategies include complex, tax-advantaged leasing structures. The IRS/taxpayer disagreements are now making their way through the judicial system, and 2003 may bring some clarity to some of the tax issues surrounding transactions such as LILOs and QTEs.

People and Systems

Talent within the leasing industry is aging, and most companies agree that recruiting new talent is difficult. In response, a number of lessors have established or enhanced training programs that should produce leadership for the future. Although finding and retaining quality people is always an issue, it isn't a top concern for many leasing companies.

Similarly, while most lessors are focused on enhancing operational efficiencies through better systems, the industry does not seem to be facing any systemic technology problems. Companies are finding they can still get the job done with their existing hardware and software solutions.

■ ■ ■

The leasing industry faced severe challenges in 2001. As for 2002, it seems to be a year of repairing and rebuilding, with most organizations returning to the basics of a sound leasing business, such as credit quality, risk-based pricing, and residual value management.

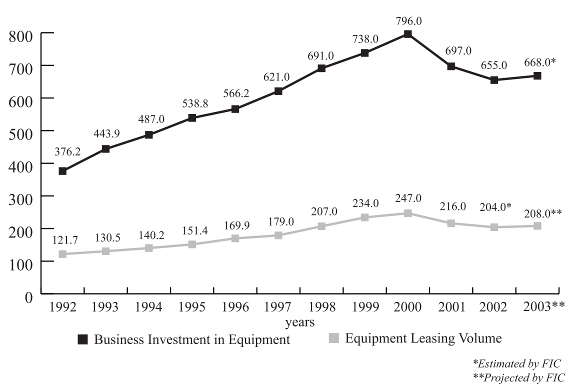
Industry performance in 2003 will depend upon the state of the economy. Many industry insiders are heartened by an increase in business spending and believe that the U.S. is on the path to an economic expansion. Others remain concerned about the still-sputtering economy and believe that a double-dip recession is likely. The industry's prevailing attitude toward 2003 is one of cautious optimism.

LEASING INDUSTRY OVERVIEW

Leasing continues to be the most widely used method of asset-based financing in the United States. It has accounted for approximately one-third of external financing of total capital investment, with a high point of $247 billion in 2000 (See Figure 1). Global volume is close to $500 billion annually.

Figure 1

Business Investment in Equipment and Equipment Leasing Volume
Source: FIC



Leasing is an attractive financing alternative for several reasons, including:

- Ease of asset acquisition
- Increased liquidity/control of monthly costs
- Flexibility to meet changing needs and reduced risk of asset obsolescence
- Lower financing costs when the lessor shares tax benefits
- Off-balance sheet presentation for operating leases

KEY FACTORS AFFECTING 2002 LEASING INDUSTRY PERFORMANCE

Despite the ongoing desirability of leasing as a financing option, these are challenging times for a number of reasons. Chief among them: the recession. A majority of leasing executives interviewed for this report attributed the industry's declining growth rates to the performance of the U.S. economy as a whole. The events of September 11 also had an impact on the industry. Both of these factors are discussed below; others are explored later in the report.

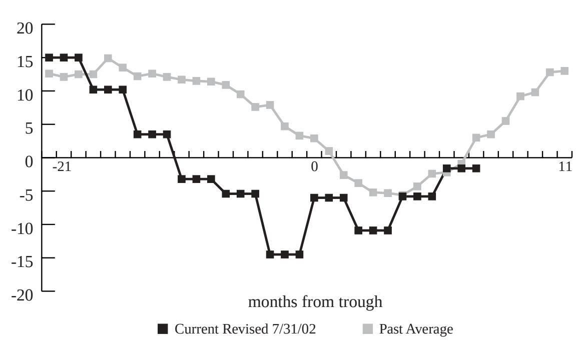
The Economic Downturn

While previous post-World War II recessions were triggered by a decline in consumer spending, the current recession was sparked by a dramatic decline in business investment in two categories of key importance to the leasing industry: (1) information processing equipment and software and (2) commercial construction.

The economy as a whole grew only 0.3% in 2001 with negative growth in three of the four quarters—a marked change from the 3.8% to 4.4% annual growth rates between 1997 and 2000. Overall business investment began to decline in the fourth quarter of 2000, well before the onset of the recession in April 2001. Investments fell to -14.5% in the second quarter of 2001, improved to -6% in the third quarter, and then dropped to -10.9% in the fourth quarter, most likely as a result of September 11. However, overall business investment improved in the first and second quarters of 2002 and many are optimistic that business investment will follow the pattern of previous recoveries.

Figure 2

Comparison of Current Business Investment Performance and Past Average Business Investment Performance
Source: BEA & ECRI[1]



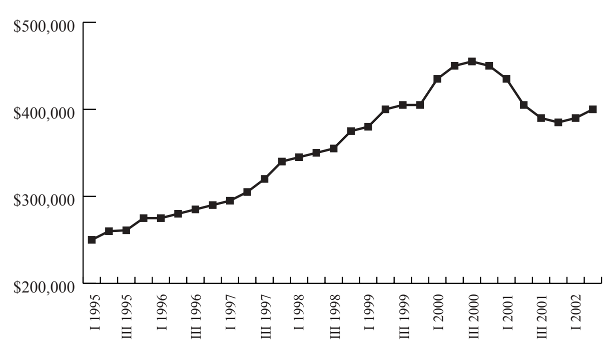
[1] Bureau of Economic Analysis and Economic Cycle Research Institute

As Figure 3 shows, from 1995 through mid-year 2000 information processing and software experienced a surge in investment, largely as a result of the dot-com explosion and Y2K systems preparation. The surge ended with the collapse of the technology boom. In 2001, computer hardware sales fell 16.5% from the previous year. Equipment sales in the telecommunications sector dropped by more than 20% in 2001, and related capital spending is expected to decline between 15% and 30% in 2002.

Even with recent declines, however, investment in information processing equipment and software is at 1999 levels, still high compared to historical investment levels.

Figure 3

Business Investment in the
Information Processing and Software Segment
Source: 2002 BEA



Impact of the Economy on Industries Served

The extent of the decline in business equipment investment varies by industry. Following is the outlook for some of the key industries served by the leasing market:

- **Air transportation.** Despite an increase in aircraft deliveries in the late 1990s, the U.S. airline industry began facing serious financial problems in 2001. September 11 was a climactic event, one that may push some airlines into corporate restructuring, or, in extreme cases, bankruptcy. According to *Air Transport World*, a trade publication, the domestic airline industry stands to lose an estimated $6.0 billion in 2002, on the heels of an estimated loss of $9.0 billion in 2001.

  Airline flights are down by 20%, and an estimated 800 aircraft had been decommissioned[2] as of June 30, 2002. Growth is still negative one year after the September 11 terrorist attacks, a sobering circumstance, given the historical 5% growth rates. Lease rates also continue to decline. As a result, Large-Ticket lessors will most likely suffer steady declines in new and recurring business over the next year. Additionally, many lessors may incur losses resulting from uncollectable accounts and residual value impairments.

  Industry recovery will be slow, as companies restructure from current over capacity while combating tepid economic conditions. The recovery period will last well into 2003 and possibly longer should political and economic events hamper air travel. Some observers believe that it may take up to 5 years to balance supply and demand.

- **Truck and rail transportation.** The use of trucks for transporting goods declined in 2001 as industrial production slowed and demand for consumer goods moderated from the high levels of the late 1990s. Rail transportation has fared better. Ton miles grew 1.1% in 2001 despite a 3.7% drop in industrial output, and growth is expected to continue through 2002, largely on the basis of increasing demand for coal. But while rail-car use has held steady, short-term lease rates have declined.

  Moderate consumer spending has provided some stability for the industry, and gradual improvement is expected for the balance of 2002 and on into 2003. Sustained growth will only come with increases in manufacturing and business investment.

- **Paper and forest products.** Overcapacity is keeping prices low even as production facilities are shut down. Profits are expected to improve slowly as demand growth closes the overcapacity gap. Paper and paperboard tonnage declined 7.2% and 1.1%, respectively, between April 2001 and April 2002. Volume changes are directly related to the strength of the U.S. economy.

[2] Equipment Leasing and Finance Foundation's 2002 Industry Future Council Report.

