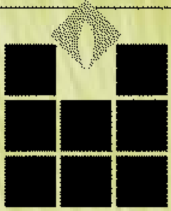

EQUIPMENT LEASING AND FINANCE FOUNDATION

2003 STATE of the INDUSTRY REPORT

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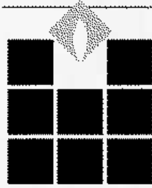

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The Equipment Leasing and Finance Foundation is the only non-profit organization dedicated to providing future oriented research about the equipment lease and financing industry.

The Foundation accomplishes its mission through development of studies and reports identifying critical issues impacting the industry.

All products developed by the Foundation are donor supported. Contributions to the Foundation are tax deductible. Corporate and individual contributions are encouraged.

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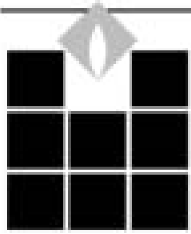

EQUIPMENT LEASING AND FINANCE FOUNDATION

2003 STATE of the INDUSTRY REPORT

Prepared by:

FINANCIAL INSTITUTIONS CONSULTING, INC.

October 2003

2003 STATE of the INDUSTRY REPORT

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Preface

The Equipment Leasing and Finance Foundation (the Foundation) has selected Financial Institutions Consulting, Inc. (FIC) to prepare its State of the Industry Report. The mission of the Foundation is to focus on and evaluate future trends and their impact on the leasing industry. The Foundation and FIC have designed this report to analyze and interpret the performance of members as presented in the Equipment Leasing Association's (ELA) 2003 Survey of Industry Activity (the Survey) and, using this and other information, project and discuss future implications for the industry.

FIC is a strategy consulting firm focusing on bank and non-bank financial services firms and the vendors that support them. Our areas of specialization include working with clients on strategic issues related to commercial finance/leasing, small business and middle market financial services, commercial cards, and the affluent market.

The FIC Methodology for this analysis incorporates statistical data, our past client experience, and in-depth personal interviews. Both FIC and the Foundation wanted to take advantage of the leasing industry's valuable human capital. Therefore, in addition to presenting data from the Survey, the report includes FIC proprietary research and analysis as well as the insights and perspectives of leasing industry executives and analysts. FIC conducted in-depth interviews with 16 industry experts representing a cross-section of lessor types, ticket sizes, and industry vendors.

The Survey reflects year-end 2002 performance. Therefore, it cannot present a fully accurate picture of the leasing industry today. Overall economic conditions improved in the second quarter of 2003, however, increased investment in new business equipment was not uniform across all types of equipment. For example, investment in transportation and industrial equipment continued to decline in the second quarter while investment in computers and software increased.

Therefore, our interviews focused less on recent performance and more on qualitative assessments of current issues and the critical challenges facing the industry. The industry experts who shared their insights include:

Ellen Alemany
Glenn Davis
Jack Firriolo
Paul Frechette
Tony Golobic
Steven Grasso
Kathryn Jackson
Thomas Jaschik
John McCue
Paul Menzel
Rick Remiker
James Renner
William Verhelle
Philip Walker
Robert White
Rick Wolfert

We thank these individuals for their generous commitment of time and candid insights into the intricacies, opportunities, and challenges 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.

October 2003

The Equipment Leasing and Finance Foundation is pleased to present the 2003 State of the Industry Report. Given the challenging times in the industry and world economy during the past two years, this report serves as an invaluable resource to equipment lease financing companies, industry observes and investors. We believe you will find the trend analyzes, statistical interpretations and poignant comments from industry leaders practical to you and your company.

As the economy takes a turn for the better, we hope you find the information contained in this report useful in planning for the upswing. The Equipment Leasing and Finance Foundation is your resource for industry research and knowledge. Please let us know how we can be useful to you in the future. I encourage you to visit our website at http://www.leasefoundation.org for more information and research reports.

Sincerely,

James R. Renner

Chairman

Equipment Leasing and Finance Foundation

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The lessor types analyzed in this report fall into three categories: bank-affiliated lessors (either subsidiary or integrated), captive leasing companies, and independent financial services lessors.

We think it is important to clarify the definitions of these various lessor types:

Bank-affiliated lessors often combine leasing activities with other bank functions. They use internal funding sources and operate under the jurisdiction of the Comptroller of the Currency and/or the FDIC. They may be integrated with the bank or organized as a separate entity within the bank holding company.

Captive leasing companies are the subsidiaries of dealers or manufacturing companies. They are primarily engaged in financing parent company products. Occasionally, they will also finance other companies' products sold as a solution set by their parent.

Independent, financial services lessors are usually finance companies offering leases directly to businesses and not affiliated with any particular manufacturer or dealer; alternatively, independents may also be the financial services subsidiary of a corporation that does not restrict its financing activities to the parent company's product and actively generates new business outside of those products.

The Survey captures four lease size segments: micro ticket ($0-$25,000), small ticket ($25,000-$250,000), middle market ($250,000-$5 million), and large ticket (over $5 million). The Survey's definition of large ticket differs from that of some players. By their definition, large ticket begins at $10 million.

We begin this report with an overview of the leasing industry's recent performance and projections for future industry growth and activity. We then discuss current performance, ongoing challenges, and key opportunities by type of lessor and ticket size. The report then goes on to discuss the major issues that senior managers are now addressing.

Finally, we conclude this report by updating the vision of the future of leasing that was outlined in the 2003 Industry Future Council Report (available from the Foundation). We took the opportunity to re-interview many of the participants of the IFC meetings that formed the basis of the report. We asked them if they had changed their perspective in the past seven months and, if so, how.

As strategy consultants to the leaders in the financial services industry, we have, throughout this report, offered our perspective on how the various issues identified through the Survey and related interviews may impact the leasing industry. Where possible, we have offered insights into how best practice players are reacting and what lessors might do to survive the challenges and take advantage of the opportunities in the market today.

Charles B. Wendel
President
Financial Institutions Consulting, Inc.

Matthew L. Harvey
Senior Engagement Manager
Financial Institutions Consulting, Inc.

Executive Summary

Despite historically low interest rates, leasing continues to be an important financing vehicle for equipment in the U.S. A number of years ago, The Department of Commerce estimated that slightly more than 30 percent of all new investment in business equipment is leased. Industry leaders believe that statistic continues to be accurate and that it will remain relatively stable (+/- two to three percent) in the near future.

Based on the Bureau of Economic Analysis' most recent GDP estimates, we estimate total leasing volume for 2003 to increase only slightly over 2002 (See Figure 1). Our projection for 2004 shows a modest five percent increase over the previous year. Of course, these projections, based on estimated GDP, assume relative geo-political stability. Continuing instability in the Middle East or another 9/11-like incident could, of course, dramatically impact any economic recovery.

From the Survey and our interviews with industry leaders, a number of key messages emerge:

- Despite declining revenues, reduced new business volume, and increased charge-offs, respondents have, for the most part, maintained satisfactory levels of profitability in part by tightly controlling costs
- Currently, the industry faces two main challenges: current economic conditions and the potential impact of accounting, legislative, and regulatory changes. Executives discussed other issues, such as whether leasing has become a commodity product, the role of technology in the leasing industry, and operational efficiency. However, as one executive stated, "If I survive this economy, then we can talk about differentiating myself from other lessors and streamlining my processes."
- Many respondents however, particularly in the small ticket market, are seeing the beginnings of an economic upturn. While survival during the recent down cycle depended on operational efficiency in the form of reduced operating costs, success in the upswing depends on the ability to rapidly adapt to changing markets and customer needs. Best practice players have taken time to streamline their processes, re-examine and, if necessary, re-price their portfolio, and adjust their strategic focus to best take advantage of future opportunities
- Accounting, legislative, and regulatory changes may have dramatic impact on certain industry segments. However, most executives we spoke with felt that, while some provisions, if enacted, may have a dramatic affect on a small, highly specialized segment of the industry, for the most part, their business would be unaffected. For example, while FASB Interpretation Numbers (FIN) 45 and 46 have been in place for nearly a year, executives we spoke with have seen no appreciable impact on their business

Even by the most optimistic forecasts, certain segments of the leasing industry will continue to experience significant challenges for the next 12 to 24 months. For some, sheer survival is the goal. For others, those with the will and the resources, these challenging times have provided an opportunity to refocus their approach, streamline their operations, and clarify their strategies leaving them poised to take maximum advantage of the next economic up cycle.

More than ever, success in this industry requires focus, flexibility, and the ability to rapidly adapt to changing environments.

Leasing Industry Overview

Overall, 2002 was a challenging year for the industry. Total leasing volume declined, but some equipment categories continued to perform strongly. Profitability (ROE and ROA) also declined and credit issues, in the form of delinquencies and charge-offs, increased. While many lessors struggled through the year, top performers streamlined operations and processes to best position themselves for the anticipated economic rebound.

In this overview of the overall industry, we provide an analysis of the Survey results in a number of areas of importance, including:

- New business origination
- Profitability and funding
- Asset/credit quality
- Operations
- E-commerce activities

In addition to providing analysis of the survey results, we will leverage our industry interviews as well as client-related and industry sources to determine the possible implications for the industry.

New Business Origination

For the 132 Survey respondents, 2002 new business volume declined by 4.6 percent over the previous year. Bank leasing companies experienced a significant drop in new business volume with captives and independents, financial services firms showing modest increases (See Figure 2). By ticket size, micro ticket showed a substantial increase in new business volume (23.5 percent) while the other segments experienced declines (See Figure 3). By channel, vendor and captive programs gained in importance over the previous year (See Figure 4), demonstrating the increasing importance of Point-of-Sale financing.

New business volume by equipment type shows most transportation, construction equipment, and industrial equipment volume down over the previous year (See Figure 5). However, investment in medical and information technology increased during the same period. Based on interim GDP reports, information technology and computers may continue to show strong growth in 2003 (See Figure 6). Transportation and industrial equipment continue to decline.

Industry Perspective and Potential Implications

Many of the players in the small ticket arena we spoke with indicated that volume in that segment continues to improve with Point-of-Sale channels driving growth. This could be viewed as a leading indicator of improved economic times, since a large portion of small ticket volume is driven by small business owners who are able to rapidly adapt to changing economic times. The conventional wisdom is, “when small business owners buy, things are looking up.”

However, industry leaders also noted that much of the new business volume they are seeing today is “replacement” equipment rather than “expansion” equipment. Business owners are

comfortable enough with economic conditions to replace aging equipment, but not enough to invest in expanding operations. As one executive stated, "With everything happening in the world today, all the uncertainty, business owners are remaining very cautious when it comes to new investment"

Potential Implications

- As Point-of-Sale origination channels increasingly dominate the small ticket segment, those lessors that have failed to build strong vendor relationships, or the infrastructure to support them, will increasingly be at a disadvantage in this segment. Direct origination of small ticket leases will continue to decline as customers increasingly accept the convenience of "one stop shopping."

Profitability and Funding

Profitability, in terms of both Return on Equity (ROE) and Return on Assets (ROA), declined in 2002 (See Figure 7[1]). Average ROE declined sharply to 11.2 percent down 2.5 percent from the previous year and 3.7 percent from the five-year high in 1999. ROA declined .4 percent from the previous year to 1.2 percent. Average ROA declined nearly 30 percent from the five-year high in 2000. In keeping with the low-interest rate environment, average pre-tax yield fell to 8.1 percent from over 10 percent in 2001 (See Figure 8). Average pre-tax spread declined from 2001 but remained strong relative to earlier years. Lessor's average cost of funds was 3.9 percent, a 26 percent decrease from the prior year.

More respondents used securitization as a funding source in 2002. Of the 135 respondents, 30 securitized assets in 2002 versus 27 in 2001. However, the average volume declined 12 percent from over $782 million to about $688.5 million (See Figure 9). In 2002, significantly less volume went through commercial paper conduits (42.6 percent of total volume versus 63 percent in 2001), probably due to restrictions (both real and perceived) on the use of special purpose entities.

Industry Perspective and Potential Implications

Industry players are putting an increased focus on profitability. They no longer book deals just to add volume, but look at each deal in terms of pre-determined profitability hurdles. Some players have gone a step further and have reevaluated their entire existing portfolio. They will re-price deals that do not return the required profitability and, in some cases, will exit the customer. According to one executive, "Most customers understand that we need to earn a certain return on each deal. Very few have reacted badly to re-pricing."

[1] PriceWaterhouseCoopers took FY 1998-2001 figures directly from previous years' surveys. The respondent base, in terms of its composition and the number of respondents was different each year. The 2001 data shown in this chart will not agree with the 2001 data for this year's survey respondents as reflected in the SIA. It is, however, directionally correct and consistent with previous years' treatment

Potential Implications

- Increasingly, the markets will favor those players that create rational profit hurdles and manage to them. Rewards could include higher ratings resulting in reduced cost of capital and, for public companies, increased share price.

Asset and Credit Quality

As shown in Figure 7, 2002 charge-offs increased 75 percent over 2001[2] to 1.4 percent. The ELA's Performance Indicators Report (PIR) for the second quarter 2003 also shows charge-offs increasing for the first half of this year (See Figure 10)[3]. This year's respondents report that 96.2 percent of receivables are current (less than 30 days) versus 95.7 percent for 2001 (See Figure 11). Non-accrual assets increased from 1.9 percent of receivables and non-accrual assets to 2.3 percent during the same period.

This year's respondents reported approving 67.5 percent of lease applications received and booking 53.2 percent[4]. The ELA's second quarter 2003 PIR is consistent with the Survey, reporting a 66.7 percent approval rate in the fourth quarter 2002. According to the PIR, the first half of 2003 shows a substantial increase in approvals (See Figure 12). However, survey respondents approved just 50.2 percent of dollars submitted and booked only 39.4 percent, indicating a bias toward smaller ticket deals.

Industry Perspective and Potential Implications

All of the industry executives we spoke with indicated a substantial decline in both delinquencies and charge-offs in the first half of 2003. In the words of one executive, "The weaker companies have been weeded out by now. Those that remain, that have survived, are strong, substantial companies. We view the decline in delinquencies and charge-offs as another indication that we have reached the trough in this economic cycle and that things are headed back up."

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[2] ibid.

[3] The ELA's Performance Indicators Report (PIR) tracks the performance of a static set of leasing organizations in six key areas. Because the PIR tracks the same companies, it typically provides reliable trend analysis. However, extraordinary events within a particular organization may create anomalies. Within the current set of companies tracked by the PIR, two had significant reductions in staffing, indicating they are either exiting or reducing their activity in the market. This could also impact charge-off levels as those players either run-off their portfolios or prepare them for sale.

[4] The Survey's data for total dollars submitted, approved, and booked is inconsistent with data for new business origination. Seventy-six companies submitted information regarding applications/dollars processed versus 135 companies for new business origination. As such, we include only relative percentages in our analysis.

Many executives also stated that their tightened credit requirements are likely to remain permanent. One bank lessor executive said, “With Basel II coming and our bank parent’s credit concerns, we are sticking with blue-chip customers only.” Many independent, financial services lessors, concerned with market reaction, are also accepting deals from only the highest quality customers.

Potential Implications

- With many lessors accepting only pristine credits, opportunities may exist for players to earn significant profits lending to customers with less than perfect credit. Those customers understand their limited options and are usually willing to pay more in order to get credit. In addition, they may be likely to remain loyal customers even when their circumstances change.

  However, lessors that choose to enter that market must have the underwriting, collections, and risk management skills and processes to price deals commensurate with the risk and to manage those deals on both a transaction and a portfolio level from start to finish.

Operations

The 2003 Survey reports respondent data in two areas of operations: equipment remarketing and operational efficiency in terms of Full Time Equivalents (FTEs). Since comparative 2001 data for the same set of respondents are not available, we use data from the 2001 survey. As noted elsewhere, the comparison is not absolute but should be directionally correct.

Respondents report that, in 2002, 20.5 percent of lessees renewed their lease at expiration and that 52.4 percent purchased the equipment outright. This compares with 27 percent and 54 percent respectively in 2001 (as reported by respondents in the 2002 Survey). The seven percent decline in the number of lessees renewing their lease at expiration may indicate a significant loss of revenue and profit to lessors. Lessors typically generate substantial profits on renewed leases as they incorporate all the costs associated with the lease into the original contract.

Net earning assets per FTE increased from $10.9 million in 2001 to $11.9 million in 2002 (See Figure 13) indicating that lessors are increasing overall productivity. Significantly, both loan and lease revenue per FTE and net income per FTE declined, a further indication of eroding profitability.

Industry Perspective and Potential Implications

A number of players we spoke with emphasized their focus on operational efficiency. Many have taken the opportunity to reexamine and streamline their processes and operations, consolidate certain functional areas, and automate processes in a number of areas. The result is that these companies are able to approach the market with efficient, flexible organizations able to rapidly adapt to changing conditions. One executive stated, “As a

result of our process improvements, we feel we are able to identify and react to opportunities quicker than most of our competitors. We feel this gives us a real competitive advantage."

Potential Implications

- As the generic leasing product continues to become commoditized, operational efficiency will become a competitive advantage. The ability to rapidly respond to changing customer needs and market requirements and the discipline to price each deal to meet internal profit goals may continue to increase the performance gap between best practices players and "also rans."

E-Commerce Activities

Nearly 44 percent of respondents describe themselves as engaged in some type of e-commerce activity. As shown in Figure 14, however, the definition of e-commerce varies widely. Making available marketing materials and publishing rates and sales promotions as well as providing links to other Web sites are the most common method of e-commerce. Typically, vendor programs engage most heavily in e-commerce. As Figure 14 shows, nearly 50 percent of all transaction processing for vendor origination occurs online. Similarly, lessors make nearly 40 percent of credit decisions for vendor programs online compared with only 18 percent for direct origination deals.

The promise of originating significant new business volume directly through the Web has not materialized. Respondents indicate originating 3.2 percent of new business volume via e-commerce in 2002 versus 2.3 percent in 2001 (See Figure 15). While that is a significant year over year increase, it remains a relatively small percentage of overall new business origination. It is likely, however, that these data are somewhat misleading. While the Internet has not generated significant *new* business volume (i.e., increased total leasing volume), a significant percentage of vendor and captive program business flows through the Web. For example, as noted above, lessors process nearly 50 percent of vendor program transactions over the Internet. Based on 2002 new business volume by origination channel, nearly $13.5 billion, or nearly 12 percent, of new business was originated through the Web.

Industry Perspective and Potential Implications

Over the years, we have spoken with numerous leasing executives about the role of technology and, more specifically, the Internet, in their business. Four or five years ago, many looked upon the Internet as a channel that could replace their sales force and eliminate document processing. Today, every executive we spoke with views the Internet as a tool to help them work more efficiently and to communicate more closely with their customers. Many have found the Internet an effective customer service tool, allowing end-customers as well as vendor program sales people to access an increased amount of information whenever they wish and to view that information in any format they wish.

Lessors have also found what many banks have found: customers demand the Internet as a sales/service channel option, even though they may not use it. Web access has become, in many ways, another cost of doing business.

Potential Implications

- Best practice players are using the Internet as a tool to increase productivity and efficiency. By leveraging the customer self-service capabilities of the Internet, they are able to re-deploy human resources from customer service functions to revenue generating sales functions.
- Given their point of sale financing convenience, vendor programs drive increasing amounts of new business volume. The best players rely on technology and the Internet to manage their vendor programs, transacting everything from applications to approvals online. They also provide their vendor partners unprecedented access to information as well as the flexibility to manipulate it

Lessor Profitability

Overall, operating margins remained healthy. Despite a decline in both ROE and ROE, lessors reported an average net operating margin of 16.4 percent (See Figure 16), indicating lessors have been successful in controlling costs in the face of declining revenues.

