2004 Industry Future Council Report

EQUIPMENT LEASING AND FINANCE FOUNDATION

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About The Equipment Leasing and Finance Foundation

The Equipment Leasing and Finance Foundation is a 501c3 non-profit organization that provides vision for the equipment leasing and finance industry through future-focused information and research. Primarily funded through donations, the Foundation is the only organization dedicated to future-oriented, in-depth, independent research for the leasing industry. Foundation products include the Industry Future Council Report, the State of the Industry Report, and the Journal of Equipment Lease Financing and numerous research reports. Established in 1989, Founders include leasing industry member Paul S. Gass, the Equipment Leasing Association of America, and others. Visit the Foundation online at www.LeaseFoundation.org.

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Executive Summary:
Leasing industry segments have differing views of the future.

While a universally gloomy mood prevailed throughout 2002 and the beginning of 2003, the leasing industry's outlook for 2004 is showing signs of encouragement and enthusiasm in the small and medium ticket segments, while large ticket lessors remain under significant stress. With most economic measures trending positive, lessors are almost in universal agreement the non-tax-oriented segments of the leasing business will prosper, at least in the short term. The uncertainty surrounding proposed regulatory and tax policy has had a stifling effect on the large ticket leasing segment, and there appears to be no significant, predictable event that would change that direction.

Lessors are very confident that they have adequate capital to grow their business. U.S. manufacturing, down in 2001 and 2002, began rebounding in late 2003 and shows signs of moving higher in 2004. Small and big-ticket lessors alike foresee low and stable interest rates for the year, and many also predict vigorous capital spending by corporations through 2007.

Most industry participants agree that certain high profile business failures, questionable business practices, and public opinion surrounding some large transactions have created an environment of skepticism and heightened scrutiny. Lessors also believe that competitive pressures will lead to further consolidation and a decreasing number of lessors over the next three years. This foretells continuing competition among a smaller number of players, keeping pressure on returns potentially limiting the total availability of capacity due to credit concentration issues. Innovation continues, but it appears to be more focused on process and efficiency than on creative structures. With annual volume of approximately $35 billion in tax-oriented leasing, there is concern about a potentially dramatic reduction in that volume in the future.

The 2004 presidential election is of interest chiefly in the sense of what legislation could occur after the new administration takes, or the current administration retains office in January 2005. Candidates' politics were of less concern than whether they were "responsible" or "irresponsible" regarding economic policies.

The biggest worries, especially to big-ticket lessors, are proposed legal and regulatory changes that are having a stifling impact on leasing volume even before they become effective. One would limit cost-recovery when lessors lease to certain tax-exempt organization such as states, municipalities, universities, some health care providers, and public service organizations. Cross border leasing is under significant pressure as well.

These provisions would redefine the tax deductions available on property leased to tax-exempt entities, and possibly to owners that use leased property to provide every type of service to such entities. They significantly restrict the flow of private capital to fund civic and infrastructure spending, and would consequently affect the Federal government, state and local governments including schools and universities, hospitals, municipal and regional transportation authorities and other tax-exempt organizations.

The 2004 IFC Meeting – *A Quest For Clarity*

The Equipment Leasing and Finance Foundation Industry Future Council held its 23rd annual meeting January 2004 in Washington, D.C. This year's session was sponsored by American Lease Insurance.

Attending were 22 senior executives, including representatives of every ELA Business Council steering committees — small ticket, middle market, banks, large ticket, vendor finance companies and service providers. The meeting's facilitator was Joseph C. Lane, vice chairman of Bay4 Capital LLC, and former Chairman of the ELA.

The IFC meeting is a forum for industry leaders to develop a long-range view of the future of the industry, including the influencing forces, trends that will change the market, variables that will signal the pace and direction of change, and anticipated actions and reactions among industry players. This report briefly summarizes those discussions.

In preparation for the meeting, the Foundation distributed a survey to members of the Business Council steering committees and a number of individual members covering all segments of the leasing industry. The survey prompted respondents to identify key issues and trends. In most cases, the IFC followed through with telephone discussions to clarify responses. The result formed the basis of the meeting's agenda.