- **Construction.** Although residential construction fared better than many sectors in 2001, cutbacks in business spending on office and industrial buildings drove an overall decline in construction spending. Many industrial construction projects were put on hold. Capacity utilization is less than 75% and may need to rise into the 80-percentile range before additional capacity will be built. This overall weakness continued into the first two quarters of 2002.

  Residential construction has recently fallen off due to consumer worries about economic recovery, unemployment, and terrorism. Increased concern over a housing price bubble is adding to consumer caution.

- **Industrial manufacturing.** Decreases in sales of construction, farm machinery, and heavy trucks have affected large portions of the manufacturing sector. Recent gains in industrial production are a positive sign and order rates for capital equipment have shown some signs of firming, but a significant upturn is contingent upon the improvement of the national economy.

- **Wholesale and retail.** The slow growth of consumer spending has been troublesome for the retail industry, particularly with consumers shifting more of their discretionary dollars to discounters. Consumers' incomes continue to outpace inflation and spending has been further supported by mortgage refinancings. However, personal bankruptcies and defaults are rising and household debt levels are approaching all-time highs. The key factor across the entire wholesale and retail chain is sustained consumer confidence, itself an uncertainty in the current political and economic conditions. Forecasts are for real personal consumption (adjusted for inflation) to grow by 3.1% in 2002 moderating to 2.9% in 2003.

September 11, 2001

Respondents to the Survey survey cited a short-term disruption in deal flow as one of the key outcomes of September 11 for the leasing industry. For 30 to 45 days following the terrorist attacks, many transactions already in process were put on hold and few new transactions were initiated.

Going forward, the events of September 11 are expected to prompt growth in some industries such as technology and national defense. Advancements in security technologies, business continuity planning, increased defense spending, and the greater use of regional and corporate aircraft, for example, may serve to balance the loss of Large-Ticket leasing opportunities in other sectors.

Industry Growth and Profitability

Growth

New lease volume is directly related to economic growth and investment in business equipment. Despite concerns about a possible double-dip recession (i.e., the economy stalling during the recovery process), most economists believe that the national economy will rebound in 2002. The GDP growth rate is projected to increase by 2.4% over 2001, rising to 3.1% in 2003. These expectations suggest that the leasing industry, with its more than 30% share of total business investment, can expect some growth.

The American economy has proven to be resilient despite the end of the technology boom and the accompanying declines in the stock market. The modest growth forecasts for 2003 are based on the belief that businesses are working through over capacity and strengthening their financial structures. This would set the stage for renewed investment and growth, for the economy as a whole as well as for the leasing industry.

It's important to note, however, that throughout the recession, consumer spending slowed but did not fall, suggesting there is not a great deal of pent-up demand to drive a sharp recovery. Absorbing the overcapacity from the late '90s surge in business investment won't happen immediately. It will take time for companies to build their profits and regain investor trust.

Furthermore, the fragile economy is susceptible to shocks that could impede recovery. A rise in unemployment, higher oil prices, war and other international conflicts are all potential factors that could slow consumer and business spending.

Profitability

Given the current economic environment, lessors are carefully managing their businesses to preserve profits. Even though declining interest rates have helped to boost profits, credit decisions and infrastructure investments are now being closely scrutinized. As indicated in Figure 4, Survey respondents reported the average pre-tax spread on new business increased from 3.9% in 2000 to 4.1% in 2001, primarily as a result of the sharp decrease in cost of funds year-over-year. Some executives felt that the spread improvement was not sustainable in the near term due in part to the deterioration of credit quality and strong competition for fewer credit worthy transactions.

Figure 4

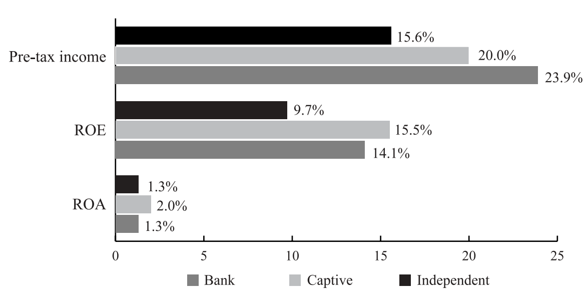
2001 vs. 2000 Weighted Average Pre-Tax Spread on New Business Volume
Source: 2002 Survey

	2001	2000
Pre-tax yield	9.4%	10.3%
Cost of funds	5.3%	6.4%
Pre-tax spread	4.1%	3.9%

Because the mix of Survey respondents changes annually, it's difficult to make precise year-over-year comparisons. But when considering the overall five-year history of survey respondents for directional purposes, profitability ratios continued to show strength in 2001.

Figure 5

2001 Profitability Ratios by Lessor Type
Source: 2002 Survey



Over the long term, behaviors demonstrated in 2001 and 2002 may be beneficial to the industry. If lessors continue to improve their portfolio risk and asset profiles and seek growth within that context, there would be a positive affect on future industry profitability.

SEGMENTS: SMALL-TICKET, MIDDLE-MARKET, AND LARGE-TICKET

Market-Segment Performance

For ELA members participating in the Survey, growth and profitability vary by ticket segment and type of lessor.

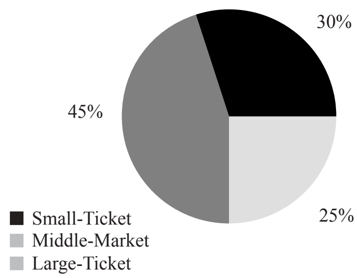
"Ticket segment" refers to transaction size. There are three core segments of the leasing market: Small-Ticket, Middle-Market, and Large-Ticket.

- The **Small-Ticket segment** comprises transactions up to $250,000. This market encompasses the Micro-ticket segment, which is made up of lower-priced equipment (up to $25,000), such as fax machines, personal computers, and copiers. Leasing in this market is driven primarily by convenience of acquisition, maintenance and disposal. While tax-oriented leasing is part of the Small-Ticket market, conditional sales contracts and money-over-money leases are far more common types of transactions.
- The **Middle-Market segment** consists of transactions ranging from $250,000 to $5 million. This segment has a high concentration of information technology related products and caters to the individual lessee's specific needs; both tax-oriented leases and money-over-money leases.
- The **Large-Ticket segment** is made up of lease transactions that exceed $5 million and focuses on higher-priced equipment, such as aircraft, mainframe computers, ships, and satellites. This market is currently extremely competitive, with a large number of players pursuing a relatively small number of transactions. It is also price-sensitive because of the high cost of equipment leased. A significant portion of the leases in this market are tax-oriented transactions that are complex in their structure and documentation.

Figure 6 shows the percentage of total new business volume in each market.

Figure 6

2001 Estimated Total New Business Volume by Ticket Segment
Source: 2002 Survey



(Note: Micro-Ticket included in Small ticket segment)

The following chart shows new business volume by end-user industry and ticket size for 2002 Survey participants:

End-User Industry	Overall	Less than $25,000	$25,000 to $250,000	$250,000 to $5 million	Over $5 million
Agriculture, forestry, fishing	11%	0%	10%	1%	1%
Construction	14%	22%	26%	3%	1%
Finance, insurance, real estate	5%	2%	2%	13%	5%
Health services	6%	5%	6%	7%	4%
Other services, excluding health	8%	8%	7%	22%	1%
Industrial/manufacturing	10%	9%	8%	17%	12%
Truck transportation	9%	27%	2%	4%	2%
Wholesale/retail	8%	3%	20%	9%	3%
All other	29%	24%	19%	24%	71%
Totals	100%	100%	100%	100%	100%

Small-Ticket

Small-Ticket leasing is approximately 30% of the total volume reported by all Survey respondents. It is an important market segment to many lessors. Of Survey respondents, 60% of Banks, 85% of Captives and 48% of Independents reported involvement in Small-Ticket leasing.

Key industries served by the Small-Ticket segment are construction, trucking, and wholesale/retail. The types of equipment financed in 2001 included office machines (16.2%), agricultural equipment (15.8%), industrial/manufacturing equipment (15.2%), and trucks and trailers (13.1%). This was consistent with the previous year.

Small-Ticket had difficulties in 2001 and the first half of 2002, largely because its customers and product bases were victims of the sluggish economy. This segment has endured substantial credit and residual losses from leases in the commercial construction and trucking industries. Because both of these industries have excess capacity to absorb, growth and increased profitability for lessors serving these markets will be difficult in the near term.