- Bank lessors, surprisingly, reported the highest interest expense (44 percent of revenues versus 21.7 percent for captives, and 34.7 percent for independent, financial services firms). Bank lessors also carry a higher provision for bad debt than do other lessors, 19.9 percent versus 9.1 percent for captives and 16.5 percent for independents, financial services firms (See Figure 17).
- Captive lessors performed the best, reporting an average net operating margin of 19.5 percent (See Figure 16) driven primarily by lower interest expense and provision for bad debt than other lessor types (See Figure 18).
- Independents, financial services firms reported the lowest net operating margin, 12.5 percent (See Figure 16). Relatively high S, G & A expense drove their results (See Figure 19).

Banks

Bank respondents generated 37.6 percent of new business volume in 2002, a 12.9 percent decline from the previous year (See Figure 2). Most of that new volume originated through direct sales. However, for this year's respondents, vendor programs are becoming increasingly important (See Figure 21). More than other lessor types, banks rely on purchasing business from third parties.

Relative to other lessor types, banks generate a higher percentage of their revenues directly from lease and loan activities (See Figures 17, 18, and 19). While saddled with a reputation for

"nickel and diming" customers with fees, this year's bank respondents generated less fee revenue (as a percentage of total revenue) than did captives and independent, financial services firms.

Although bank lessors report the lowest level of debt and inter-company borrowings of the three lessor types (57.2 percent of total assets versus 74.5 percent for captives, and 62.8 percent for independent, financial services firms), they report the highest interest expense. Since 80 percent of bank's debt and inter-company borrowings represents inter-company borrowings, the relatively high interest expense indicates transfer-pricing levels designed to repatriate substantial profits either to the bank unit or to the parent holding company, indicating bank lessors may be even more profitable.

In terms of credit quality, banks fall in the middle versus other players when compared across several categories (See Figure 20). Over 96 percent of receivables were current (defined as less than 30-days) at the end of 2002 and 1.7 percent were over 90-days past due. Bank charge-offs (as a percentage of net receivables) were 1.3 percent compared with 1.5 percent for captives and 1.2 percent for independent, financial services firms.

A number of bank lessor executives we spoke with indicated an increased, or in some cases, a completely new, focus on selling to existing bank customers. In previous years, we had seen a significant dichotomy of sales approaches by bank lessors. Some banks focused almost exclusively on existing bank customers. One bank executive told us that upwards of 80 percent of his business came from the bank's middle market clients. Other banks specifically avoided trying to sell to existing customers, often citing difficulties in working with bankers as the primary reason.

However, given the drop-off in available business over the past year, bank lessors have recognized that they can no longer afford to ignore a "captive" pool of potential customers. A number of bank lessors are developing programs to increase leasing's share of mind with the corporate banker. Often, this takes the form of increased information about the product, increased joint sales calls, and, most importantly, increased compensation for the corporate banker to sell the leasing product. Although most of these programs are relatively new, lessors that have consistently worked with and through their corporate banker channel have reported, at least anecdotally, relatively high penetration of the customer base and relatively attractive returns.

Increasingly, community banks are beginning to recognize the value of leasing as a potential product to offer their customers. However, for the most part, they have entered the market in a relatively small way, typically by purchasing third-party paper or by starting their own programs targeted at existing bank customers. The main obstacle to community bank success in the leasing market is the lack of leasing knowledge and expertise. According to industry insiders, a number of community bank leasing portfolios have "blown up" because of poor credit decisions.

Captives

This year's captive respondents generated 30.2 percent of total new business volume and reported the highest average new business generated. Each captive respondent generated over

$1.4 billion in new business compared with $.8 billion for banks and $.7 for independent, financial services firms. Captives generated over 88 percent of all new business through captive and vendor programs (See Figure 21). The $3.8 billion in new business volume originated directly may reflect the activities of captives that have expanded their focus to include non-related direct sales.

Captives report the highest profitability of any lessor type in terms of both net operating margin and ROA. Although captives report fewer earning assets than banks and independent, financial services firms (See Figure 22), they generated an ROA that was 50 percent higher than the other lessor types. In addition to lower operating expenses, a comparison of revenues as a percentage of earning assets (See Figure 22) indicates that captives also enjoy the highest pricing in the industry.

As Figure 20 shows, captives have the highest past-due receivables. They also have the highest charge-off rate (1.5 percent of net lease receivables versus 1.3 percent and 1.2 percent for banks and independent, financial services firms respectively). The relatively high past-due receivables and charge-off rate likely indicated captive's continued focus on pushing sales of its parent's products. Typically, manufacturers enjoy a much higher margin on the sale of product than they do on financing; therefore, some parents push their captive finance unit to accept sub-optimal credits in order to increase product sales.

Generally, captives enjoy a relatively privileged position in the leasing industry. As our introductory descriptor implies, they have a captive customer base to which to sell and they often leverage the parent's balance sheet for relatively low-cost funding. Several years ago, a number of captive finance companies began to expand beyond financing the parent's products. Some manufacturers, eager to put idle cash to work, encouraged their finance subsidiaries to act like general-purpose commercial finance companies.

In recent years however, as idle cash dried up and the market emphasized a renewed focus on core competencies, a number of those captives turn commercial finance companies have pulled back, restricting their activities to once again just financing the parent's product.

Independent, Financial Services Firms

Many in the leasing industry view independent, financial services firms as a troubled lessor type. Although they generated over 32 percent of new business volume in 2002, a very small number of very large companies dominates the category. Data reported in the Survey includes the responses of those large players.

Typically, independent, financial services firms are the least profitable lessor type. This year, independents reported an average net operating margin of 12.5 percent (See Figure 16). Generally, two factors drive independents lower profitability, higher operating expenses (See Figure 19) and a relatively high cost of funds. This year's respondents, however, reported the highest pre-tax yield of any lessor type and the highest pre-tax spread (See Figure 23). But,

interest expense and sales, general, and administrative expense reduced independent's net income after taxes to 8.8 percent.[5]

Although this year's respondents report healthy operating results, many executives we spoke with believe that, aside from the few large firms, independents will continue to struggle. Some believe that most independents, "will soon be relegated to being brokers or to sub-prime business." However, most industry insiders believe that independents can survive as niche players offering specialized products or services.

Transaction Size Profitability

To thoroughly analyze the leasing industry, we must examine profitability by transaction size as well as by lessor type. Small ticket transactions drove new business volume in 2002, generating 37.4 percent of total new business volume (See Figure 3). Micro ticket transactions, while generating only five percent of new business volume, generated impressive returns. Average pre-tax spread for the segment was eight percent (See Figure 24) and average net operating margin was 23.7 percent (See Figure 25). Large ticket transactions, generating 29.5 percent of new business volume was the least attractive reporting an average net operating margin of 12.1 percent and ROA of .8 percent (See Figure 25). Defining characteristics of each transaction size include:

- *Large ticket*: This segment typically enjoys favorable pricing and relatively low origination costs. The economic downturn has hit this segment particularly hard, notably in aircraft. This segment will also likely be the most heavily impacted by the looming legislative and accounting changes
- *Middle Market*: In the past, many considered the middle market a "tough" place to play. Lackluster pricing, high origination costs, and increased competition as both small and large ticket lessors "squeezed" the middle market typically defined this segment. This year's respondents however, report relatively low costs and healthy profitability
- *Small ticket*: High-volume, low-margin typically exemplify small ticket transactions. As one executive stated, "If you touch a small ticket transaction twice, you have eaten up your profit." Lessors generate most of this business through vendor or captive programs and delinquencies are always an issue
- *Micro ticket*: High administrative costs and low depreciation expense typify this segment. This segment enjoys very high pricing as well as high pre-tax spreads.

Large ticket

The large ticket segment has been particularly hard hit by the economic downturn. Three end-user industries contribute nearly 50 percent of large tickets new business volume: air transportation (17 percent), manufacturing (19.7 percent), and railroads (11.7 percent). Each of

[5] As noted, results for this category include the performance of a few very large, well performing players. While the Survey does not weight results by size (with one exception), the results from those companies will improve the average performance of the entire category

these industries has experienced significant economic difficulties in the past two years and show few signs of recovery.

Traditionally, large ticket transactions returned the highest profitability of any segment. Premium pricing and low origination and bad-debt costs generally drove profitability. This year's respondents also reported premium pricing and relatively high pre-tax spread (See Figure 24); however, they also reported higher operational expenses, particularly in provision for bad debt and interest expense (See Figure 26). However, despite the large provision, this segment has the fewest delinquent receivables (See Figure 27).

In addition to the serious challenges posed by the current economic slowdown, the large ticket segment is most at risk for the negative impact of upcoming and potential accounting, legislative, and regulatory changes. Many of the issues discussed later in this report heavily impact this segment.

While large ticket lessors face a number of challenges, including steep declines in volume, legislative and accounting issues, and a high-cost infrastructure in a time of declining profits, there are also opportunities. In the near term, success in this segment depends on controlling costs, managing credit quality, and developing the flexibility to meet changing conditions.

Middle Market

This year's respondents report that new business volume declined 9.4 percent from the previous year, the largest decline of any ticket segment (See Figure 3). Although middle market transactions commanded the lowest pre-tax spread (See Figure 24), average net operating margin was a respectable 18.4 percent. ROE was 20.5 percent, indicating that middle market transactions are typically highly leveraged.

As shown in Figure 28, the middle market generates a significant portion of new business volume from vendor and captive programs. Traditionally, middle market deals had high sales and origination costs associated with them. By increasingly relying on vendor and captive origination channels, middle market lessors are able to reduce their need for a costly sales force. As Figure 26 demonstrates, this year's middle market lessors have been relatively successful at containing costs.

Middle market respondents reported 4.8 percent of accounts were greater than 31 days old (See Figure 27). This compares with 5.3 percent for small ticket and only 1.1 percent for large ticket. For the full year, middle market respondents reported only 1.3 percent losses to charge-offs (See Figure 27). Only large ticket transactions reported lower losses, .9 percent.

Last year's State of the Industry Report contained the following quote from a leasing executive: "The middle market is becoming increasingly commoditized. Reducing costs, improving efficiency – I see opportunity in that segment." Middle market transactions are increasingly beginning to resemble small ticket transactions. Increasing numbers of deals are being generated through vendor and captive channels and some more innovative players have successfully

replaced their traveling sales force with a centralized sales force using technology to communicate with potential customers.

Focus on Small Ticket

Given its importance to the leasing industry, this year's Survey contained a focused section on small ticket leasing. Lessors involved in the small ticket segment provided additional data related to key equipment types, application processing, and credit decisioning. Analysis of the additional operational information reveals:

In 2002, 68.8 percent of all respondents indicated some involvement in small ticket leasing (See Figure 29). However, only 56 percent of banks indicated involvement in this segment, compared with 87.5 percent of captives. Success in small ticket leasing requires a highly automated, factory approach. Many banks are unable or unwilling to create the systems and processes needed to compete and choose, instead, to outsource their banking customers' small ticket needs.

Respondents reported that four equipment types generated nearly 82 percent of small ticket new business volume in 2002 (See Figure 30). Of the top four, industry executives say that only medical equipment has consistently performed well. Some small ticket lessors indicate they have recently seen improvement in office machinery and PCs as well

Overall, respondents involved in the small ticket segment approved 68.3 percent of all submitted applications representing 59.2 percent of submitted dollars. They funded 51 percent of applications and 41.7 percent of submitted dollars (See Figure 31). Captive's approval rate significantly outpaced other lessor types, approving 83.1 percent of all submitted applications and 77.4 percent of submitted dollars.

Just over half of respondents involved in the small ticket segment use some type of scorecard when making credit decisions (See Figure 32). Only 47.6 percent of those lessors that do use scorecards make automated credit decisions.

Respondents either auto-decision or "auto-score plus" (meaning the deal is scored, but a credit officer also looks at it) almost 42 percent of small ticket deals (See Figure 32). The average maximum transaction size for auto-decisioning is $125, 000. (The 25 percentile was $50,000 and the 75 percentile was $194,000, representing a significant range among respondents). Only 9 percent of small ticket deals are completely auto-decisioned.

Given the need of small ticket lessors to reduce costs and increase efficiency, auto-scoring and auto-decisioning deals may appear an obvious choice. However, as in other areas of financial services, lessors do not have sufficient experience with the technology to control credit quality. Relatively few players, namely those that have invested substantial time and resources, can successfully rely on auto-decisioning.

Small Ticket/Micro Ticket[6]

Small-and micro ticket together generated over 42 percent of new business volume in 2002. As Figure 28 shows, both the micro- and small ticket segment is highly dependent on vendor and captive channels for origination. Small ticket lessors reported an average net operating margin of 20.3 percent and ROA of 1.3 percent. Micro ticket lessors generated an average net operating margin of 23.7 percent and ROA of 2.1 percent. The Survey shows that pre-tax yield for micro- and small ticket transactions was 11.9 percent and 8.1 percent respectively and that cost of funds were highest for this small ticket at 4.0 percent. Cost of funds for micro-transactions was 3.9 percent.

In the 2001 State of the Industry Report, we noted that, in that year, over 60 percent of small ticket applications were scored, 19 percent were auto-decisioned. As it was the beginning of this current economic downturn, we observed that, "the current economic downturn will service as the acid test for [credit scoring]. If the auto-score model proves faulty, small ticket lessors will face serious losses as the slowdown continues." Two years later, and credit scoring appears to have held its own. While the percentage of applications lessor auto-decision has decreased from 19 percent to 7 percent, small ticket respondents do no report significantly higher delinquencies or charge offs than middle market or large ticket lessors.

Success in these segments depends on perfecting a "factory-like" approach to all aspects of the business system. Automation is particularly important for managing the vendor channel as shown in Figure 14. One small ticket lessor we spoke with attributes much of their vendor program success to their technology: "Using the Internet, we are able to process applications from our vendor partners faster and, as a result, give them a decision much quicker. They appreciate that, as does the end customer. But, where we really excel is in our ability, on an ongoing basis, to give our vendor partner the information he needs in the format he wants it. Our vendors appreciate that, the end customers appreciate that, and, in the long run, it saves us money. Instead of having a customer service rep gathering the information, the vendor partner does it himself."

Key Industry Challenges

Two themes overwhelmingly dominated our discussions with leasing industry executives: economic conditions and the potential impact of expected accounting, legislative, and regulatory changes. While individual managers may have discussed issues relevant to their particular company or market focus, these two issues dominated.

The Economy

We tried to focus our discussions with senior management away from an analysis of the economy and towards more actionable ideas. Rather than bemoaning the current economy (although it is showing signs of improvement), we wanted lessors to focus on steps taken to

[6] While the Survey data for small- and micro-ticket differ, the issues facing both and the approaches necessary to achieve success are similar. Therefore, we have chosen to discuss the two segments together

survive the current conditions and to position themselves for the future. The question we posed was simple: "How do you manage through a really bad economic downturn and how do you position yourself to take advantage of the rebound, when it occurs?" Three key themes emerged from those discussions:

- Ø Tighten operations
- Ø Pick a niche, but be prepared to move
- Ø Pay attention to the customer

Tighten operations: In our discussions, executives touched on a number of elements that they believe are critical pieces of operational efficiency:

- 4 Streamlined processes
- 4 Intelligent use of technology
- 4 Pricing discipline
- 4 Correctly compensated sales staff

One of the primary focuses of tightening operational efficiency is to reduce costs – to do more with less by creating better processes and working more efficiently.

A number of lessors we spoke with told us that they have programs in place that allow them to "continually update" business processes. A smaller number of players, for a variety of reasons, took the opportunity to conduct "zero-basis" business process enhancements. That is, they started from a blank slate and ask themselves, "If we were building this business today, *de novo,* how would we want it to look?" Most companies are unable to commit the time and resources necessary to conduct this type of exercise on a company-wide basis, but clear value exists in doing this on a much smaller scale with a business line or department.

A number of years ago, financial services firms invested significantly in technology, particularly the Internet. Conventional Wisdom at the time was that the Internet would replace "flesh and blood" sales people and customers would begin generating significant portions of new business through the web. In addition, the customer would also do all the work. Clearly, this did not come to pass, although today, many customers do demand Internet access to their financial services provider, typically as a supplement to other channels. For financial services firms, including lessors, the Internet has become just another cost of doing business, not another sales channel.

Today, lessors are investing in technology that focuses on specific goals, such as a sales management solution or CRM software. Lessors also recognize the power of the Internet as a tool both internally (to work more efficiently) and externally (to create customer "stickiness").

At several recent ELA meetings where members discussed operational efficiency, they also discussed pricing disciplines. One of the issues raised is the need for many lessors to review their portfolios and perform a "post-mortem" on every deal to determine whether the deal is profitable. Everyone agreed that would be an excellent idea but that it was unlikely that their company would do doing it.

However, we spoke with a few players that built profitability hurdles and then reviewed every deal to determine whether it met the hurdle. If the deal did not meet the firm's profit goals, they went back to the customer, explained the situation, and re-priced the deal. According to one executive, "Customers understand and respect that you must make a profit. Our customers are generally satisfied with the level of service we provide, and they understand that there is a cost associated with receiving that level of service. We have had very, very few complaints and no defections."

One issue that a number of lessors are beginning to understand is the importance of aligning sales force compensation with the lessor's goals. One senior manager stated that they had just completed a program of re-formulating everyone's compensation packages and aligning them with the strategic goals of the company. They went so far as to work with other organizations to create compensation incentives for sales partners. Although only a few weeks old, the program is already showing results.

Pick a niche, but be prepared to move: A number of leasing executives we spoke with discussed the importance of choosing a few areas of focus and then excelling at them. Since relatively few companies have the resources and the expertise to play in every market, smaller companies have no choice but to define a niche for themselves. According to interviewees, three factors are critical to the success of this strategy: 1) Choose a niche where you have an existing advantage or success, 2) Strive to become the best in that niche, and 3) Be prepared to move and find another niche if the environment changes.

1. Choose a niche where you have an existing advantage or success. A number of smaller lessors have achieved success by competing based on industry specific knowledge. Rather than financing equipment in a broad range of industries, the have chosen a small number of specific industries or equipment types in which to focus
2. Strive to become the best in that niche. By focusing their efforts on a limited range of activities, these players have developed a reputation for expertise and excellence throughout the industry
3. Be prepared to move and find another niche if the environment changes. A number of niche players have acknowledged their inability to successfully compete if "the big guys" decide to enter the market in a determined way. However, they recognize that their ability to move quickly in a changing market is a competitive advantage

Pay attention to the customer: Until recently, harvesting existing customers was not a priority for many in the leasing industry. Once the sales rep booked the deal, he likely never contacted the customer again. Similarly, a number of bank-owned leasing companies, until recently, never focused on selling to existing bank customers.

According to one executive we interviewed, very few leasing companies have any mechanism to track customer satisfaction. He went on to say that even few have the ability to measure repeat business. Retailers have long recognized the value of the repeat customer. Even many financial services firms today recognize the value of cross-sell, that is, selling additional products to existing customers, for increasing customer retention. Successful lessors are beginning to develop processes to increase sales to existing customers and ensure repeat business.