The discussion was divided into several sections — the environment, the industry, products and markets, and people. The effort was to determine where there was agreement, where there were differences of view, what was fact-based conclusion, and what was judgment-based speculation. Where there was general consensus on an issue, the Council focused on what factors might change, and what would be the "sign-posts" that might signal such change.

The Environment

Interest Rates

Participants' consensus was that rates would remain low for the next year but would trend higher over the next five years. The sustained low rates of the past few years have hurt leasing volume, as customers have been more prone to purchase. Higher interest rates, per se, were not considered a threat to the industry, as most lessors match fund their portfolios and pass through the impact of higher rates. Said one participant: "Rates hit 20 percent in the 1980s, and we still made money."

Of concern was the ability to adjust pricing during the rise, as history indicates there is generally a lag in the market's absorption of rate increases. During the rise, this inertia puts pressure on spreads. There were three analytical reasons for the expected increase: the growing and worrisome Federal deficit, the weakening dollar on foreign markets, and the capital demands of an improving U. S. economy. There also was a fourth, intuitive reason — rates are cyclical by nature, they will stay low during the election year when traditionally little happens on the legislative or fiscal fronts, but they will rebound simply because they always have.

As one participant said: "They just can't stay low forever. What's down goes up. The longer they stay down, the greater the odds they will go up later." Said another, deferring to psychology: "If we think they're going up, they will go up."

Regarding interest rate impact on portfolio quality, there was general agreement that the recent, lower-rate environment might have masked (or avoided) some problems that would have been more prominent or visible if lessees were under rate pressure. This suggests a need for prudence and careful underwriting of risk as interest rates rise and strain cash flow of customers.

The Council anticipates a change in the lease-versus-buy conclusions of lessees in the future. Prevailing low rates have tipped the scale in favor of "buy", but as economic growth continues, and rates rise over time, lessors expect to see an increase in volume as lessees return to the leasing market as a reliable source of capital for expansion.

Competition

Through consolidation and lessors simply deciding to get out of the business, competition remains intense among leasing companies. Just recently, however, there has been a birth of new lessors that seem to be balancing that scale. As one indicator of this trend, the number of new memberships in the Equipment Leasing Association reached a record high last year.

Both trends are expected to continue, but overall, there will be fewer lessors in three to five years. Most also see banks becoming the dominant category of lessors, versus independents or captives. This will be due to plentiful capital supply at low cost. Meanwhile, as banks continue to manage their tax capacity centrally, some speculated that the trend could lead to more comparative analysis of the returns available from bank-owned leasing operations versus funding third party leasing companies as an asset class. This could mean a significant change in the character or "flavor" of the market, and is one of the trends the Council identified for continuing evaluation in the future.

Perception of Leasing

The public view of the industry remains somewhat negative at a time when business still is rebounding from scandals at Enron, WorldCom, Tyco and others. Leasing company failures have come chiefly from less malicious activities— overvalued residuals, stretching beyond core knowledge base, or dependence on patterns of income and tax payments which come under threat by subsequent legislation or regulation. Additionally, lessors were particularly hard hit by the impact of terrorism on the airline industry and other capital-intensive businesses. Nonetheless, the Council highlighted the overwhelming number of individuals and companies who have continued to thrive through decades of successful business characterized by integrity, and an ability to rely on their counterparts in the industry to act in a fair and honest manner.

But the market, frequently reacting to false or misleading information, groups leasing transactions with other tax-motivated deal structures perceived to be a drain on tax revenues. Big-ticket, and some middle ticket lessors are more affected by this tendency, as most small ticket lessors said, “taxes are not a driver of my business at all.” The Council expressed concern about the level of misinformed rhetoric – especially during an election year – that may have a damaging effect on public perception of leasing’s role in capital formation and financing an economic recovery.

Regulation

FIN 45, FIN 46 and Basel II were the primary focus of current regulatory issues. The trend toward more regulation is expected to continue, with vigor.