On a more positive note, the wholesale/retail industry has performed moderately well. Provided consumer confidence does not slide dramatically, leasing into the wholesale/retail markets should continue to provide stability for Small-Ticket lessors.

Not surprisingly, some Small-Ticket lessors saw a significant drop in demand for new equipment leases. This was due in part to the unfavorable economic conditions in the segment's target industries and to lessees purchasing or re-leasing equipment when their leases expired. The latter helped relieve pressures on residual values but created new lease origination issues that will be felt in future years. One leasing executive noted:

"In Small-Ticket, we either re-lease or sell the equipment to our customers at term. We find that more people are not buying new equipment now, so they are willing to keep their old equipment. It has really played to our advantage."

Some Small-Ticket lessors have exited the leasing market, either as a result of mergers and acquisitions or because of business failure. Many of those remaining are optimistic. Even though there hasn't been a sharp increase in the total amount of equipment financed by Small-Ticket lessors, the fact that there are fewer competitors should result in increased originations for the remaining players.

In terms of profitability, average pre-tax income was 20.1% of revenues, higher than that of the Middle-Market (18.3%) and equal to that of the Large-Ticket segment. Return on equity was 13.5%, as compared to 18.7% for Middle-Market and 12.3% for Large-Ticket.

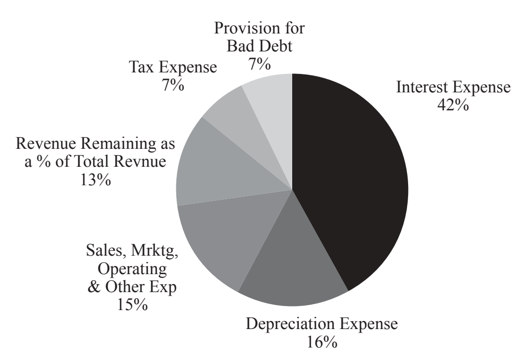
In the Small-Ticket leasing market, profitability is driven by volume and efficiency. Any problems encountered during the lease can significantly impair the bottom line.

"I think people misunderstand how expensive it is to manage Small-Ticket transactions. If you touch it more than twice, you have used up all of your profit on that deal. I believe that some pricing decisions being made in this segment are ridiculous. People are pricing deals almost as if they were Middle-Ticket transactions. But there is a very different cost structure. There are fixed costs in doing deals – documentation, D&B analysis, and so forth."

Small-Ticket had the highest interest expense of all of the leasing segments: 42% as a percentage of revenue versus 26% and 36% for the Middle-Market and Large-Ticket segments, respectively. Small-Ticket's performance is due in part to high debt balances. Debt balances represented 82% of assets, as compared to 73% and 46% for Middle-Market and Large-Ticket, respectively.

Figure 7

2001 Small-Ticket Lessor Expense Components as a Percentage of Total Revenues
Source: 2002 Survey



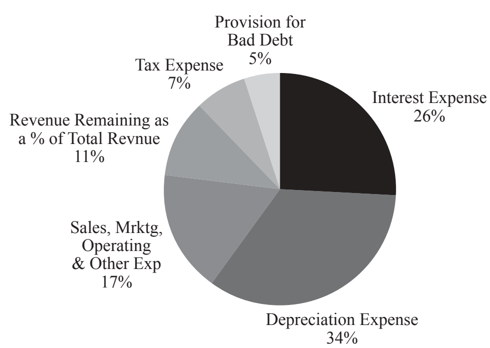
The provision for bad debts was high for Small-Ticket lessors, at 7.3% of revenues as compared to 5.2% for Middle-Market and 8.0% for Large-Ticket. Small-Ticket's showing may be partially due to unexpected losses that some executives attributed to failed credit-scoring models.

Small-Ticket reported a poor receivables aging and the highest portion of non-accruing assets as a percentage of receivables (3.1%) of the three market segments. Again, this appears to stem from the financial difficulties of the segment's customer base.

Middle-Market

Figure 8

2001 Middle-Market Lessor Expense Components as a Percentage of Total Revenues
Source: 2002 Survey



The major industries served by the Middle-Market segment are construction and retail/wholesale. The Survey indicated that of the three market segments, Middle-Market generated the smallest share of new business volume (25%) in 2001. With approximately 46% of new business volume coming from computer-related services, software and hardware, this segment is significantly affected by trends in technology spending. Many potential customers are not acquiring new information technology due to overcapacity from previous upgrades and investments made in preparation for Y2K.

Although the Middle-Market reported the lowest profitability of the three market segments (average pre-tax income was 18.3% of revenue), it had the highest average return on equity (18.7%). This can be attributed to the Middle-Market having a much higher ratio of liabilities to net worth than the other segments.

A large proportion of the Middle-Market consists of captive lessors, which often have easy access to capital based on parent-company support.

With regard to new volume, sales per sales employee were the lowest of the group, approximately $20 million. It is also interesting to note that 68% of submitted applications were approved in 2001, as compared to approval rates of 81% and 73% in the Large- and Small-Ticket segments, respectively.

"For Middle-Market, we assess credit using financial statements, but we also meet every potential customer before making a decision. We don't buy deals."

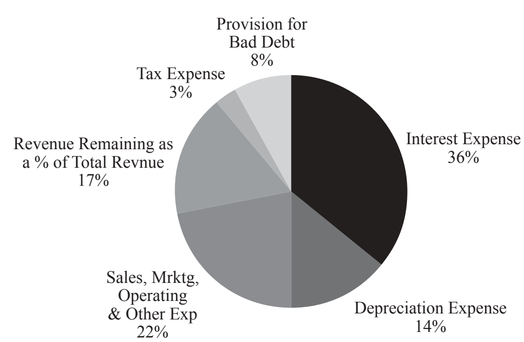
"The Middle-Market is becoming increasingly commoditized. Reducing costs, improving efficiency – I see opportunity in that segment."

The growth of the Middle-Market will be largely dependent on technology spending. The segment should benefit from an expected technology-industry rebound in late 2002 and 2003. Profitability should also improve as Middle-Market organizations take steps to improve their efficiency.

Large-Ticket

Figure 9

2001 Large-Ticket Lessor Expense Components as a Percentage of Total Revenues
Source: 2002 Survey



For those participating in the Survey, the Large-Ticket market generated 45% of new business volume in 2001, the highest percentage of all leasing segments. Aircraft represented the largest component of this segment, with 26.2% of business volume. Railroad equipment was second with 12.1% followed by office machines with 10.5%.

From a profitability perspective, Large-Ticket was an attractive leasing segment in 2001, generating average pre-tax income of 20.1% of revenues. This segment had a lower return on equity than did the others. When comparing after-tax profitability, Large-Ticket's low income-tax burden (3.3% of revenues in 2001 versus 6.7% and 7.2% for Small-Ticket and Middle-Market, respectively) indicates the tax-advantaged nature of many transactions in this segment. Large-Ticket also had the lowest effective tax rate and the best aging of receivables of the three segments.

While Large-Ticket leasing enjoyed favorable economic conditions in the early part of 2001, the picture has been less positive since the fourth quarter of that year. Key industries served and assets leased (airplanes and rail-cars) are experiencing economic difficulties, as discussed earlier. The IRS is challenging certain tax structures used by lessors, which is significant because of the number of transactions that are driven by tax benefits. Lastly, many companies use leasing as an off-balance sheet financing technique. The accounting rules that allow for this type of treatment have been widely criticized and are now being revamped.

Notwithstanding the impressive statistics of the Large-Ticket segment in 2001, many lessors are nervous about the future.

"I would say the prognosis is fair at best, (The Large- Ticket) is under a host of different assaults. Product availability in cross-border markets is shrinking, and the increased attention the IRS is paying to tax shelter issues and leases in general is casting a pall on the market."

"General economic conditions and interest rate levels are arguing against much robust growth. In fact, I expect a contraction in the total amount of business over the next couple of years."

Others are more optimistic:

"You would have to believe that the growth attributable to capital expenditures in Large-Ticket is going to have to come back. There will have to be larger opportunities out in the marketplace as a whole. The segment should grow in the next 12 months."

Some lessors are anxiously awaiting the new accounting rules governing synthetic leases and are aggressively creating successor structures to refinance and recharacterize leases of this nature. Many believe that this is the next horizon of the Large-Ticket market, and that their technical capabilities, pricing, efficient execution and flexibility with regard to lease structuring will ultimately reward them with business when opportunities begin to arise. In the meantime, Large-Ticket lessors are focusing on project-finance transactions and the energy sector and refinancing existing products that still work.