Greater numbers of bank-owned leasing companies are beginning to recognize the value of existing bank customers as a source of new business. In the past, some cited difficulties overcoming internal bank silos or getting past the corporate banker "watchdog" as reasons for going outside the bank's customer pool. Today, some senior bank management, recognizing the retention value in selling more products to existing customers, is working with leasing management to create training programs and compensation packages that will encourage bankers to consider leasing as a product they offer their corporate client.

While paying attention to current customers is a basic concept in many industries, it has not always been the case in leasing. However, with current limited growth opportunities, some lessors are looking inward to exploit new business potential in existing customers. What they will also likely find is that it is significantly less expensive to retain a customer than it is to acquire a new one. As the economy turns and business begins to pick up again, these lessors will succeed with a base of satisfied customers that cost less to sell and service.

Accounting, Legislative, and Regulatory Changes

Apart from the economic slowdown and its implications, industry discussion focuses on anticipated accounting, legislative, and regulatory changes. There are three major issues keeping industry leaders awake at night:

1. FIN 45 and 46
2. Congressional action on defining "economic substance"
3. Adoption of international accounting standards

Earlier this year, FASB finalized FIN 46, *Consolidation of Variable Interest Entities,* and FIN 45 dealing with reporting of loan guarantees. FASB intended both to increase transparency into corporations' financial activities and to cause the balance sheet to accurately reflect a company's true liabilities.

Many in the industry anticipated that FIN 46 would significantly increase lessors' cost of funds by restricting the use of popular funding vehicles such as Commercial Paper Conduits. Large ticket lessors feared that the increased scrutiny on and restriction of variable interest entities would reduce synthetic lease volume.

FASB Interpretation 45 tightens disclosure rules for loan guarantees and requires companies to recognize those guarantees at their market value when they are issued. Previously, loan guarantees were only recognized on the books when/if the company was required to honor them. The change means that third-party loan loss guarantees that are common with some types of funding vehicles will become liabilities on the books of the guarantor, even though historically they are rarely suffered any loss. The change could also affect residual guarantees, potentially resulting in higher leasing costs.

Despite their anticipation, both industry insiders and analysts agree that the two FASB rulings had little noticeable impact on the industry. However, as one large ticket lessor stated, "FIN 46

in particular would, for the most part, impact large ticket deals. However, this market is so slow, it would be very difficult to tell if the FASB ruling reduced volume or not!"

The second issue keeping leasing executives up at night involves attempts by the U.S. Congress to enact legislation codifying the "economic substance doctrine."

In 1975, in order to reduce the use of abusive tax shelters, the Internal Revenue Service began applying an economic substance test on transactions to determine whether they had a true business value or whether they were transactions that existed for the sake of obtaining tax benefits. Over the years, the courts coupled the "business purpose" doctrine in conjunction with the economic substance doctrine to determine the legitimacy of the transaction. The business purpose doctrine requires that there be at least a potential for pre-tax profit from the transaction. The meaning of economic substance has been defined through court rulings in recent years. Some lawmakers have attempted to draft legislation codifying economic substance. Many in the leasing industry fear that the attempt to codify the court precedence will have unintended results that could profoundly impact the industry.

While many managers agree that this is an important issue with many ramifications for the industry, they also point out that it would primarily affect a specific segment of large ticket lessors, specifically, those engaged in certain cross-border transactions and other tax-based activities. They also agreed that vigilance was the only response, and they praised the ELA's success in keeping the issue out of legislation thus far.[7]

The third issue lessors are continually aware of is the potential adoption of international accounting standards. In October 2002, FASB and the International Accounting Standards Board (IASB) issued a Memorandum of Understanding representing their commitment to adopt consistent and compatible accounting rules. An Exposure Draft identifying and addressing certain specifically identified differences between U.S. and international approaches is expected by late this year.

The intent in adopting IASB standards is to improve comparability of financial statements across national jurisdictions. In addition to providing uniformity and transparency for investors, it will eliminate any potential "accounting advantages" gained by companies operating under different accounting rules than domestic competitors.

Primarily at issue with the adoption of international accounting standards (since foreign-owned companies and many multi-nationals already use them) are efforts by the UK Accounting Standards Board to require the capitalization of all material leases. If adopted as part of an effort to conform to international standards, one of the main advantages of leasing over direct purchase would disappear.

In addition, the IASB's Revenue Recognition Project could also impact the off-balance sheet treatment of many types of leases.

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[7] The economic substance test appeared before the California Legislature in an anti-tax shelter bill. The Legislature amended the bill to remove the section that would have codified an economic substance standard.

The intent of The Project is to develop definitions of contractual rights and obligations to be applied to all future reviews of accounting standards, including lease standards.

The Project identifies three types of contractual rights and obligations: conditional, unconditional, and mature. The analysis of these contractual rights and obligations will be used in considering the three stages of contracts "from inception to completion": wholly executory, partially executory, and wholly executed.

How these terms are ultimately defined will determine whether an obligation must be recognized on a lessor or lessee balance sheet.[8]

The executives we spoke with agreed that the adoption of international accounting standards could pose a threat to the leasing industry. Once again, however, they noted that the impact of losing off-balance sheet lease treatment would likely be felt only in the upper middle market and large ticket arenas. Typically, small ticket lessees choose leasing for cash flow reasons or to manage equipment obsolescence, not to manage their balance sheet or for tax advantage. Conversely, it is larger firms engaged in larger transactions that possess the financial sophistication to manage their balance sheet composition and tax benefits through choice of financial vehicles.

Once again, most senior managers took a "wait and see" attitude. As one executive noted, "We have been talking about international accounting standards for years now. It is becoming 'the Boy Who Cried Wolf.'" An analyst from an international ratings agency that follows the industry noted that they do not factor either of these issues (economic substance and international accounting standards) into their assessment of the industry, "We don't even see them on the radar for several years."

In addition to these three major accounting, legislative, and regulatory issues, bank lessors must also comply with the Patriot Act, legislation intended to combat terrorism and money laundering. While bank lessors do not find its provisions onerous, they are time consuming and increase the cost of doing business.

One trend that has gone largely unnoticed affects not only the leasing industry but all corporate America. In the release of Interpretations 45 and 46, FASB signaled its move from a "rules-based" approach to a "principles-based" approach to standard setting. Using a rules-based approach, those responsible for financial decision-making simply followed the "letter of the law", literally. A principles-based approach means that decision makers are required to interpret and follow the *intent* of the law. Accountants and lawyers, mindful of their own accountability in the post-Enron world, are likely to err well on the side of caution, potentially costing companies significantly in foregone tax benefits.

[8] From the ELA's draft notes from an International Conference Call Meeting of National Leasing Associations on August 14, 2003

Service Providers

The ELA does not survey service providers as part of its Survey and, as a group, they are typically left out of the State of the Industry Report completely or mentioned only in passing. However, as we interviewed industry leaders in preparation for this year's report, one senior manager put forth an intriguing hypothesis that merits highlighting. He stated his belief that many smaller lessors are not as automated as they should be because of the lack of technology providers focusing exclusively on the segment. His hypothesis begs the question of whether the leasing industry is large enough to support dedicated service providers. This section discusses, anecdotally in the absence of data, the State of the Service Provider.

In recent years, even as leasing volume and profitability have declined, the number of service providers (service provider members of the ELA) has grown. Today, there is approximately one service provider for every two leasing companies. In the words of one senior executive, "That is clearly unsustainable." One possible explanation for the increased number of service providers is that when companies shed senior level leasing staff as a result of a merger or a market exit, those people return to the industry they know best, but in a different capacity. Instead of joining another leasing firm, they may start their own equipment remarketing business.

The question of how many of the service providers only serve the leasing industry is difficult to answer. Aside from service provides that are strictly leasing focused (e.g., equipment remarketers, brokers, etc.) members of the Service Provider Business Council feel that the number of firms that count the leasing industry as their only market is declining rapidly.

The implication is that lessors will find it increasingly difficult to find service providers possessing detailed knowledge of the industry. The most logical example may involve software providers. Because many of the software firms dedicated to the leasing industry could not survive with a single focus, they "genericized" their product in order to market it to other financial services firms. In some cases, this means they are unable to provide upgrades for lessors using their product. In the case of software, some lessors possessing the resources often develop their own solutions. However, that requires time and money that could most likely have been put to better use.

Leasing is sufficiently different from other industries that the development and maintenance of certain capabilities, such as technology, may be a strategic imperative for the industry. Given the importance of technology in all aspects of leasing, the industry may want to explore ways to work together to ensure that industry specific expertise will exist in the future.

Final Thoughts: A Look Back to the Future of Leasing

While preparing the 2003 Industry Future Council Report[9] in January, FIC asked Council participants to write the title and lead paragraph of an imaginary 2008 *Fortune Magazine* article about the leasing industry.

That exercise resulted in citing four key topics that participants believe will define the industry:

1. Focus on value added services

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[9] Available through the Equipment Leasing and Finance Foundation

2. Slowing consolidation
3. Thriving independents
4. Operational excellence and discipline

Seven months later, as we prepared the 2003 State of the Industry Report, we asked some of the Council participants to update their views.

Executives agreed unanimously that, today, two of the trends, focus on value added services and operational excellence and discipline, define the industry. Disagreement existed as to the future of the independents. A small number of executives believe that independent lessors will find their place again within the industry, but most believe that the challenges will prevent independents from ever becoming more than small niche players. Those same executives believe that the turnover of independent lessors will continue to fuel consolidation.

Based on these updates, we would reorder our list of key emerging trends:

1. Operational excellence and discipline
2. Focus on value added services
3. Slowing consolidation
4. Thriving independents

Operational excellence and discipline: Interviewees believe that this has already become ingrained in successful players. As discussed above, a focus in this area is critical not just to survive the current downturn, but to thrive in the future.

Focus on value added services: In January, Council participants expressed the belief that, increasingly, customers will lease to take advantage of the leasing company's balance sheet, asset management expertise, tax appetite, treasury function, and structuring ability. Lessors that are able to differentiate themselves today on the basis of those capabilities, as well as provide excellent sales and service, will be in a position to focus on identifying and meeting the next trend in customer requirements.

Slowing consolidation: For the 2003 Industry Future Council Report, participants discussed several reasons why they believe consolidation will slow in the near future:

4 Economic conditions and investor and regulatory scrutiny will force many "insane" competitors (those lessors competing on an unsustainable basis, such as loss-pricing or overly optimistic residual values) out of the market.

4 Regulatory changes will force more assets on the books, altering the financial picture of many firms that traditionally used acquisition as a means of growth. Their ability to fund acquisitions will be limited.

4 Investor's memory of recent leasing industry "train wrecks" will begin to fade. Capital will become more readily available to independent lessors with sound processes, pricing and risk management.

They expressed the belief that a return to "sanity" would renew investor confidence in the industry and begin to stabilize the competitive landscape.

Most lessors we spoke with agreed that, for the most part, the “insane” competitors have been forced out of the market. However, as an industry analyst noted, “Only time and a steady track record will bring investors back into this industry.”

Thriving Independents: Last winter, a number of Council participants expressed the view that independents could once again thrive as bank and captive leasing companies struggled under increasing regulation. Today, more industry insiders, as well as analysts, believe that independents can exist, but only within certain parameters. Those that succeed do so because they bring to the table a proven management track record, a consistent source of inexpensive funding, and an existing network of contacts within the industry. For example, a number of successful independent lessors are run by long-time leasing executives with funding provided by venture capital groups. The one thing that interviewees did agree on is that most independents are unlikely to ever become large. The funding obstacles to substantial growth will likely force their sale.

By many accounts, 2002 was an extraordinarily difficult year for many segments of the leasing industry, and for some segments, 2003 continues to be difficult. While overall, survey respondents reported reasonable profits, they did so on reduced volume by tightening their operations and reducing costs. In the words of one executive, “It was the year of scrambling for every dime.”

Beyond the economy, the industry continues to face challenges presented by the potential impact of accounting, legislative, and regulatory changes. Some of these proposed changes may primarily impact only certain segments of the industry. Others are likely to have a broader impact on the entire industry.

By many accounts, however, the economy has turned a corner and is beginning to pick up. Those companies that not only survived, but also took the opportunity to reinvent themselves, could well become tomorrow’s leasing stars.

About Financial Institutions Consulting, Inc.

Financial Institutions Consulting, Inc. (FIC) focuses on providing advice and counsel on issues related to growth and profitability for financial services clients. We emphasize practical, bottom-line results based on quantitative and qualitative research and an in-depth understanding of industry dynamics.

In addition to completing prior projects for the ELA and The Foundation, our work in leasing has included process streamlining, segmentation strategy, and new business acquisition. Our activities include conducting formal engagements, leading brainstorming sessions, and providing ongoing retainer counseling to clients.

Please visit our website at: www.ficinc.com for more information about our consulting and advisory services. We also e-mail a weekly newsletter on topics of critical importance to the industry and read by over 4,000 financial services executives worldwide. You can sign up for that email on our website.

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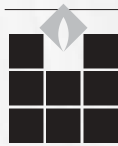
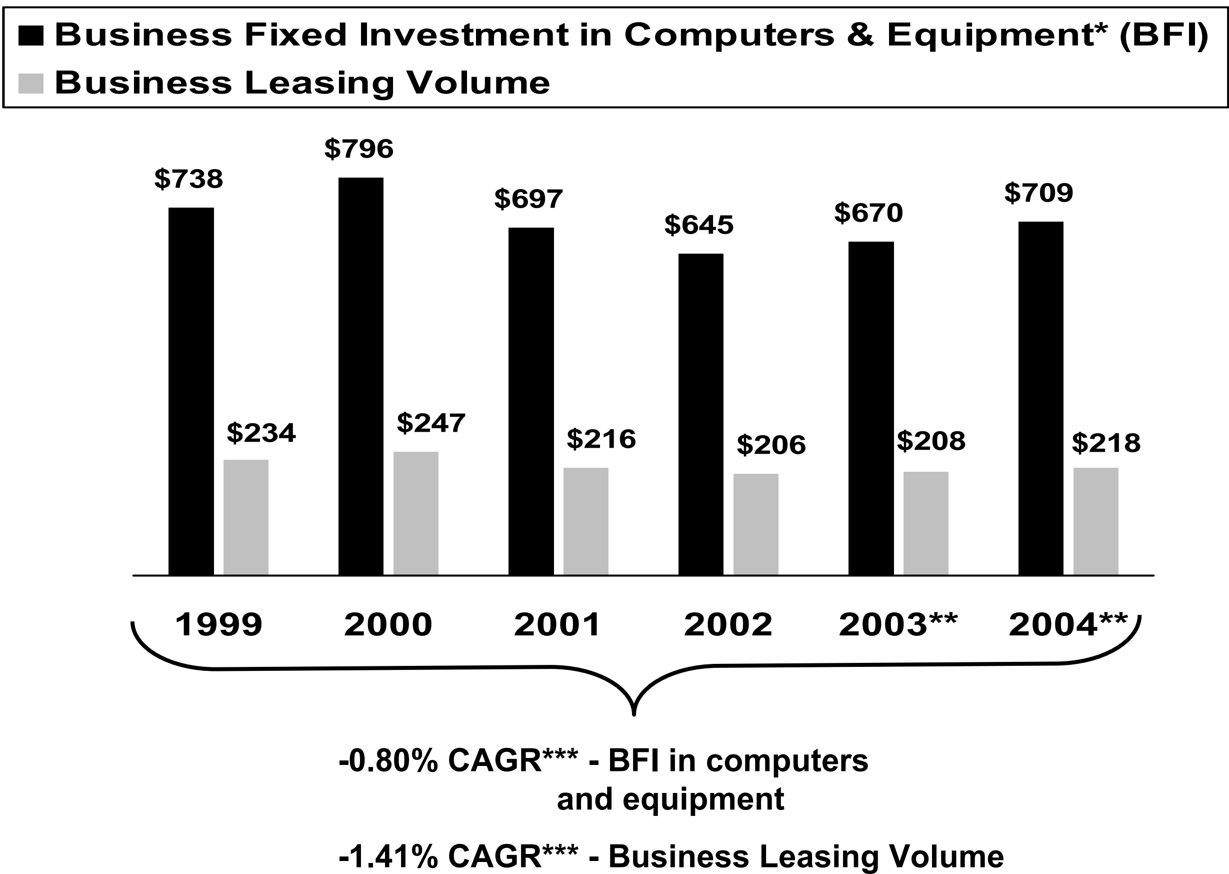


EQUIPMENT LEASING AND FINANCE FOUNDATION

2003 STATE of the INDUSTRY REPORT

REFERENCE CHARTS



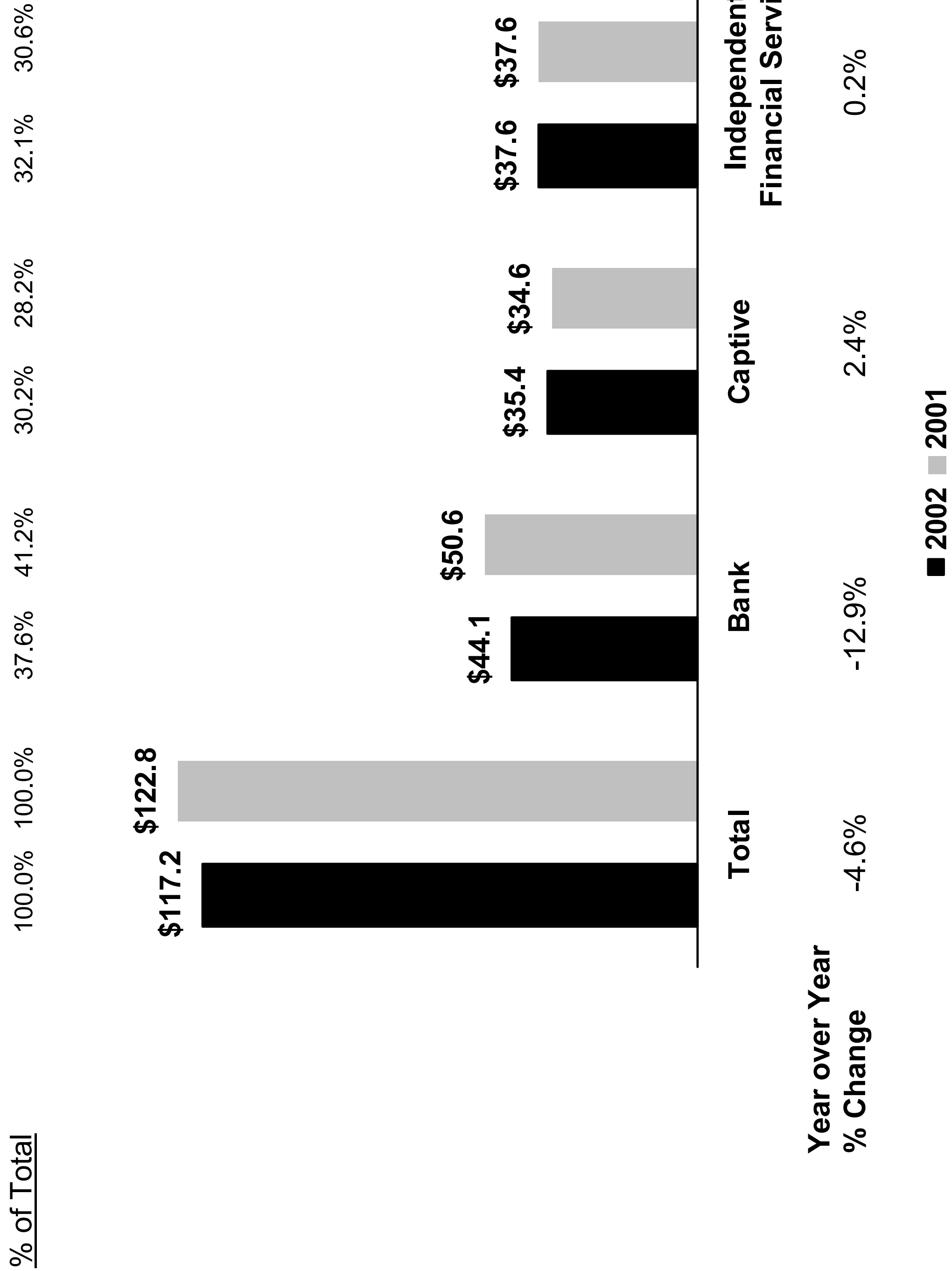
* Does not include software
** Estimates
*** Compounded Annual Growth Rate
Source: ELA, FIC Analysis, National Association of Business Economists