LESSORS: INDEPENDENT, CAPTIVE AND BANK-AFFILIATED

Lessors can be categorized into three groups: independent/financial services leasing companies, captive finance organizations, and bank-affiliated organizations.

- **Independent lessors** are typically financial services companies that offer leases directly to businesses and are not affiliated with any one manufacturer or dealer. Many provide a wide range of products and services, including leasing, lending, consulting, and transaction coordination. An Independent can also be the financial services subsidiary of a corporation that does not limit its financing activities to the parent or other affiliate's products. The Survey categorizes as Independents certain large captives possessing a significant percentage of non-parent product financing.

- **Captive lessors** are subsidiaries of a manufacturer or dealer. At least 50% of their volume or portfolio is comprised of products manufactured by their parent company and/or affiliated companies. Captive leasing is generally offered as a means to boost the parent's product sales by making another financing option available to customers. By acting as the lessor, the manufacturer retains control over product disposal and possibly the replacement sale. It can also gain an edge over other finance providers by supplying accessories and services that complement the leased asset. Captive lessors may enjoy subsidies from the parent manufacturer, allowing them to offer below-market rates.

- **Bank-affiliated lessors** combine leasing activities with other bank functions, using internal funding sources and operating under the jurisdiction of the Comptroller of the Currency and/or the FDIC. These lessors may be set up as separate leasing companies while remaining part of the bank holding company.

Regardless of which category they belong to, leasing companies typically offer a wide array of services that complement the lease. Increasing competition is giving rise to a trend toward specialization.

Figure 10

2001 New Business Volume by Lessor Type
Source: 2002 Survey

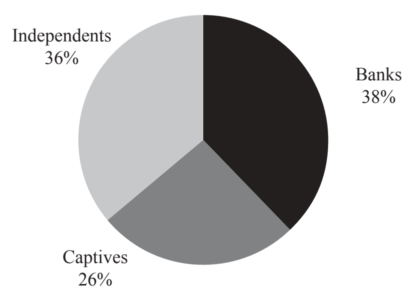
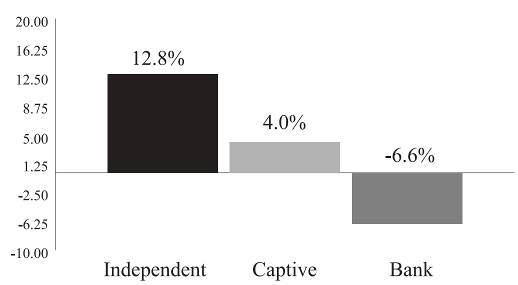


Figure 11

2001 New Business Volume Growth Rate by Lessor Type
Source: 2002 Survey



Independents

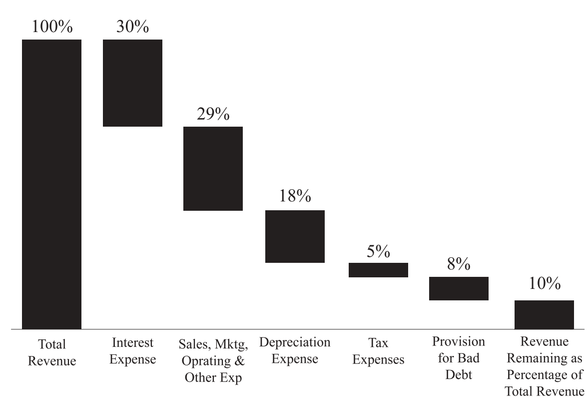
Independents responding to the Survey originated 38% of new business volume in 2001 and showed the highest year-over-year growth rate (13%) of all leasing sectors. Thirty-nine percent of Independents' new business volume was concentrated in industrial/manufacturing (10.5%), medical (11.1%) and office machines (17.8%).

Independents' 2001 average pre-tax yield on new business volume was the highest of all lessor groups; 10.4%, down from 10.9% in the previous year. Their average cost of funds on new volume declined to 5.3% in 2001 from 6.5% in 2000. As a result of keeping pre-tax yields up, Independents captured the second highest average pre-tax spread on new business; 5.1%, up 70 basis points from the prior year. This advantage, however, did not reach the bottom line. The total non-tax expense burden for Independents was 84.4% of revenues, compared to 76.1% for Banks and 80% for Captives.

Independents' lower profitability is driven primarily by their higher overhead costs. Banks and Captives, being part of larger organizations, do not always have to bear the full overhead burden. Some functions, such as human resources, may be handled by the parent company. Some overhead costs for these entities may not be fully attributed in the leasing company's income statement. Sales, Marketing & Other Costs expressed as a percentage of revenue were 29% for Independents in 2001, a significantly higher statistic than those reported by Banks and Captives. Captives may have an advantage over Independents in that the Captive's parent company provides both customers and products to finance.

Figure 12

2001 Independent Lessor Expense Components as a Percentage of Total Revenues
Source: 2002 Survey



Independents generated an average return on equity of 9.7% in 2001 versus 15.5% for Banks and 14.4% for Captives. The majority of the Independents participating in the Survey were smaller companies when compared to the other industry groups. Independents' average total asset size was approximately $0.6 billion as compared to Captives' and Banks' average total asset size of $3.3 billion and $1.9 billion, respectively.

One of the major challenges for smaller Independents is tapping into efficient capital markets. Many of these companies have had little success gaining access to the securitization market. Independents often have to put more equity into deals. Of Survey respondents, Independents had the smallest average debt-to-equity ratio, 3.9:1 as compared to Banks' 5.8:1 and Captives' 5.6:1 ratios. Access to cost-effective funding is a significant barrier to entry for those that would like to enter this market space, and it is unlikely that this will change anytime soon. Lack of liquidity is forcing an increasing number of existing Independents out of the market.

Captives

Of new business volume reported by Survey respondents in 2001, Captives garnered approximately 26% of the total, a 4.0% increase over the previous year. Assets financed by Captives in 2001 included agricultural equipment, computer hardware, aircraft, and construction equipment.

A Captive's growth and profitability is directly linked to its parent company's product acceptance in the marketplace. Given that many Captives finance technology products, it is not surprising that new volumes were modest. But Captives continue to command a dominant place in the industry. According to the Monitor 100, when ranked by new business volume, five of the top 10 leasing companies in 2001 were Captives.

To support their parents' sales objectives, Captives will often offer prospects incentives in an effort to make the equipment sale and equipment financing more attractive. These incentives can range from discounts on the equipment cost to interest rate buy-downs that will reduce the lessee's rental payments.

In uncertain economic times, sales incentives become more attractive to parent companies. Said one lessor:

> *"Our manufacturer is much more willing to subvene rates now. This year, a tremendous number of customers are delaying and postponing their acquisition decisions. In this context, the manufacturer has agreed to and we introduced a six-month same-as-cash program. A classic manufacturer subsidy."*

Although many non-captive leasing executives speak of Captives' "irrational pricing," the pricing structures used by Captive lessors are fundamental to their value proposition.

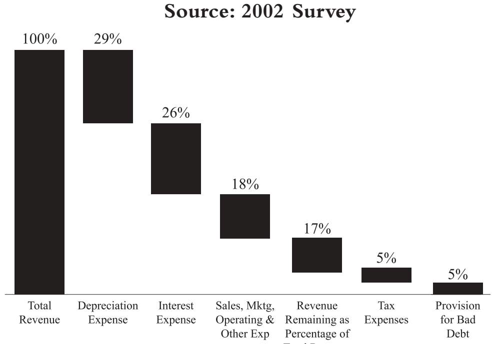
In 2001, the Captives participating in the Survey recorded the lowest average pre-tax yields on new business volume at 9.7%, a 4% drop from 2000. They also reported the highest average cost of funds at 5.8%. Captives did experience a 13% decline in cost of funds between 2000 and 2001. Banks and Independents also experienced significant declines in the average cost of funds, 19% and 18.5%, respectively, in 2001.

On an overall basis for Captives, the decline in the average cost of funds exceeded the decline in average pre-tax yield in 2001, with average pre-tax spread improving to 3.9% from 3.5% in the prior year. However, pre-tax spreads for Captives were weaker than those of both Banks (5.2%) and Independents (5.1%).

The Captives' cost structure is presented in Figure 13. The relatively low Sales, Marketing, Operating & Other Expenses percentage, at 18%, suggests that some sales and operations support is provided directly by the parent.

Figure 13

2001 Captive Lessor Expense Components as a Percentage of Total Revenues
Source: 2002 Survey



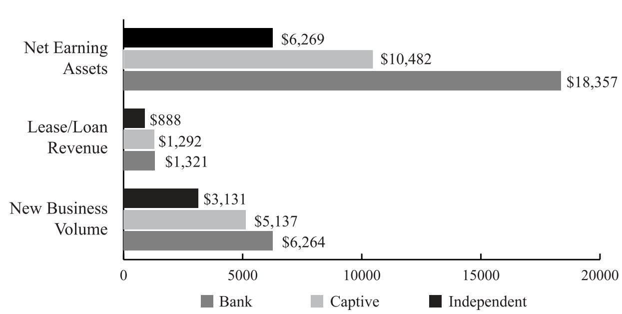
The cost structure also shows significant depreciation expense, 30% of total revenues, compared to 18% for Independents and 6% for Banks. This showing is the result of a Captive's greater willingness to finance equipment acquisitions through operating leases. Because of their extensive equipment knowledge and access to efficient remarketing channels, Captives tend to be more successful than other types of lessors at managing portfolios with a high concentration of operating leases.

"Captives will have a better opportunity to liquidate the equipment that comes back. They have the ability to refurbish equipment and reintroduce it into their own channels. Other lessors don't have that."

Captives continued to be highly productive and efficient in 2001, generating more than $5.1 million per employee in lease and loan revenue. This productivity can be attributed to a Captives' tight integration into the manufacturer's or vendor/dealer's sales process and network.

Figure 14

2001 Productivity per Employee (000s) by Lessor Type
Source: 2002 Survey



While Captives have certain advantages over other lessors, in some cases they make business decisions that they might not make if they were independent. For example, given the lackluster economy, some parent companies use the Captive to finance deals with riskier credit standings. Captives approved and funded lease applications in far greater proportions than did Independents and Banks in 2001.

"We operate in places we would not have entered without our parent's request. There are not too many independent leasing companies going to Russia or Malaysia, Mexico or Brazil. We're in there to support our parent, but it's had a negative impact on our ROE."

For smaller Captives in particular, meeting parents' performance targets can be extremely difficult. Some parents are rethinking the long-term strategy of their Captives. Some manufacturers are closing their small Captive finance companies, and then offering finance alternatives to their customers through a "white label" arrangement with another lessor. A key reason for this shift in strategic direction is that the parent must create a significant leverage position for the Captive.

"With the rating agencies being as tough as they are, with sales and revenues down, with margins being squeezed, a lot of manufacturers are asking themselves, 'Why do I want to be in the finance business? I need to outsource this function, reduce leverage on the balance sheet, and get the ratings agencies to be more favorable to my position.' I think the medium- to small-sized Captives are going to go down in number. The truly large Captives will not exit the market, of course. But the others are probably rethinking their strategy."

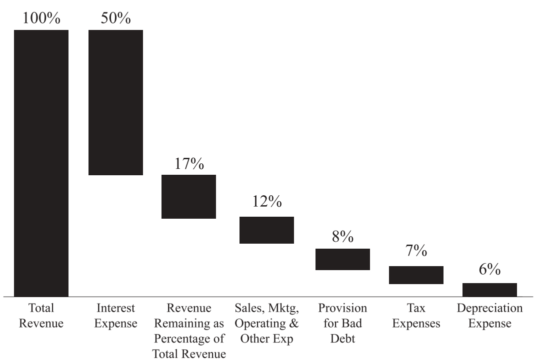
For Captives to succeed over the long term, they will need to meet their parents' ROE targets. They will have to work with the parent to design and implement support programs that will help maximize overall corporate profitability. And they must develop and maintain their remarketing channels to support a portfolio with a high concentration of operating leases and significant residual positions.

Bank-Affiliated Lessors

Although Bank lessors captured the largest share of new business volume in 2001 (38%), their new volume declined 6.6% from the previous year. This decrease is attributable to a number of factors, among them: reduced capital spending; a shrinking pool of creditworthy transactions; tightened credit standards; and, a decision to limit aggregate exposure to individual companies.

Figure 15

2001 Bank-Affiliated Lessors Expense Components as a Percentage of Total Revenues.
Source: 2002 Survey



Approximately 40% of Bank lessors' 2001 volume consisted of trucks and trailers, computer hardware, construction equipment, and aircraft, all of which have been significantly and negatively affected by the economic downturn.

"A lot of Bank lessors are paring down. Some have gotten out of the business. Others are committed to it. I don't see much (short-term) expansion in the business."

Still, Banks reported higher pre-tax income as a percentage of revenues (23.9%) than did other types of lessors in 2001.

The availability and cost of funding has continued to be an advantage. Banks' average cost of funds on new business volume decreased from 6.3% in 2000 to 5.1% in 2001, contributing to a rise in average pre-tax spread from 3.8% in 2000 to 5.2% in 2001.

The majority of Banks have not deserted the leasing market as they have in other downturns, in part because of fear that banking customers would migrate to another bank with a wider product range. But leasing is inherently different than lending, and this, according to executives at Bank-affiliated leasing companies, has created internal conflicts.

"Our competition is actually ourselves. It's the Bank's mentality toward leasing (that limits the Bank lessor)."

Leasing is, by nature, an entrepreneurial activity. Lessors have a different relationship with their lessees than Banks do with their borrowers. Their credit focus is different. And Banks are subject to certain regulations that restrict the scope of their leasing activities. One executive noted:

"We are very limited in what we can do in terms of full-service leasing because we are a bank,"

Another executive at a Bank-affiliated leasing company indicated:

"Independents can do a lot more. (Our leasing activities) are pretty much called a 'functional extension of credit.'"

Bank lessors may be wrestling with an identity crisis. It doesn't help that most large leasing companies that have recently been acquired by banks are still being integrated into the organization, making it difficult to focus on the market at a critical time.

"Banks don't always know what their leasing division is doing. As a leasing company in a bank, you have to be consistent in your message, and you have to generate higher returns than other areas of the bank. We are trying to make inroads to the bank's delivery system, but it is a constant challenge."

Some Banks are reversing the trend of competitive volatility. A few large Banks have developed substantial leasing operations and have established a position in several equipment and structural niches. Although Bank lessors face the same challenges as other lessors do with respect to asset and credit-quality declines, deregulation and entrenched leasing operations staff mitigate against the frequent "entry and exit" strategies that banks previously used.

Should this trend continue, Bank lessors, with their funding, capital access, and cost-sharing advantages, could become more significant competitors to Captives and Independents, possibly creating greater market concentration. Further, when the economy rebounds, those Banks that have exited the leasing market will likely "jump back into the game" as will regional and foreign banks and possibly insurance companies. The competition could prove formidable.

SELECTED MARKET DRIVERS

Credit Quality

When leasing executives were asked which issues concerned them most, the majority cited credit quality and default issues. Asset quality is a primary determinant by which lenders and investors fund, and participants that demonstrate good portfolio performance are rewarded with access to capital.

Many lessors were jolted into taking a hard-line approach to credit quality and risk management in 2001, which has taken the form of tougher terms and conditions, more aggressive collections activities, increased scrutiny of certain industries, and closer lessee management.

"We saw a portfolio opportunity recently, a small bank in the Midwest. They hired two new people and incented them solely on volume, not performance. This portfolio was not worth being acquired for obvious reasons."

Financial statements and credit information submitted by lessees are under increased scrutiny as a result of recent corporate scandals and accounting irregularities. Further, some lessors have begun to reduce total exposures to individual borrowers.

For lessors, moving "up-market" has the disadvantage of compressing spreads caused by pricing competition for higher-rated credits. As new originations of higher-quality, lower-yielding credits replace the portfolio runoff of higher-yielding, lower-grade credits, compressed spreads may become the industry norm until the economic cycle reverses and credit and pricing become less stringent. In addition, margins may be squeezed because of the increase in charge-offs.