Figure 1

2003 State of the Industry Report Reference Charts

Figure 2

2002 Total New Business Volume by Lessor Type
(in billions)



Source: 2003 ELA Survey of Industry Activity

2003 State of the Industry Report Reference Charts

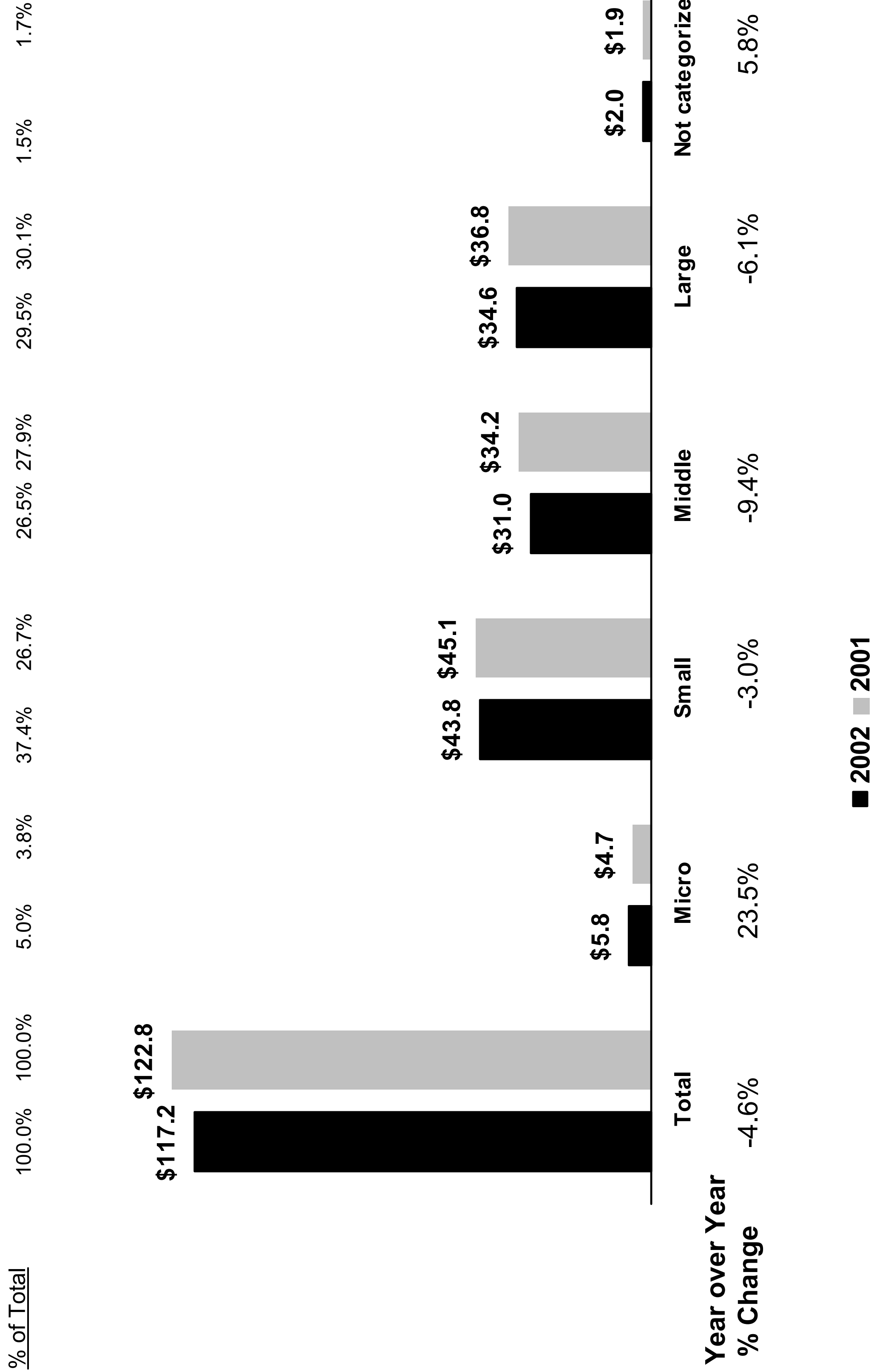
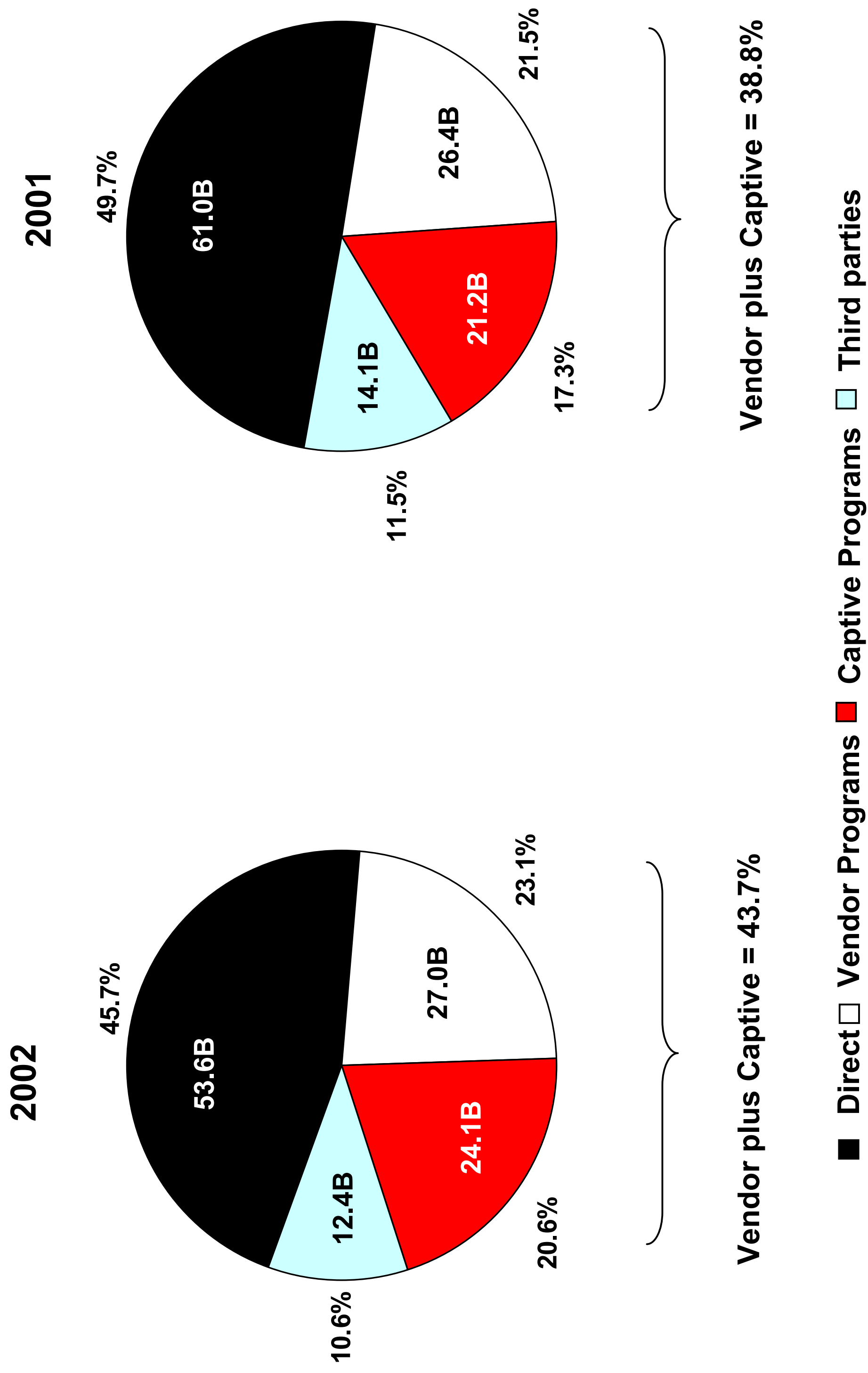


Figure 3

Source: 2003 ELA Survey of Industry Activity

2003 State of the Industry Report Reference Charts

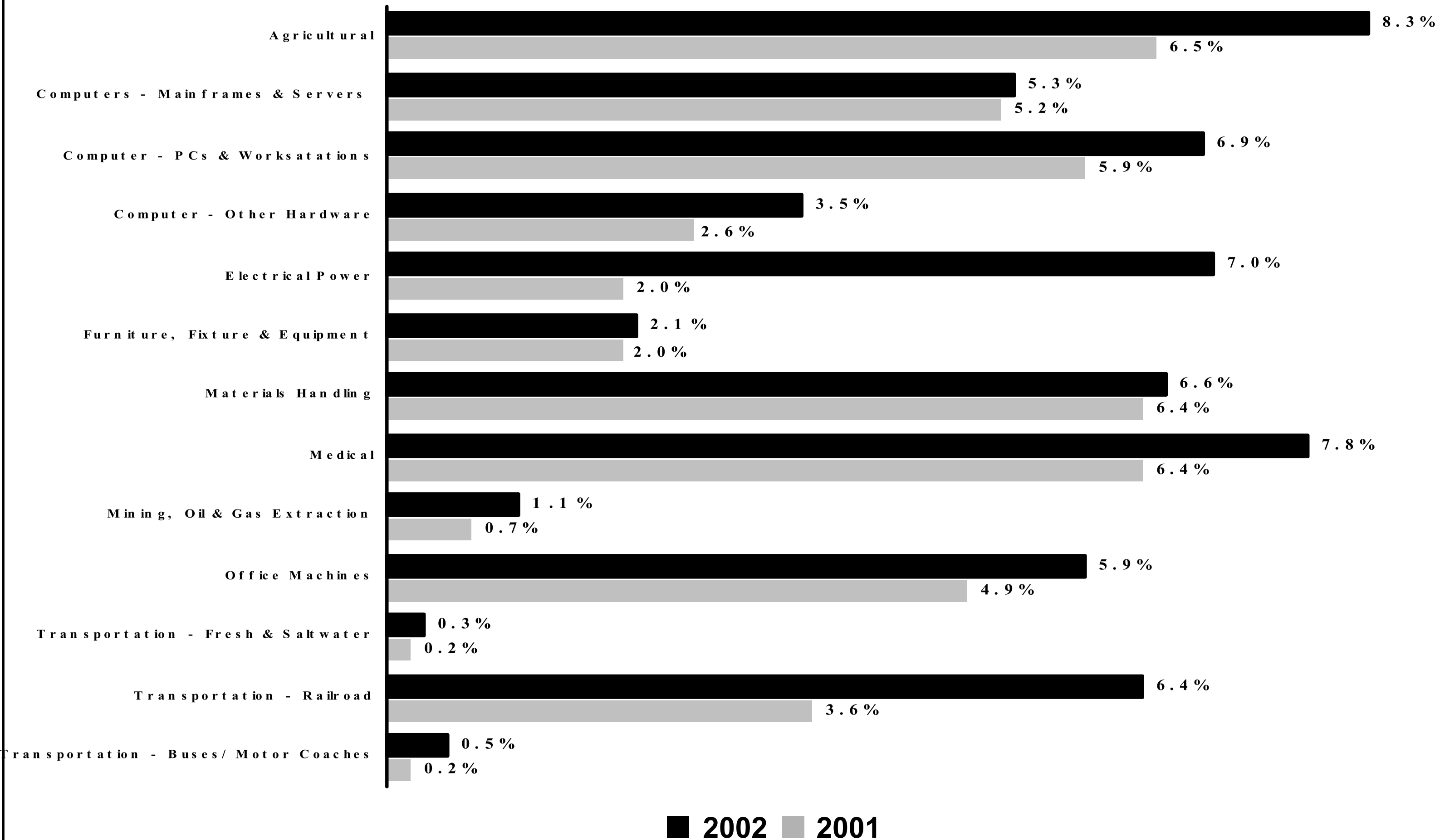
New Business Volume by Origination Channel



Source: 2003 ELA Survey of Industry Activity

Figure 4

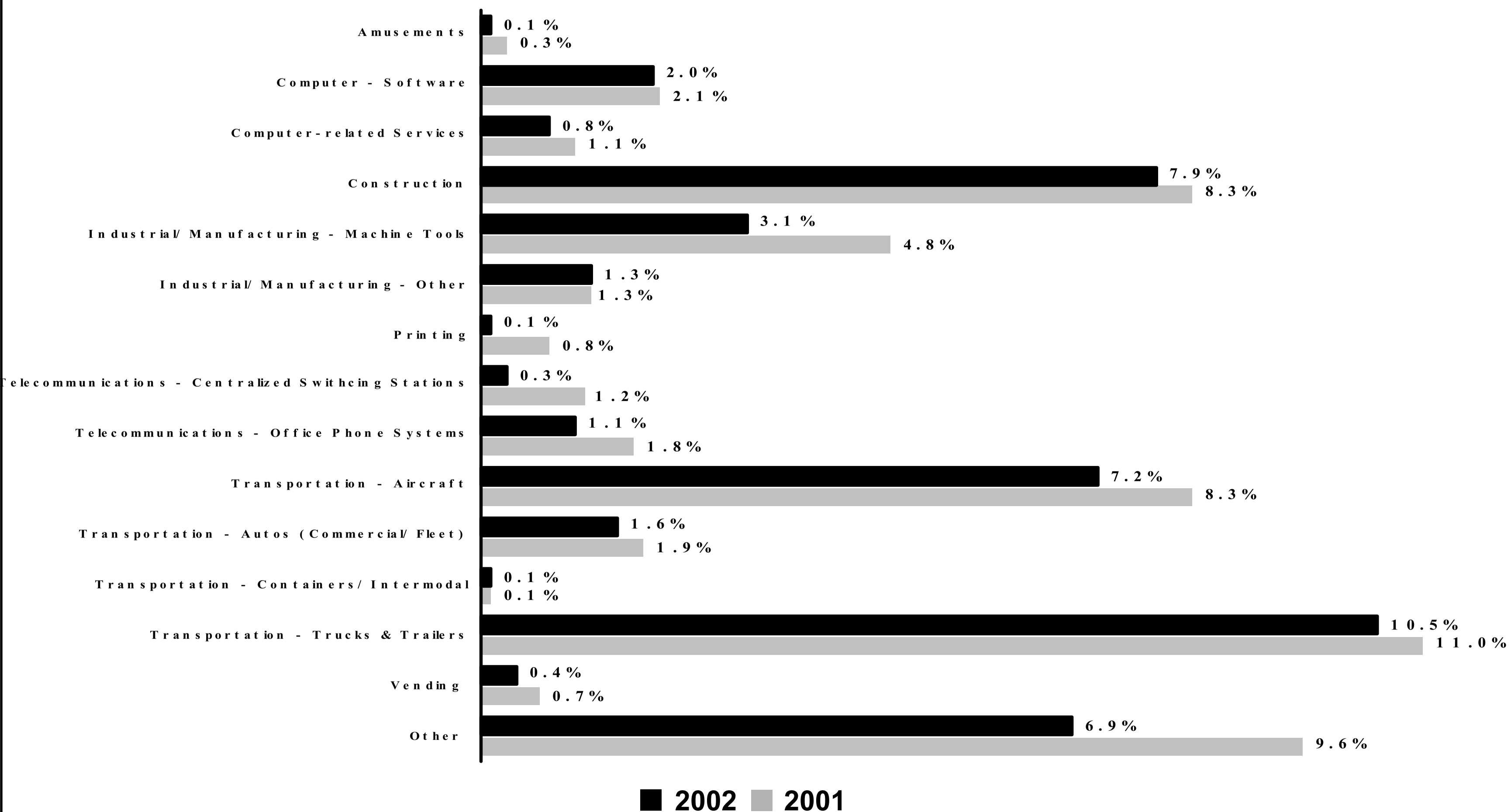
2003 State of the Industry Report Reference Charts



Note: Trend data is provided only for respondents who reported both years of data, to show how equipment types varied for same respondent base from year to year
Source: 2003 ELA Survey of Industry Activity

Figure 5a

2003 State of the Industry Report Reference Charts

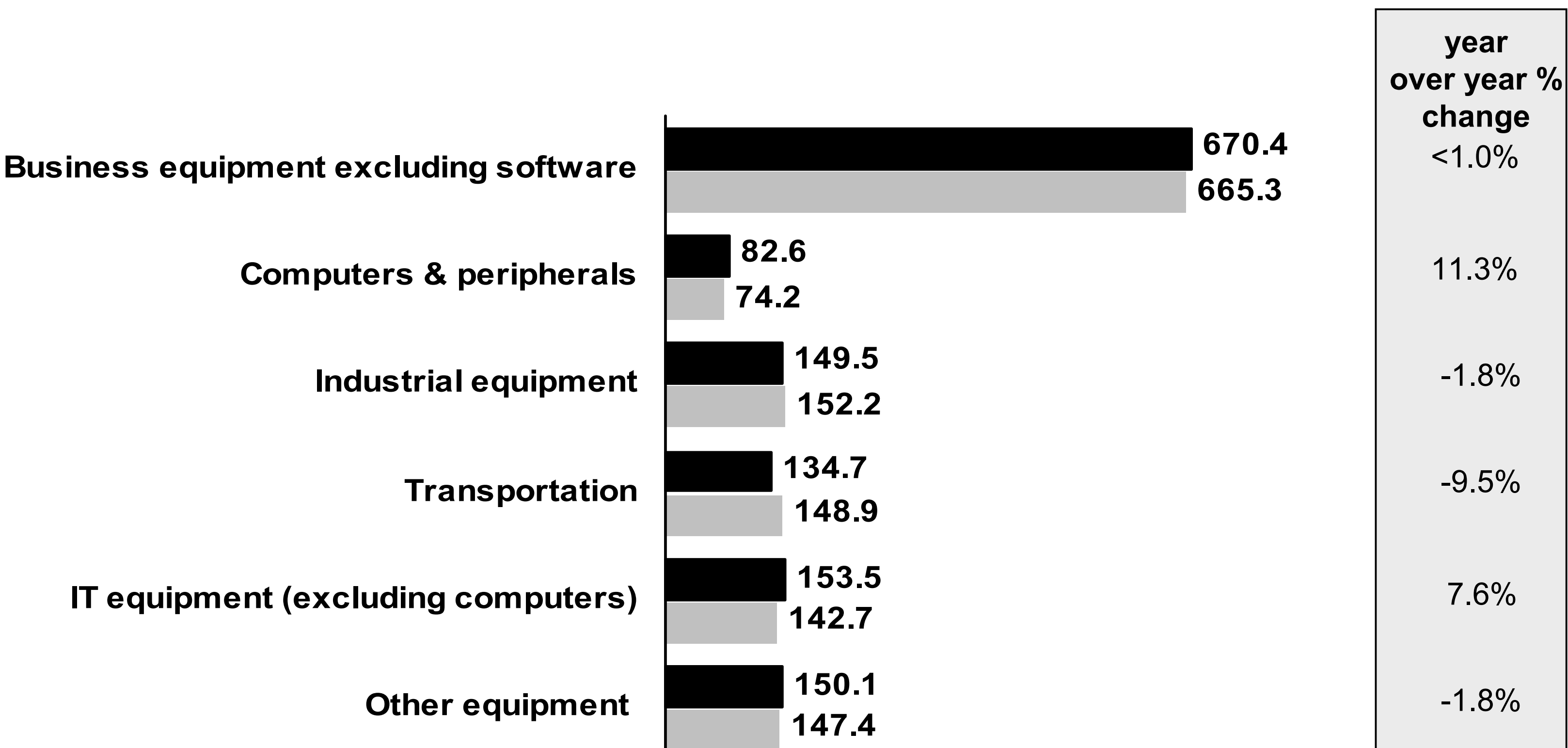


Note: Trend data is provided only for respondents who reported both years of data, to show how equipment types varied for same respondent base from year to year