The use of technology in credit analysis continues to evolve, with virtually everyone in the Small-Ticket market using some form of electronic credit scoring to help reduce origination costs. Survey Small-Ticket respondents noted that while models are helpful, they require continuous checking for statistical validity, monitoring and managing of parameters, and reviewing applicability of acceptance criteria. While credit scoring is a useful tool, many felt it is not a substitute for good credit judgment. Automated credit scoring is less prevalent in the Middle-Market and almost non-existent in the Large-Ticket segment, where transaction structuring and traditional credit underwriting take on added importance.

As seen in the Survey, as a percentage of total dollars submitted in applications, the approval rate dropped from 60% in 2000 to 53% in 2001. The Survey also shows a decline in total dollars submitted for approval over that same time period. This appears to have been a first step toward combating the declines in credit quality.

While the Survey reported that delinquencies deteriorated slightly (2.9% at 31 - 90+ days in 2001 versus 2.4% in 2000), discussions with lessors, including Survey respondents, indicated that delinquency and charge-off rates were far more dramatic. It may be that the companies that were the most severely affected by credit declines did not participate in the Survey because of business failure, acquisition, or withdrawal from certain asset classes.

Many lessors have taken action to minimize potential delinquencies by hiring new collections staff, reallocating existing staff to the collections department, and/or modifying their collection procedures. Some companies, for example, are making collection calls earlier than they used to, particularly on Small-Ticket leases, and are repossessing equipment sooner.

Leasing companies have also tightened credit approval standards, shortened lease terms, strengthened documentation, and sought additional collateral. In many cases, these standards are imposed across the spectrum in order to institutionalize credit discipline.

Has the industry moved past the worst of its credit problems? Many interviewed believe it has. They also note, however, that there are several equipment categories, including technology, telecommunications, transportation, and, most of all, aircraft that continue to have potential for large defaults.

Funding

Today's lenders are more risk-averse due to increased delinquencies and bankruptcies. Many have abandoned the leasing industry, possibly to return when the economy improves. Those that still support the industry have beefed up credit criteria, lowered advance rates, adopted new methods of pricing, and become more selective overall. Leasing companies that rely on a single funding source may find themselves in a crunch if their source decides to curtail access to funds or exit the market.

How difficult is it to gain access to funds? Funding sources that lend to the leasing industry say that funding is unquestionably available but that they are raising the credit-quality bar in terms of which transactions they are willing to fund. Concerns about credit quality, delinquencies, and asset values have altered what one lender called "the fundamentals of capital availability."

"It is the quality of the credit that is driving the argument that there is a scarcity in capital."

Larger Independents had few complaints about funding, as did Bank leasing companies and some Captives. But access to low-cost funding is a critical issue for smaller Independents, particularly those traditionally funded by banks and other larger leasing companies. Un-rated companies and companies with higher-risk originations are having a particularly tough time. It's likely that the smaller Independents will need to develop new and possibly non-traditional funding sources, which may come at a higher price than they are used to, possibly compressing margins.

As Figure 16 shows, the securitization market continues to be a significant source of funding for large Captives and Independents. Larger, more established companies whose portfolio performance has been consistently favorable dominate the securitization market. It's possible that this dominance could lead to issuer concentration, causing some investors to develop a cooler appetite for these issuers' offerings.

Information published in the June 2002 Monitor 100 indicates that seven of the top 10 leasing companies, as measured by new business volume, also were among the top 10 lessors accessing the securitization market. This indicating that large, established market participants with franchise value, a sufficient volume of quality originations, and proven track records are still finding market access.

While the number of issuers accessing the market is down, the total monetary volume remains fairly constant.

Bank leasing operations that obtain funding mainly from their parent banks and at their parents' rate are not significant issuers. Bank lessors' ability to access funding from the parent bank provides a cost-of-

Figure 16

Percent of Lessors Securitizing Assets
Source: 2002 Survey

	Overall		Banks		Captives		Independents	
	2001	2000	2001	2000	2001	2000	2001	2000
Securitized	26%	21%	11%	9%	33%	26%	39%	33%
Not Securitized	74%	79%	89%	91%	67%	74%	61%	67%
Totals	100%	100%	100%	100%	100%	100%	100%	100%

funds advantage over other leasing sectors, and is evidenced by Bank lessors' year-over-year lower average cost of funds.

Captives typically have ready access to funding due to their integral financing relationship with their parent; generally Captives take advantage of their parent's "brand" and have a steady source of origination volume from the parent's sales activities. Five of the top 10 leasing companies accessing the securitization markets are Captives. Further, the Survey shows that Captives' securitized managed assets far exceed those of Banks and Independents.

Figure 17

Securitized Managed Assets by Lessors
Source: 2002 Survey
(in 000's)

	Overall	Bank	Captive	Independent
Securitized Managed Assets	$74,567	$15,958	$143,804	$74,372

Future events, such as increases in capital spending, will likely correct this imbalance; however, in the short term, lessors should prepare their operations to deal with capital flight if they are to survive and continue to be profitable. In 2001, the Equipment Leasing Associations Capital Markets Access Committee published guidelines ("A Guide for Effective Funding and Capital Market Presentations") for leasing companies seeking access to the capital markets, which may be helpful in presenting financial and operational information to prospective capital sources.

The securitization market has not been immune to the slowdown in the economy. Transactions are being more carefully analyzed and the lead-time to complete a transaction is longer than it used to be. Issuers have experienced widening spreads, and bankers are putting more emphasis on collateral due diligence. Bankers are also scrutinizing issuers' originations channels for systemic risk potential.

"I think one of the problems of securitization in the U.S. is the flight to quality by capital sources. People are getting risk adverse."

Operationally, capital markets are focusing more closely on issuers' servicing capabilities and technology platforms. Portfolios supported by multiple systems are being examined with added care. Parties to the transaction are also focusing on the servicing staffing commitment, particularly where systems are in a transition process.

Additionally, the market is apprehensive about recent accounting developments, especially the FASBs Exposure Draft on SPEs and guarantees. Issuers that have traditionally executed their transactions off balance sheet are re-evaluating the potential impact of the impending accounting changes on their operations.

Capital generally migrates to the economic sector which provides the best return. When profitability, leverage, credit quality, and growth return, so too will funding, and well run leasing companies will differentiate themselves.

Technology

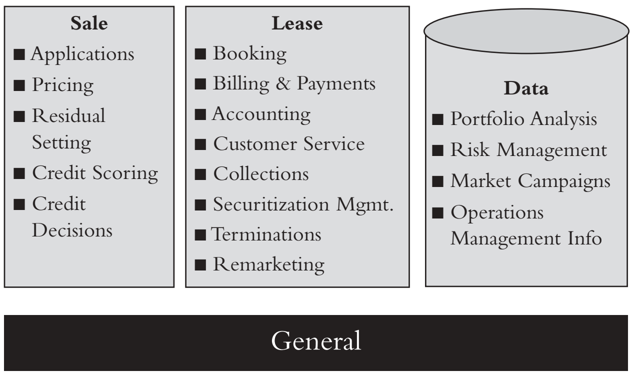
Leasing companies use technology to support a variety of business functions. Some leasing companies have developed their own systems for this purpose, while others have purchased packaged applications. Some have built interfaces between application systems for automatic data exchange, while others have made do with limited integration. Larger-volume operations have achieved higher levels of both customization and integration.

Lessors are increasingly looking to technology, particularly Web-based solutions and applications systems integration, to improve operating efficiency. Lessee demand for asset management services, electronic billing and on-lease access will require lessors to invest in technology to compete.

Technology is becoming increasingly complex and expensive, creating an additional barrier to entry. In addition, few are willing to initiate technology projects unless there is a solid business case for doing it. Moreover they are looking for shorter payback periods, with most companies seeking thresholds of 36 months or less.

Leasing companies use technology to support the following functions:

Figure 18



Software vendors are responding to lessors' demands for more integrated systems that can enhance the efficiency of their operations. Traditional lease servicing and accounting package providers are moving their solutions to a client-server platform, and, in some cases to Web-enabled access. Internet software companies that entered the leasing market to provide a Web-enabled front-end solution are pursuing partnerships and other strategies to extend their reach to systems that support the back-end of the leasing operation. Completely Web-based, full-service leasing companies have not yet materialized.

In addition, several ERP solution providers have announced plans to develop an "industrial-strength" leasing platform. Their designs call for complete integration with the ERP provider's CRM, financial contract management, and maintenance management applications. The activity in the software industry indicates that lessors' technology and system infrastructure will change significantly in the future.

Recent Technology Investments

Most recent technology investment in the leasing industry focused on two areas:

- Online/Internet support for key leasing functions
- Data warehousing

Online/Internet Investments

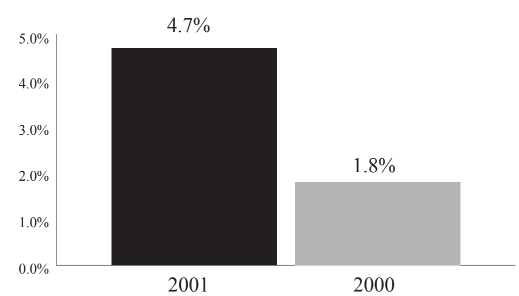
In the late 1990s, many lessors were convinced that e-brokers would fundamentally change the industry's competitive landscape. The conventional wisdom regarding the Internet was, "if you build it, they will come." Consequently, lessors created vehicles for submitting applications, for providing online approvals, and for other sales-oriented tools.

Returns on investment have generally been disappointing. According to the Survey, the dollar volume of business generated over the Internet represented only 5% of new business volume in 2001 (See Figure 19). While this was a 3% increase over 2000, the Internet hasn't had the dramatic impact on sales that lessors had expected.

"The utilization of the Internet from an application entry standpoint was very low. So we decided that the true impact the Internet would have on our business would be in facilitating information exchanges with our manufacturer partners."

Figure 19

New Business Volume via the Internet for an Average Lessor Involved in E-Commerce
Source: 2002 Survey



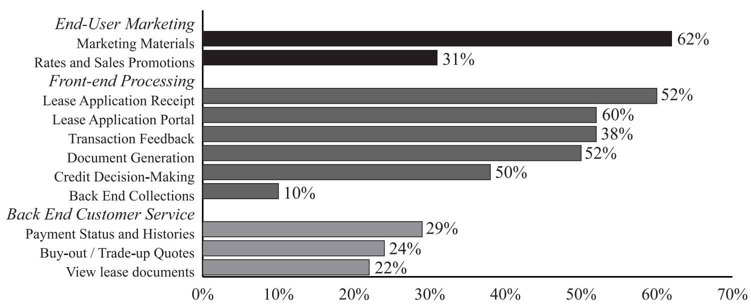
Leasing executives appear to have reached a consensus: the Internet is not driving new volume that wouldn't have come to them otherwise. Yet most lessors still believe they need Internet- and browser-based systems to retain larger customers, and, to keep pace with the competition. Now that most front-end Internet projects are either complete or in their final stages, leasing companies are using the Internet for other purposes: to streamline business operations and improve vendor, customer, and dealer satisfaction levels by making it easier and quicker to do business. Some companies are giving lessees direct access to account and asset information through secure, limited-access customer portals.

"We take work that we used to do manually, put it on the Internet, and get the vendors to do it for us free of charge. It saves me operating costs. We tell the vendors they are getting a good deal, and they agree because they see an advantage in viewing the status of deals as they are moving through the system."

Over the past few years, more attention has been paid to back-end processing, such as collections and customer service. Many organizations now look to technology to help minimize or eliminate human intervention by putting information on the Web.

Figure 20

Average Lessor Involved in E-Commerce Are Involve In
Source: 2002 Survey



Data warehousing has been another key area of investment. At one end of the scale, a lessor may use complex business intelligence tools in conjunction with a sophisticated data warehouse. At the other end of the scale, data may be extracted from the lease servicing systems and manipulated in a desktop application such as Microsoft Excel™ or Access™. Complex tools may not be necessary. Information can be input into Excel™ if there are analysts who know how to assess the information.

Whatever their technical sophistication, data warehouses are being used to better understand profitability and credit performance of current product lines, equipment types, and customer groups. Companies that don't invest in profitability analysis do so at their peril and many companies make significant investments in this regard.

"Data warehousing is a discipline that the banks in general have been engaged in since the mid-1990's…we see leasing companies undertaking initiatives on profitability analysis that are clearly a step in the right direction."

Assessing ROI

While leasing companies are continuing to invest in technology, they are being highly selective in the projects they undertake. Some companies go through a formal process of project planning and return-on-investment analysis. Others conduct a rudimentary analysis of expected operational savings.

One leasing executive described a formal and recurring process designed to drive technology improvements:

"Every two years or so, we dissect our back-office systems. We review how long it has taken for the most recent projects to be implemented, and we assess if the improvements are meeting the needs we defined at project initiation. Through this process, we learn whether our systems need to be more streamlined and more interconnected than they have been in the past."

Another Bank-affiliated leasing company executes even more frequent assessments of technology investments. In this case, technology services are provided by an IT organization within the bank, and charged back to the leasing division as an operating cost. "A complete return on investment capital analysis is prepared for every project. Additionally, 30-day evaluations of whether expected efficiencies and investment returns are being met and performed."

HUMAN RESOURCES

Historically, finding qualified managers and executives to fill positions in the leasing industry has been very difficult. But consolidation, bankruptcies, and exits have given rise to a large pool of talented and experienced leasing professionals.

"Where there used to be a real shortage of talent and company positions exceeded talent, today there are five qualified candidates for every position that is open."

Industry leaders are concerned, however, that while ample resources are available, many of these people are nearing retirement age. In addition, attracting fresh talent to leasing is becoming increasingly difficult. An economic turnaround might compound this problem if other industries are seen to have better opportunities. In a healthy economy, people are more apt to leave their jobs for new ones, so retention may become a bigger concern in the leasing industry than it is today. To address these issues, companies are adopting new recruitment and employee development programs.

Freshening the Talent Pool

Many leasing managers and executives have over 20 years' experience in the business, and executives interviewed for this report agree that there needs to be an influx of new blood into the industry. One leasing executive described his company's tactic for freshening its talent pool:

> *"We hired 22 undergrads and MBAs a year ago and have been putting them through every aspect of our company. We just hired six more, and their resumes are the best of the best. We know full well that they probably won't stay here for their entire career, but we're trying to develop talent to counter the graying of the industry."*

Through an agreement with a local university and its MBA program, one Bank lessor has hired interns from the business school and assigned them to various areas of its business. Though this pilot program is still in its early stages, a company executive described it as "wildly successful." "Every indication is that the interns love it," he said, "and we have seen benefits as well. We've been encouraged that having made a significant investment, we've had receptivity far beyond our expectations, with students knocking on our door for full-time jobs."

Emphasis on Training

Lessors are making significant investments in training. One executive described his company's efforts in this area: "We've dedicated a lot of money and resources to develop our internal training over the past five years. We offer something like 92 programs, from basic new employee training to sophisticated training on credit and legal issues."

Another leasing company, which is on a hiring freeze, is cross-training its existing staff to create more generalists in the organization. A company executive explained how it works: "Our operations people have limited credit authority. So we train them in our credit policies and in how to use and interpret our credit scoring system. This eliminates the need for a credit analyst to look at a deal that is a slam-dunk approval."

Some lessors are taking steps to educate new hires on different functions of the company so that these employees develop a big-picture view of the organization.

> *"We have a two-day employee orientation once a month where all new hires hear presentations from accounting, taxation, pricing, asset management, credit, and collections. They learn what they do and how they do it. It helps them see how all these functions fit together to service our customers."*

Re-Aligning Sales Compensation

Most executives interviewed said that their salary costs remained stable in 2001 and the first half of 2002. If any change was made, it typically involved redefining sales compensation amounts and structures. Several interviewees commented on the out-of-balance sales compensation structures of the mid- to late '90s, when the leasing industry was at the height of its growth.

> *"The salespeople making a ton of money a few years ago are now a lot cheaper salary-wise. Their salaries were absurd then, and they've realigned their expectations."*

An executive recruiter commented: "I see a lot of movement toward the variable side of compensation. Instead of being 70% fixed and 30% variable, it is now 50/50. When companies realign sales compensation for new hires, they also switch compensation for everyone. But people aren't as able to leave if they disagree with this, because there just aren't a lot of options."

REGULATORY CHANGES

Several recent regulatory developments have had a significant impact on business in general and the leasing industry in particular.