Source: 2003 ELA Survey of Industry Activity

Figure 5b

2003 State of the Industry Report Reference Charts



* May not total due to rounding
** Annualized as of June 30, 2003
Source: Bureau of Economic Analysis

Figure 6

2003 State of the Industry Report Reference Charts

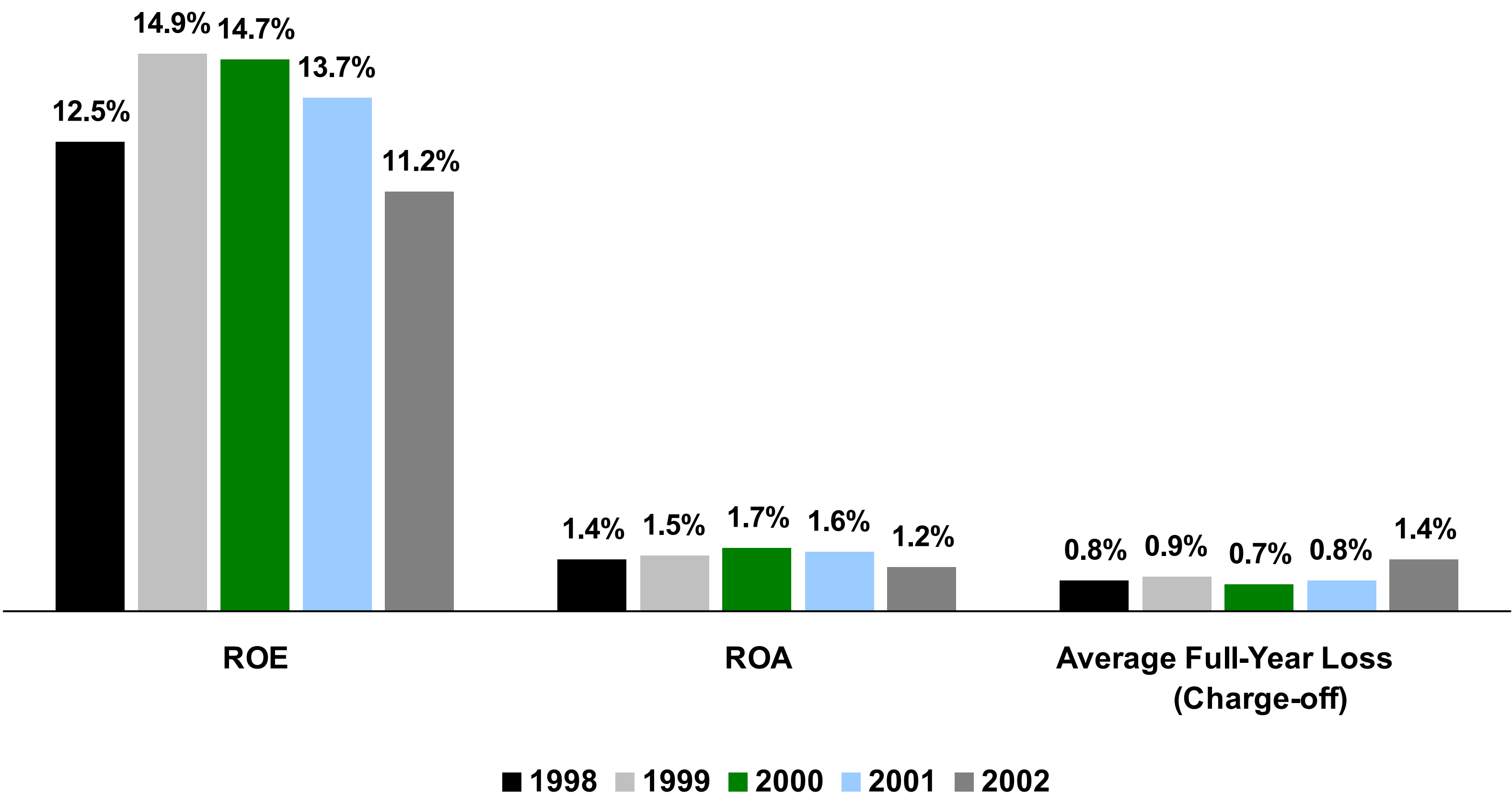


Figure 7

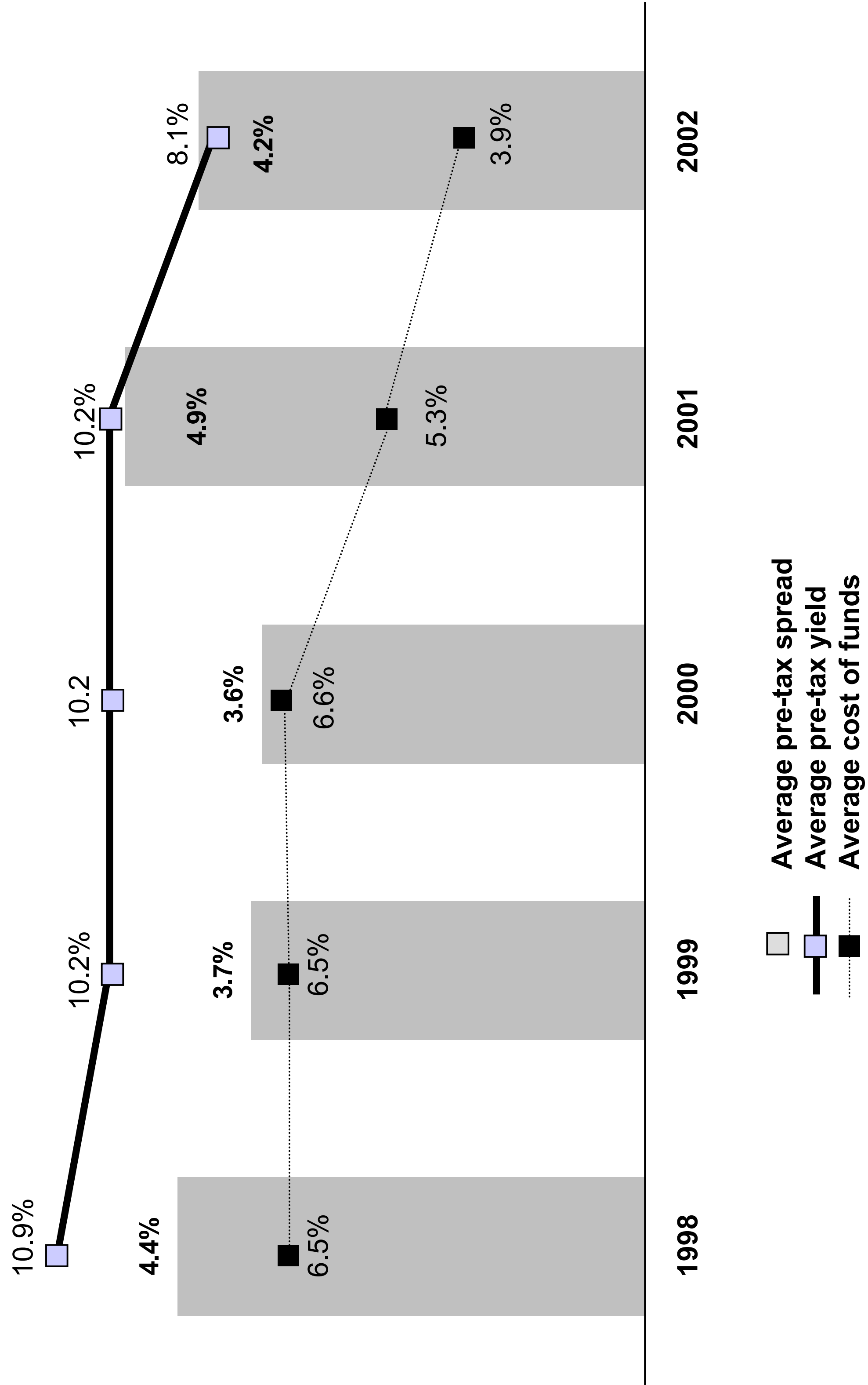


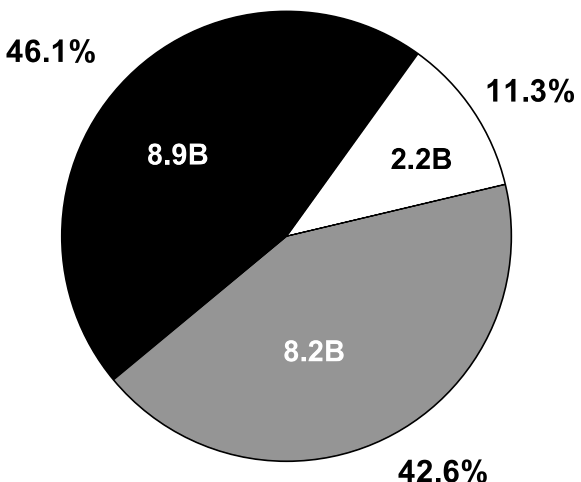
Figure 8

Source: 2003 ELA Survey of Industry Activity

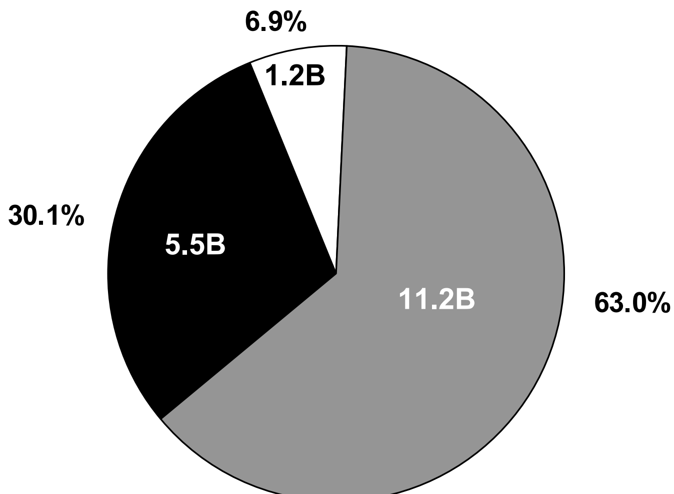
2003 State of the Industry Report Reference Charts

Volume of Securitized Assets (by vehicle)

2002
100% = $19.3B



2001
100% = $18.0B



■ Private placement □ Public Offering ▩ Commercial Paper Conduit

2002 Average volume = $688,550,000

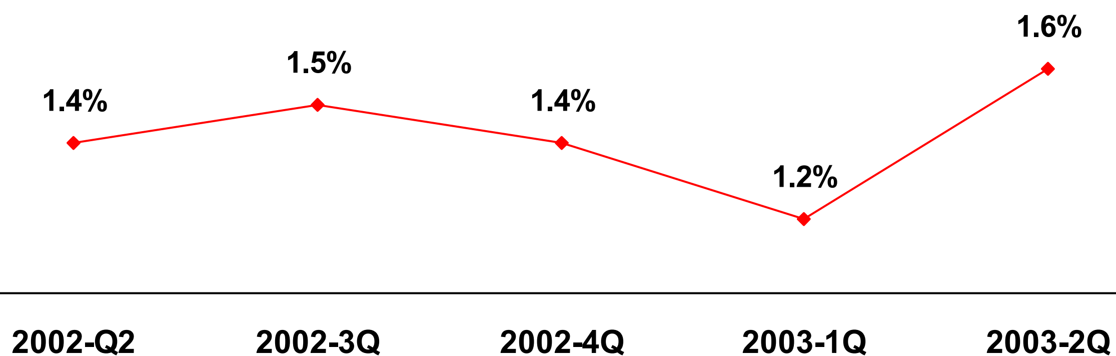
2001 Average volume = $782,806,000

Source: 2003 ELA Survey of Industry Activity

Figure 9

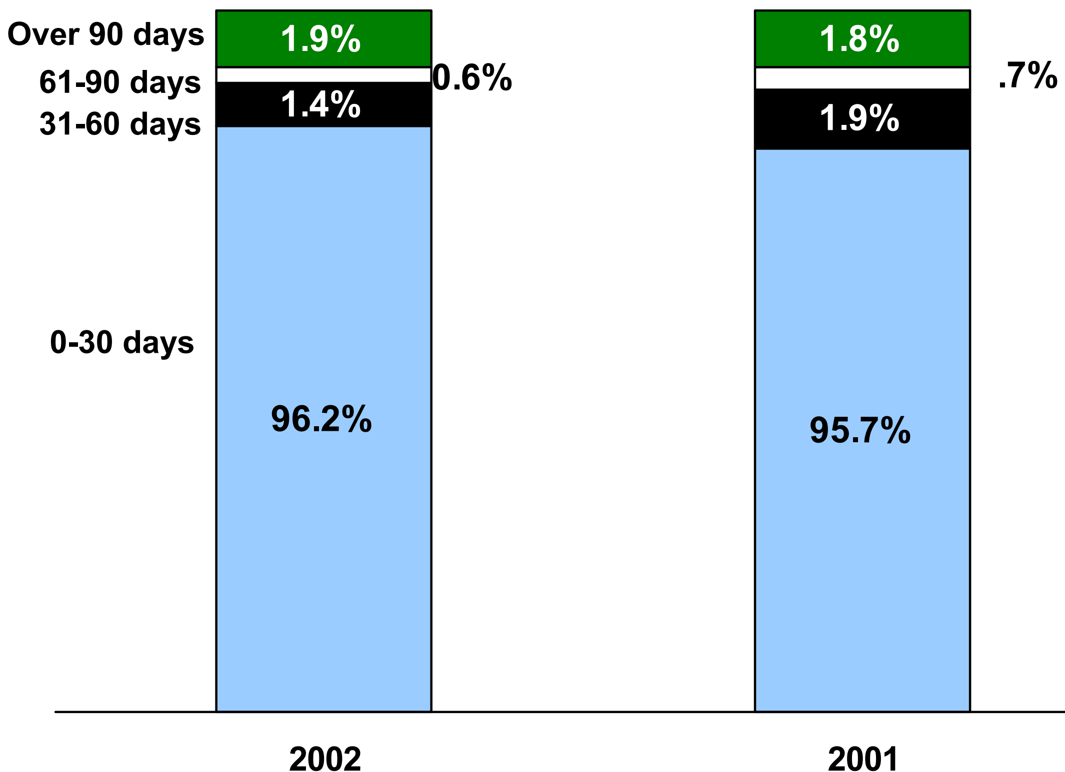
2003 State of the Industry Report Reference Charts

Average Loss (Charge-Offs) as a % of Net Receivables



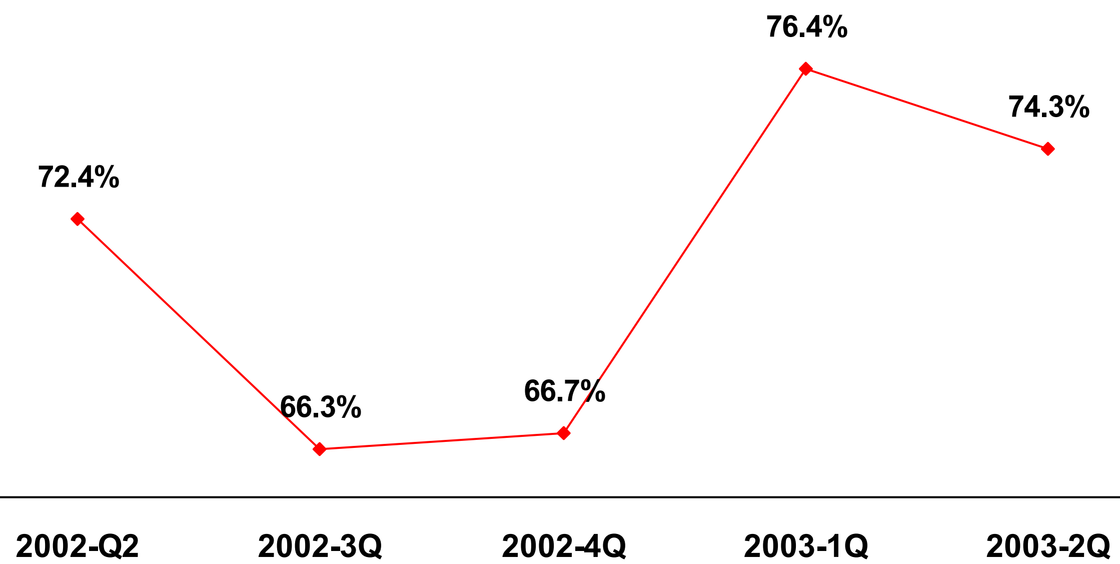
Source: ELA Performance Indicator Report – Q2 2003

Figure 10



Source: 2003 ELA Survey of Industry Activity

Figure 11

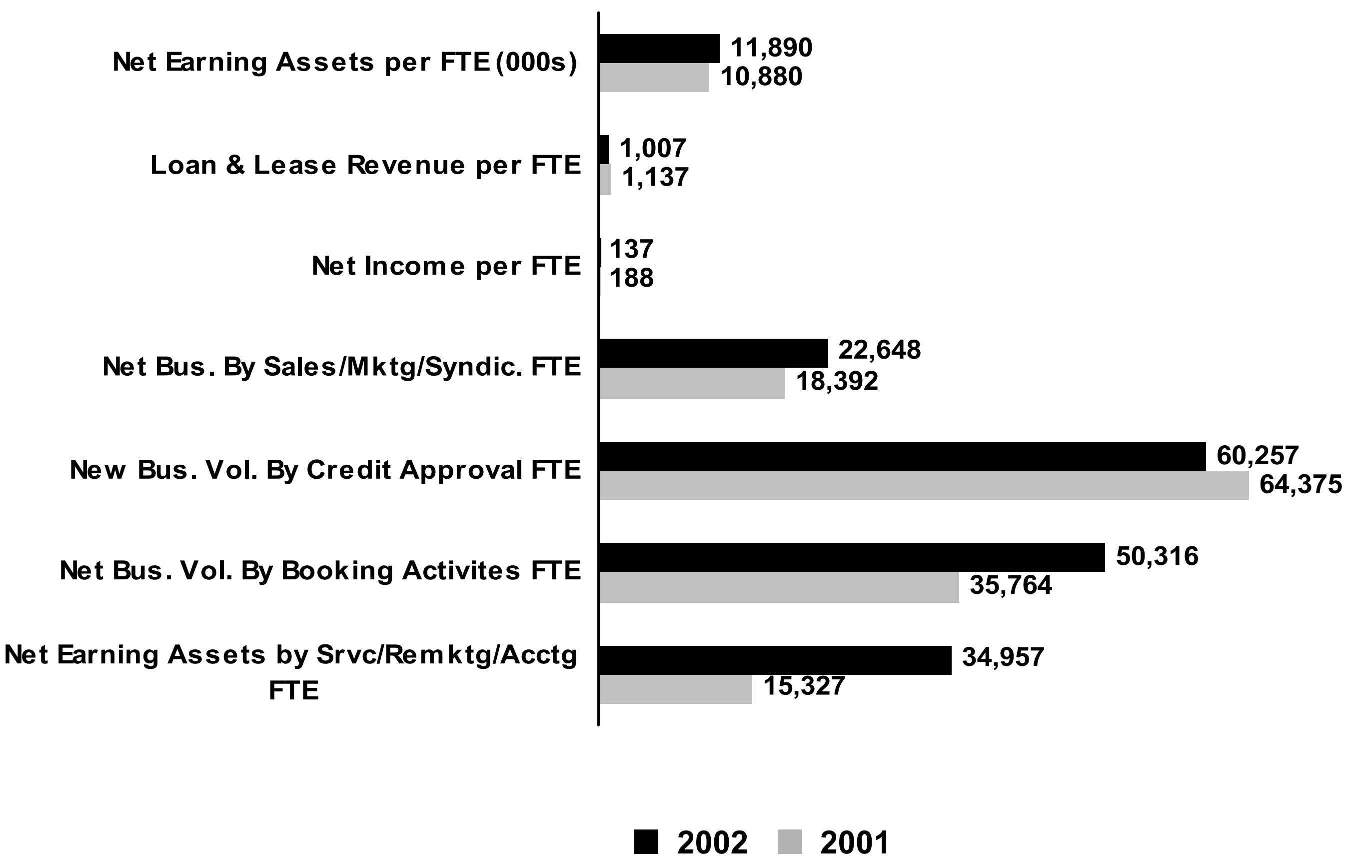


Source: ELA Performance Indicator Report – Q2 2003

Figure 12

2003 State of the Industry Report Reference Charts

Comparative Operational Efficiency
(in dollars per FTE*)



* FTE = Full-time equivalent
Source: 2003 ELA Survey of Industry Activity

Figure 13

E-Commerce Business Methods

	Percentage using method (of companies involved in e-commerce)	Originated Directly	Originated Through Vendor Program	Originated Through Captive Program	Sourced Through Third Parties
End-user Marketing:					
Marketing Materials	74.6	79.5	36.4	18.2	27.3
Rates and Sales Promotions	54.2	54.5	43.8	25	25
Links to Other Web Sites	64.4	63.6	42.1	18.4	28.9
Vendor or Equipment Partner Activities:					
Marketing Materials	50.8	-	56.7	33.3	26.7
Rates and Sales Promotions	47.5	-	53.6	32.1	25
Links to Other Web Sites	47.5	-	46.4	21.4	21.4
Reporting to Vendor or Equipment Partner	40.7	-	58.3	29.2	25
Front-end Processing:					
Transaction Processing	35.6	25	47.6	38.1	33.3
Portal for Downloading Lease Application Materials	52.5	38.6	45.2	35.5	32.3
Lease Application Receipt	62.7	43.2	48.6	32.4	24.3
Credit Decision-Making	39	18.2	39.1	34.8	30.4
Transaction Feedback	50.8	36.4	40	30	30
Document Generation	54.2	38.6	31.3	43.8	21.9
Issuing Electronic Purchase Orders	13.6	9.1	12.5	62.5	0
Back End Customer Service & Collections:					
Payment Status and Histories	45.8	45.5	40.7	22.2	14.8
View Lease Documents via the Web	15.3	13.6	33.3	22.2	11.1
Buy-Out / Trade-Up Figures		15.9	40	30	20
Asset Management 33.9	16.9	31.8	20	30	15
Financial / Tax / Services Reporting	27.1	27.3	12.5	12.5	31.3
Other*	6.8%	4.5%	50.0%	0.0%	0.0%

*Other includes document delivery, uploading equipment usage/clicks and equipment remarketing

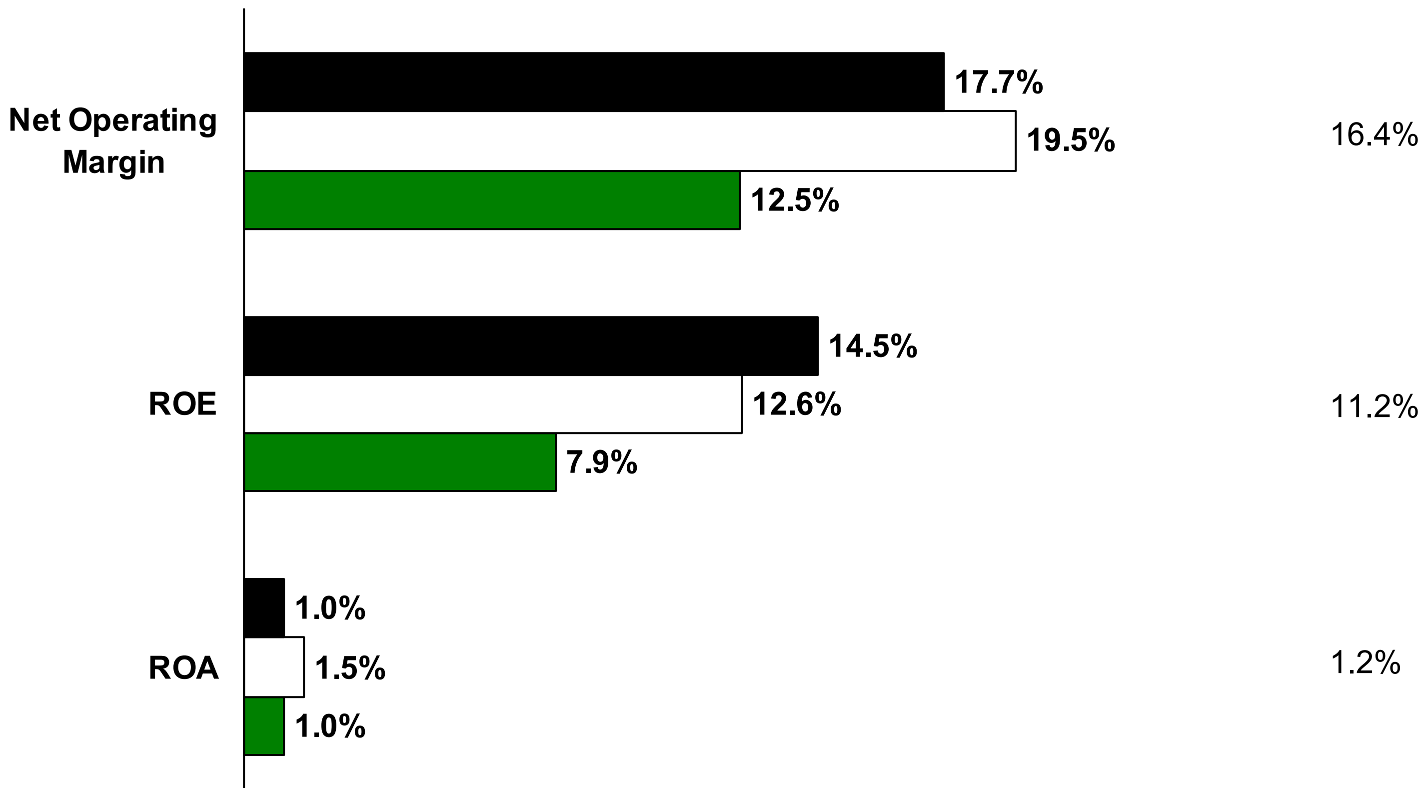
Figure 14

New Business Volume via E-Commerce

	2002	2001
New Business Volume via E-commerce Business (000)	$3,712,317	$2,816,672
Total New Business Volume (000)	$117,170,463	$122,766,496
Percentage of Total via E-commerce	3.2%	2.3%

Source: 2003 ELA Survey of Industry Activity

Figure 15



Source: 2003 ELA Survey of Industry Activity

Figure 16

2003 State of the Industry Report Reference Charts

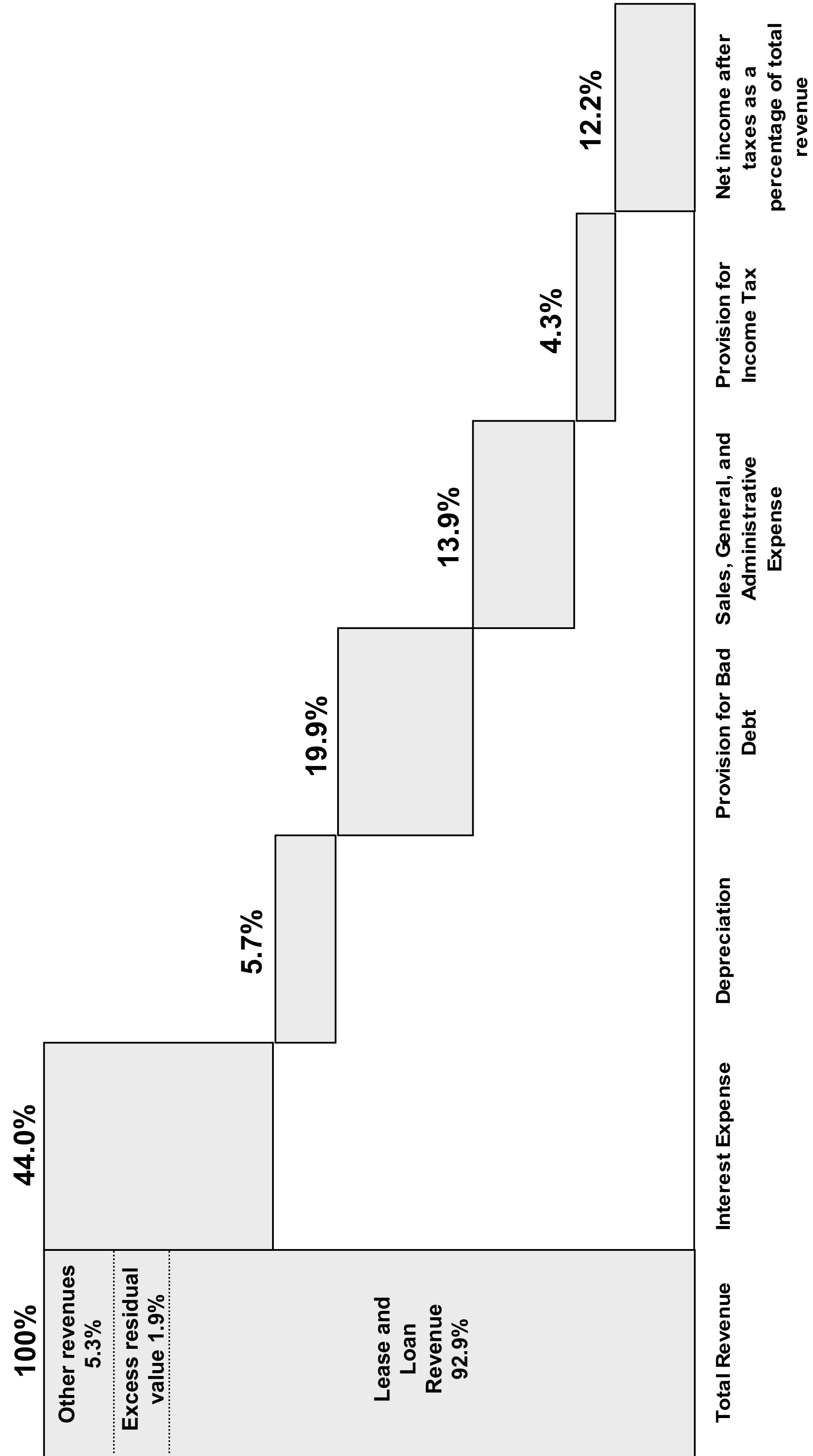
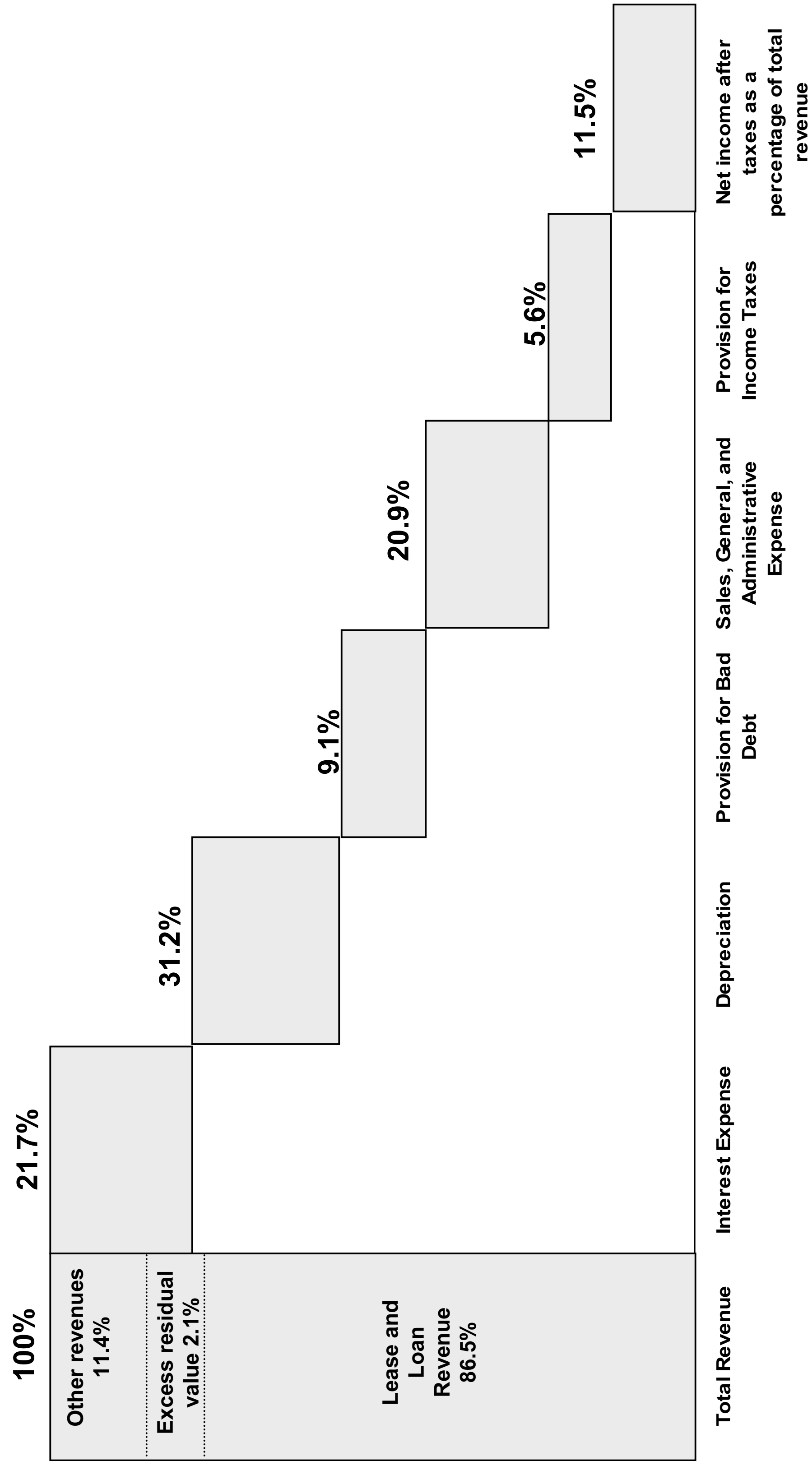