Tax

Tax considerations are often critical to leasing arrangements, and they are subject to frequent and rapid change. Expectations that the Internal Revenue Service will actively challenge aggressive tax structures appears to be driving a shift in product offerings to traditional, or "safer," leasing products. In terms of financial products, in 2001 there was a slight decrease in tax-oriented transactions and a small increase in conditional sales agreements and traditional loans.

The IRS is now pursuing many tax minimization techniques used in the recent past. Lease-in, lease-out (LILO) structures, which, for a relatively brief period, allowed for shorter tax amortization of the lessor's investment, were abolished with the finalization of the Treasury Regulations under IRS Section 467. It's unclear at this time whether taxpayers will be able to sustain the tax benefits of LILO transactions entered into prior to the final regulations.

"I think the people who were doing LILOs knew that they were on the edge. They may not admit it, but they knew it. And I think they will move from LILOs to QTEs to something else. I don't think they will get 'realigned."

Adding to the complexity of the tax environment, temporary treasury regulations regarding promoter and taxpayer reporting requirements for tax shelters were issued on February 28, 2000 and then modified on August 11, 2000 and August 2, 2001. For promoters, these regulations address registration of certain confidential corporate tax shelters and the maintenance of investor lists. For taxpayers, the new regulations require disclosure of certain tax-avoidance transactions. The new rules are complex and have significant penalties for failure to comply. In addition, proposed rules would significantly expand the definition of the term 'tax shelter.' These rules could cause some routine leasing transitions to be deemed tax shelters.

Many cross-border leasing transactions rely upon tax benefits afforded them under the Foreign Sales Corporation (FSC) and/or Extra Territorial Income (ETI) regimes. Under pressure from the World Trade Organization (WTO), the FSC regime was repealed. At the same time, Congress enacted the ETI regime, which substantially replaced and in some cases enhanced the benefits that had been realized under the FSC regime. Many companies looked to restructure existing transactions in an attempt to take advantage of ETIs enhanced benefits. However, the WTO continues to pursue the repeal of the ETI regime. If that happens, it is uncertain whether the expected ETI and ongoing FSC benefits on transactions entered into prior to repeal will be "grandfathered" like the FSC benefits were when the FSC regime was originally revoked. If, upon repeal, the benefits are not grandfathered for existing transactions, then the repeal would have a significant impact on the expected returns of many Large-Ticket leasing transactions.

The Job Creation and Worker Assistance Act of 2002 provides an additional "bonus" depreciation allowance of 30% of the adjusted basis of certain property acquired after September 10, 2001. While this represented an opportunity for most taxpayers, the Act does not allow for bonus depreciation on the purchase of assets if a binding contract to purchase the asset was entered into prior to September 11, 2001. The Act also temporarily extends the general net operating loss (NOL) carryback period from two years to five years for NOLs arising in taxable years ending in 2001 and 2002. Also, NOL carrybacks arising in those years and NOL carryforwards to those years can offset 100% of AMT income (rather than 90%); this provision generally is effective for taxable years ending before 2003.

While the tax environment has always been dynamic, the pace of change has accelerated. With the recent changes come increased uncertainties that will likely not be resolved for several years.

Financial Accounting and Reporting

Companies have historically been able to finance assets in off-balance sheet structures where neither the asset nor the related debt are reflected on the company's balance sheet. The recent failure of Enron, however, has elevated concerns about the use of these financing structures. Many investors were surprised at the magnitude of Enron's financial exposures, including financial guarantees, that were housed in special purpose, off-balance-sheet vehicles.

The Financial Accounting Standards Board recently released two exposure drafts of interpretive guidance designed to address certain issues brought to light by Enron and other widely publicized business failures. One draft deals with the consolidation of special purpose entities, and the other addresses the accounting and reporting for guarantees. Although the proposed rules are still being discussed, debated and refined, it is clear that it will be much harder to qualify for off-balance-sheet financing.

Many industry participants believe that the proposed rules have gone too far in an attempt to compensate for the perceived abuses of off-balance-sheet financing techniques. Others, however, feel that the rule changes will present an opportunity to the leasing industry. "If you look at synthetic leases, a lot of folks would expect these to be reclassified," a leasing executive said, "and this might represent refinancing or restructuring opportunities for those companies that see significant changes to their financial metrics as a result."

The current situation presents an immediate challenge for the industry, particularly the Large-Ticket lessors. Many companies have put new transactions on hold until people have a chance to understand the new requirements and how they will be applied. And while there may be an opportunity for lessors to help companies restructure their existing off-balance-sheet structures to be compliant with the new rules, this can't happen until those rules are known.

The broader question of whether the current rules for accounting for leases should be revamped remains unanswered. Although it is not currently on the FASB's agenda for consideration, it is often raised as an area of accounting that needs to be revisited.

Sarbanes-Oxley Act

On July 25, 2002, Congress enacted the Sarbanes-Oxley Act, and the President signed the bill into law one week later. The Act's intent is to restore confidence in public financial reporting in the wake of high-profile corporate scandals at companies like Enron and WorldCom. Far reaching in scope, the Act could well be the most significant reform of U.S. securities laws since those laws were enacted in the 1930's. Its full implications may not be clear for some time.

The Act addresses many topics including:

- Audit Committee responsibilities and functions
- Internal controls and new reporting requirements
- Corporate governance and disclosure issues
- Criminal penalties
- Director and officer responsibilities and restrictions
- New sanctions/protection of whistleblowers
- Restrictions on improper influence on the conduct of audits
- Auditor scope-of-services limitations
- Oversight of the public accounting profession

As intended, the Act will bring about changes in how audit committees, management, and auditors carry out their respective responsibilities and interact with each other. It also provides for enhanced and, in some cases, new criminal penalties for corporate fraud, some of which became effective immediately upon enactment.

While the Act does not specifically address the leasing industry or leasing transactions, it will certainly affect constituent organizations in the areas noted above. It will also affect how all organizations consider complex transactions, including leases, and their financial reporting and related implications. Early indicators are that appetites for highly structured and complex deals will decline in the near term.

CLOSING COMMENTS

A sluggish economy; accounting scandals; corporate governance issues; and, evolving financial reporting and tax rules have taken their toll on the leasing and finance industry, like so many others.

The industry will be focused on credit risk management and cost control until the economy and capital equipment spending picks-up. Consolidation of the industry will continue, but on an opportunistic basis. Leasing is far from a commodity, but standardization and automation that make it easier for the lessee to do business with the lessor is becoming increasingly important. Technology is also becoming a greater barrier to entry for start-ups and new captives because of its cost and complexity.

Despite these challenges, the long-term outlook is positive. The industry's fundamental strengths—creativity, determination and resilience—are intact. All of those interviewed for this report had concerns, some more serious than others, but they all had a plan for the future.

"I think August 2003 will be much different; this is a good time to build a business."

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For additional information on the research presented in this industry report, please contact:

G. Anthony Anderson, Partner
PricewaterhouseCoopers LLP
New York, NY
(646) 471-3230
Email: anthony.g.anderson@us.pwcglobal.com

Richard Lawrence, Partner
PricewaterhouseCoopers LLP
Irvine, CA
(949) 437-5712
Email: richard.lawrence@us.pwcglobal.com

Michael G. Smith, Partner
PricewaterhouseCoopers LLP
Stamford, CT
(203) 539-5635
Email: michael.g.smith@us.pwcglobal.com

Michael Thiessen, Partner
PricewaterhouseCoopers LLP
Stamford, CT
(203) 539-3658
Email: michael.thiessen@us.pwcglobal.com

EQUIPMENT LEASING AND FINANCE FOUNDATION

The Resources You Need!

The Equipment Leasing and Finance Foundation is a nonprofit organization whose mission is to promote the growth and effectiveness of equipment leasing and finance companies through programs that identify, study and report on critical issues affecting equipment leasing and finance. The Foundation works to develop the body of knowledge of equipment leasing and finance for use by the industry, academic, and policy communities. The Foundation provides the following FREE resources to you:

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4301 N. FAIRFAX DRIVE, SUITE 550, ARLINGTON, VA 22203; LISA A. LEVINE, EXECUTIVE DIRECTOR
PHONE: 703-527-8655 • FAX: 703-465-7488 • WEBSITE: WWW.LEASEFOUNDATION.ORG

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4301 N. Fairfax Drive, Suite 550 • Arlington, VA 22203
www.leasefoundation.org
703-527-8655