Figure 17

Captive Expense Components as a Percentage of Total Revenue

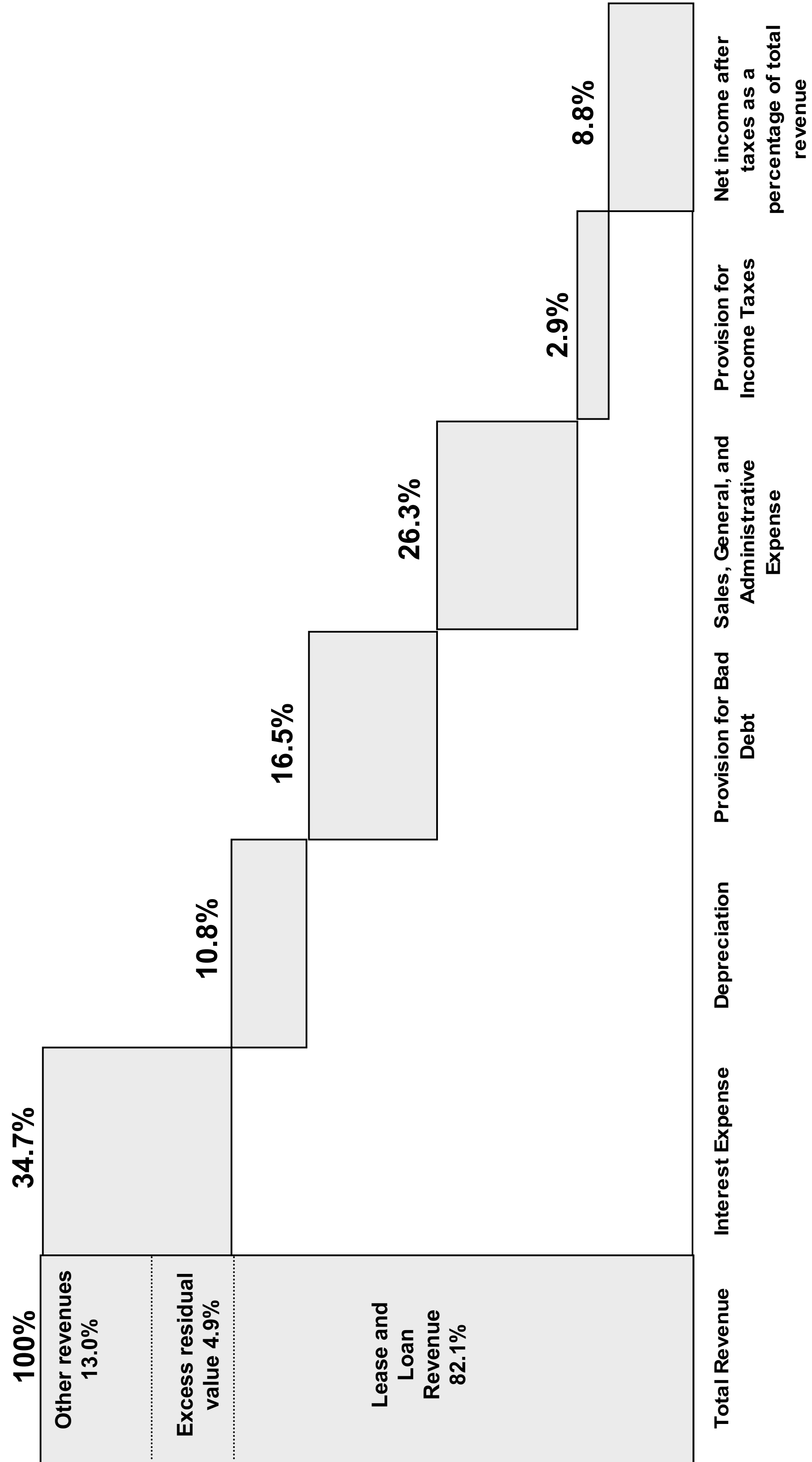


Note: Not to scale
Source: 2003 ELA Survey of Industry Activity

Figure 18

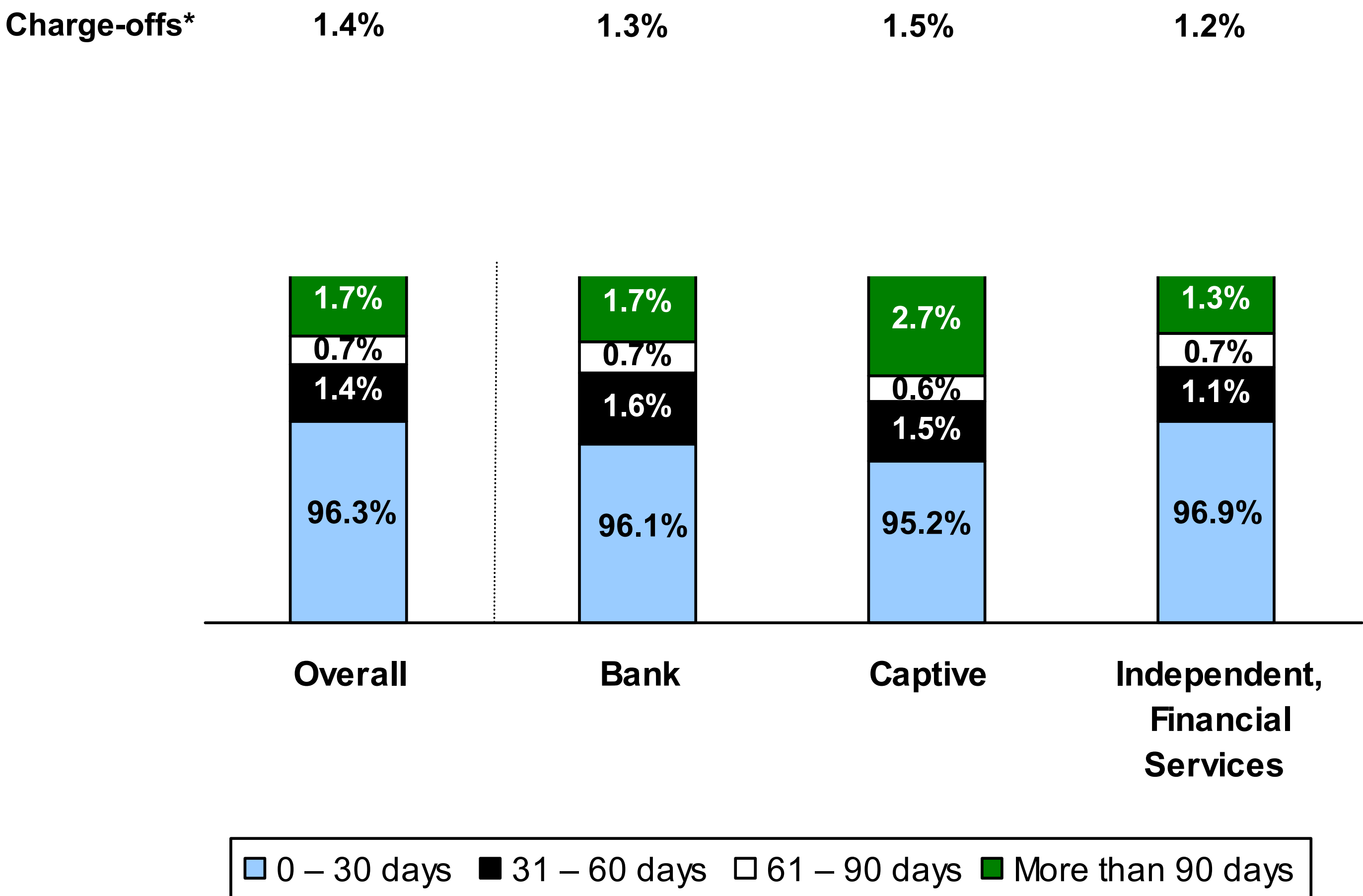
2003 State of the Industry Report Reference Charts

Independent Lessor Expense Components as a Percentage of Total Revenue



Note: Not to scale
Source: 2003 ELA Survey of Industry Activity

Figure 19

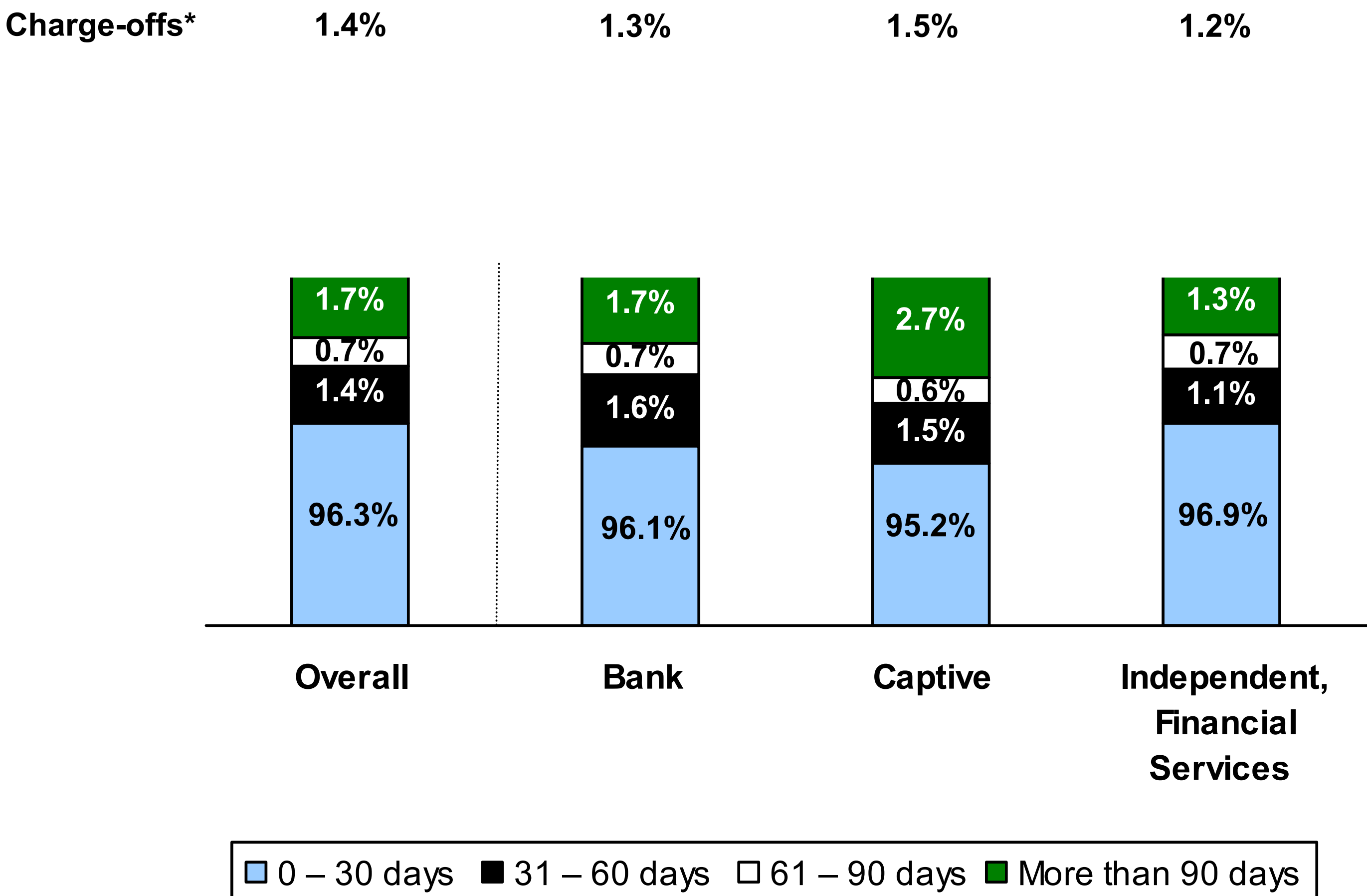


* Full year loss as a percentage of full year average net lease receivables balance

Note: Not to scale

Source: 2003 ELA Survey of Industry Activity

Figure 20



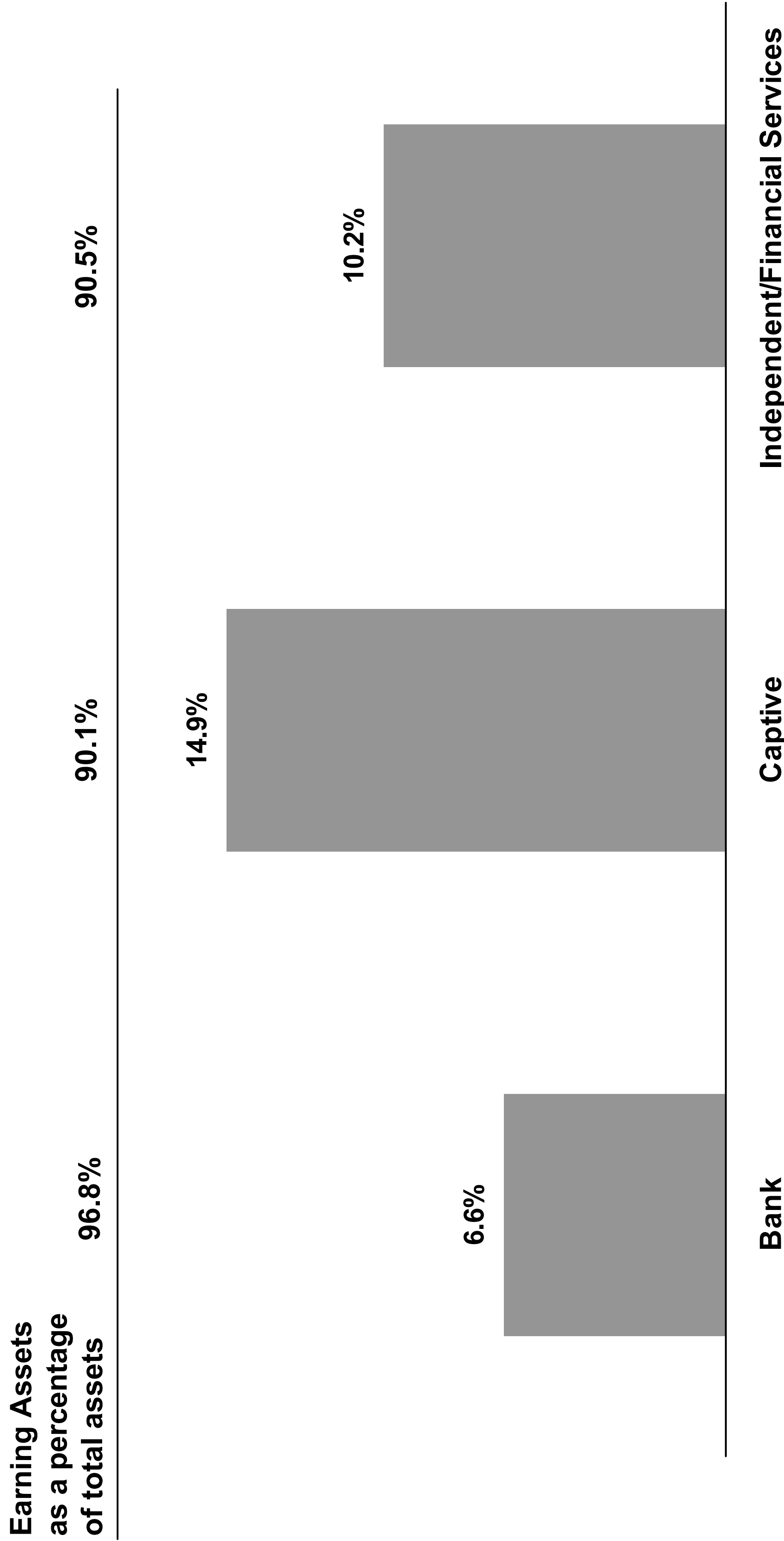
* Full year loss as a percentage of full year average net lease receivables balance

Note: Not to scale

Source: 2003 ELA Survey of Industry Activity

Figure 20

2003 State of the Industry Report Reference Charts



Source: 2003 ELA Survey of Industry Activity

Figure 22

2003 State of the Industry Report Reference Charts

Pre-Tax Yield, Cost of Funds, and Pre-Tax Spread
(by lessor type)

	Pre-tax yield	- Cost of funds	= Pre-tax spread
Bank	7.3%	3.6%	3.7%
Captive	8.5%	4.3%	4.2%
Independent, Financial Services Firms	8.8%	4.0%	4.8%

Source: 2003 ELA Survey of Industry Activity

Figure 23

Pre-Tax Yield, Cost of Funds, and Pre-Tax Spread
(by ticket size)

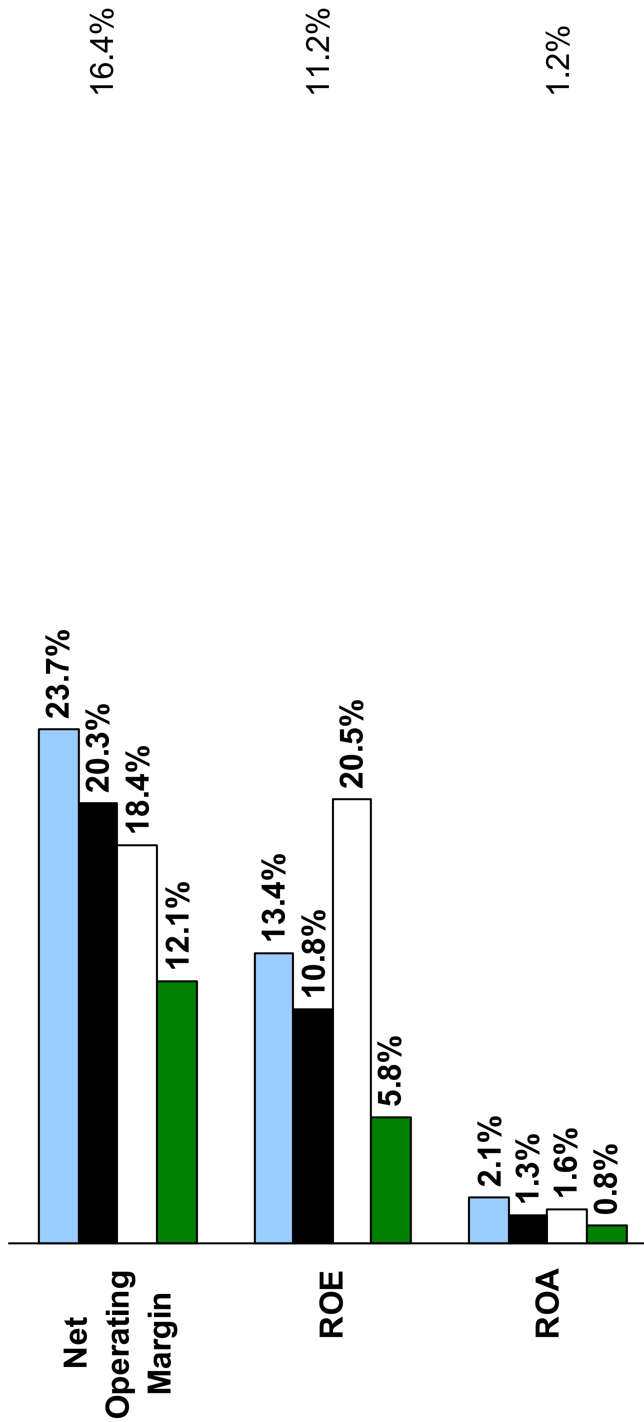
	Pre-tax yield	- Cost of funds	= Pre-tax spread
Micro-Ticket	11.9%	3.9%	8.0%
Small-Ticket	8.1%	4.0%	4.1%
Middle Market	7.5%	3.8%	3.7%
Large Ticket	8.4%	3.9%	4.5%

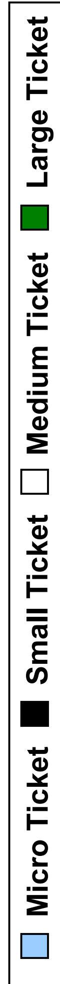
Source: 2003 ELA Survey of Industry Activity

Figure 24

Figure 25

2002 Profitability Ratios by ticket size

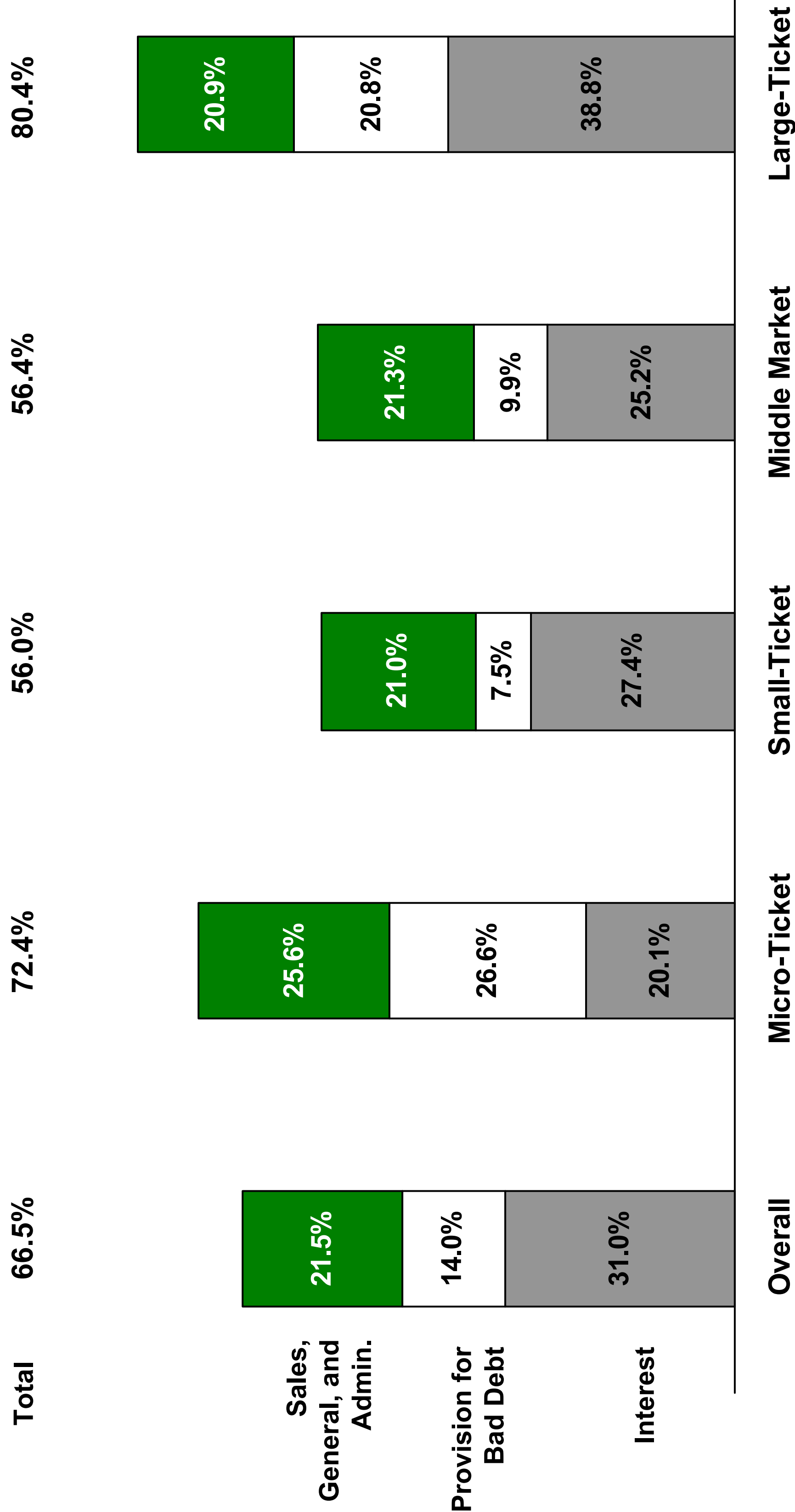




	Average
Net Operating Margin	16.4%
ROE	11.2%
ROA	1.2%

Source: 2003 ELA Survey of Industry Activity

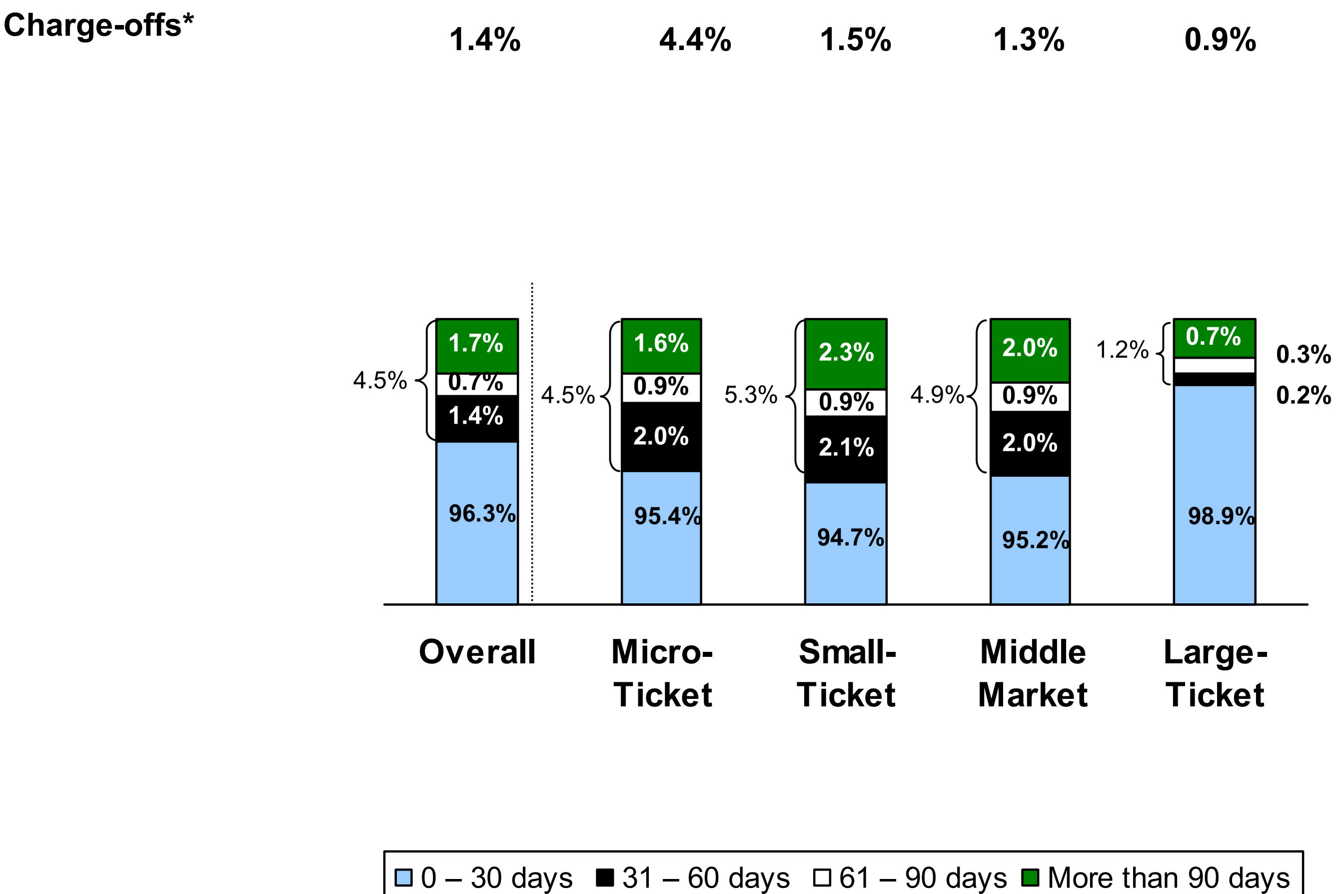
2002 Expenses* as a Percentage of Total Revenue (by Lessor Type)



* Excluding depreciation

Source: 2003 ELA Survey of Industry Activity, FIC Analysis

Figure 26

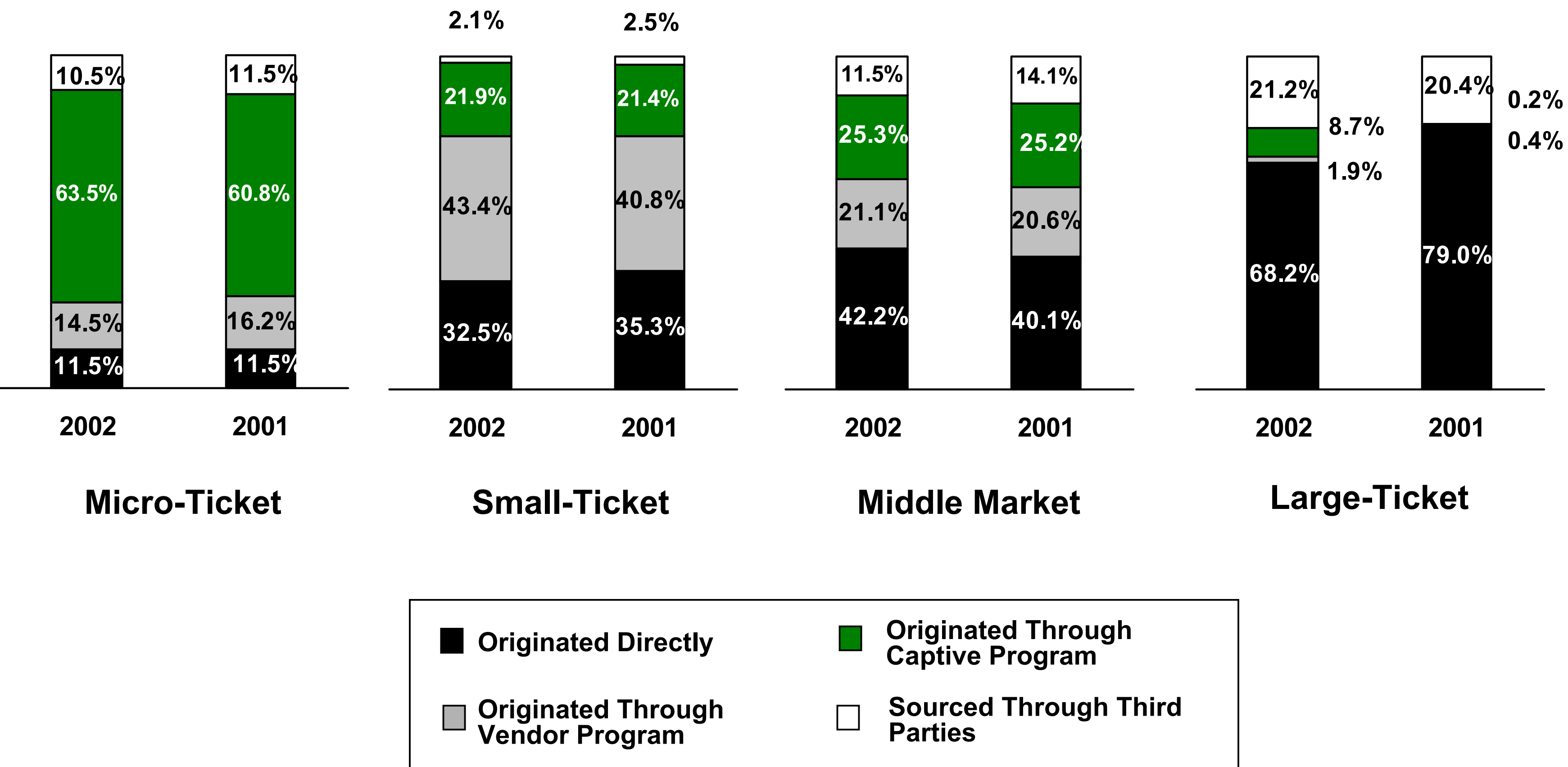


* Full year loss as a percentage of full year average net lease receivables balance

Note: Not to scale

Source: 2003 ELA Survey of Industry Activity

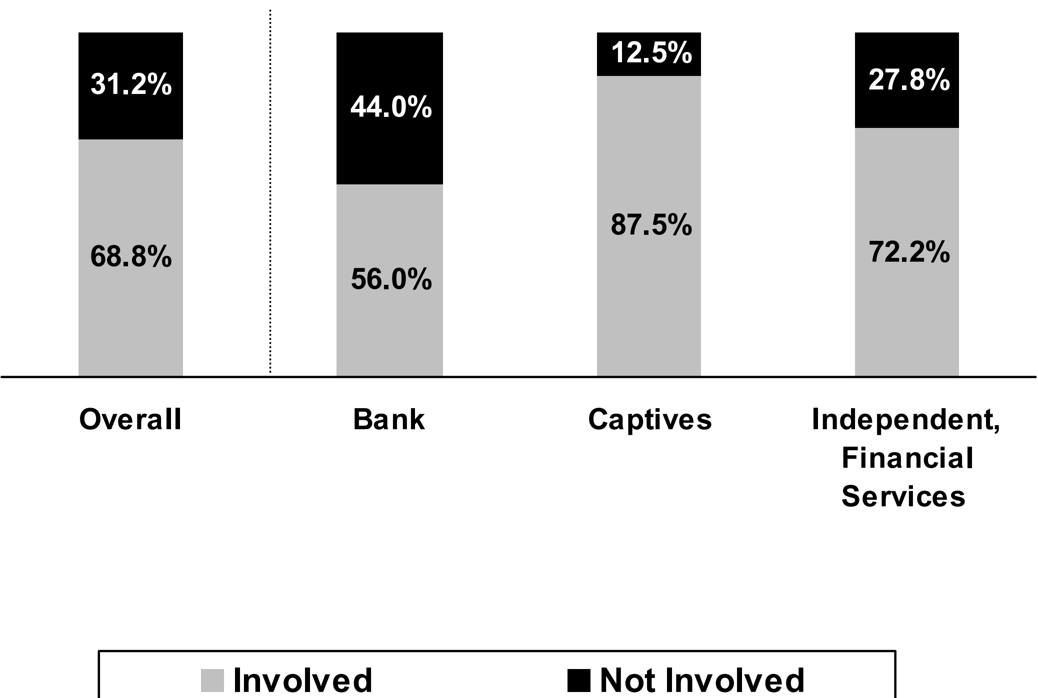
Figure 27



Source: 2003 ELA Survey of Industry Activity

Figure 28

2003 State of the Industry Report Reference Charts

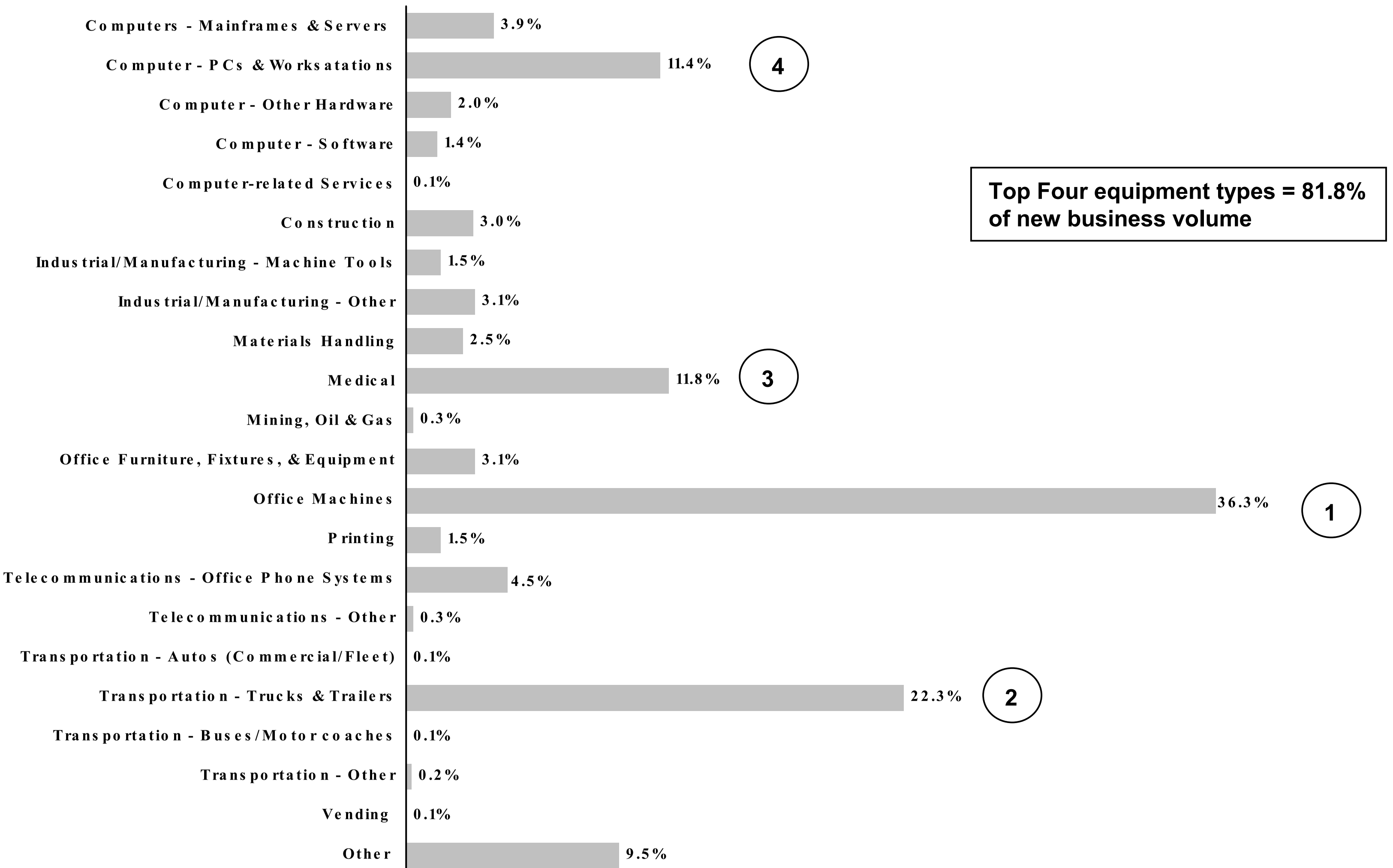


Source: 2003 ELA Survey of Industry Activity

Figure 29

2003 State of the Industry Report Reference Charts

New Business Volume by Equipment Type (small-ticket)



Source: 2003 ELA Survey of Industry Activity

Figure 30

Small Ticket Applications Processed
(by lessor type)

	Overall	Banks	Captives	Independent, Financial Services
As a % of Number of Applications Submitted, Applications:				
Approved	68.3%	63.3%	83.1%	68.6%
Booked and Funded or Brokered	51.0%	43.5%	67.9%	51.9%
As a % of Total Dollars Submitted, Applications:				
Approved	59.2%	56.8%	77.4%	58.2%
Booked and Funded or Brokered	41.7%	34.1%	61.0%	42.5%

Source: 2003 ELA Survey of Industry Activity

Figure 31

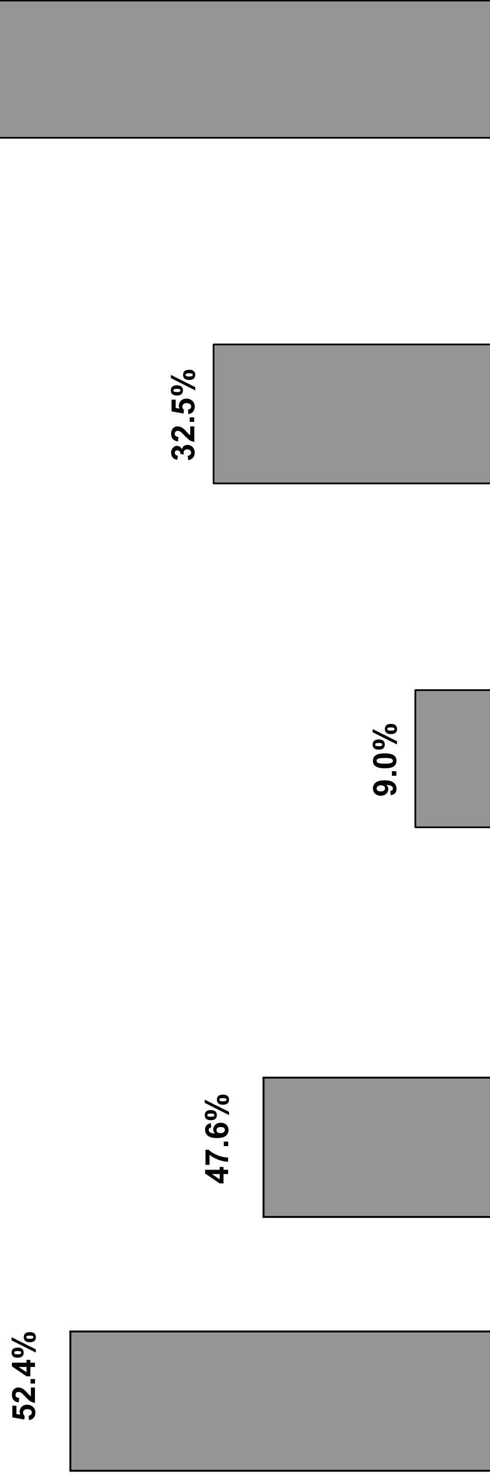


Figure 32

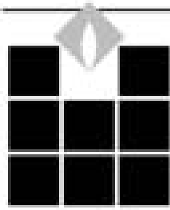
Source: 2003 ELA Survey of Industry Activity

The State of the Industry Report digests results of ELA's Annual Survey of Industry Activity.

The Annual Survey of Industry Activity is the most important source of statistical information available on the equipment leasing and finance industry. Data relating to respondent's volume and type of leasing business, productivity measures, residual experience and levels of technology investment are included in the survey. It presents balance sheet data and measures financial ratios and profitability.

In addition to the survey report, purchasers of the 2003 SIA survey will have access to BOTH the Interactive 2003 and 2002 SIA's. The Interactive SIA enables companies to benchmark their profitability and portfolio performance and operations against their peers in a secure and confidential environment.

For more information on the Survey and to obtain a copy,
please contact Bill Choi at ELA, 703-527-8655 or www.elaonline.com.



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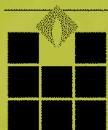

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