One expected impact of increasing regulatory and accounting restrictions will be a sharper distinction between operating leases and finance leases. This may result in a shortening of lease terms under certain circumstances, to allow for residual assumptions to achieve operating lease treatment.

Spending trends

Corporations are expected to emphasize capital expenditures over increased spending on people. However, the growing trend toward moving manufacturing and production offshore has Lessors concerned that their involvement in financing an economic rebound may be more limited than in previous cycles, as companies acquire and install machinery and tools for increased production outside the United States. There was no consensus among the Council about how they or their competitors would address this shift.

The Industry

What is leasing?

When asked to define their business, Lessors describe leasing as “equipment financing” or “financial services” over “structured financing” or “tax-oriented financing.” The Council attempted to clarify this identity as the industry works to define itself to varied constituencies. Yet hard definitions were elusive. Said a participant: “I get very pure on the word ‘lease’. My company writes leases. But I know that isn’t the only thing we do.” Said another: “I see myself as a part of an industry because we have one thing in common, be it a production machine or a piece of farm equipment or what have you. We are financing a hard asset. There are a number of people providing capital or structuring that capital or providing legal advice, and they’ve all worked together over the years. This to me is leasing.”

Others broadened that: “People now are financing — and rolling into leases — intellectual property, software and services. Or they’re rolling it into financing and sometimes calling it a lease.” Asset management, which many customers see as a function of leasing, is an all-encompassing term. “It has as many definitions as people defining it,” said one large-ticket lessor. “It goes everywhere from procurement to life cycle of the lease to remarketing and disposal of equipment. It means different things to different people.

Number of customers

Lessors have more customers now than they did last year, and they appear generally optimistic for continuing growth in the number of customers engaged in leasing. But most of this growth will happen because of lessors gaining larger market shares — effectively stealing from each other — instead of tapping into expanding markets.

One small-ticket participant characterized his business as “more customers, smaller deals, smaller portfolios; so more customers does not equate to having a larger portfolio.” Still, for many, as the economy has improved, portfolio quality is better than it has been in years, and most of the Council expected a smaller number of lessors to be working with a larger number of customers.

Credit scoring and credit standards

Credit scoring has become pervasive in small and lower-medium ticket leasing. As part of an automated process necessary for efficiency, credit scoring has been partly responsible for an overall improvement in portfolio quality. While credit standards were generally adjusted to deal with the greater loss exposure in the late ‘90’s, most expect little or no change in credit standards or underwriting criteria going forward.

Residuals

Residual value setting and realization remain important competencies of leasing. However, there appears to be an increasing trend toward residual management on a portfolio basis. In other words, while residuals are set on a deal-by-deal basis, Lessors enjoy residual upside from a smaller percentage of transactions in their portfolio where lessees’ asset management tendencies permit it. Renewals, upgrades and extensions are a greater source of return enhancement than are end-of-lease sales in the secondary market. Fewer lessees seem to place value on the relative supremacy of a lessor’s remarketing skills or asset knowledge as an added value of leasing.

The Products and Markets

How can a leasing company be successful in the future? Asked to rank various skills and attributes that may be critical to a leasing company’s success, Council members determined that “deal generation” and “customer contact” were the two most important capabilities. These were followed by, in order, cost of capital, asset management, remarketing capability and tax appetite. This ranking seems consistent with the overall confidence in capital availability, a lowered dependency on unique asset knowledge and remarketing, and a growing emphasis on economic substance over tax structuring.

Relationships

Customer intimacy remains critical to success. However, customer intimacy no longer means “face-to-face.” Many Council members described their emphasis on process, systems, billing, etc., as the source of their customer intimacy. While large ticket lessors logically rely more heavily on face-to-face interaction, small and medium ticket lessors, and vendor program providers see a growing number of end-users in their portfolios who prefer and depend on other forms of communication with lessors.

Interestingly, when asked to rank the methods most used in their business, lessors and service providers responded that telephone remains number one, followed by mail, courier, and then email. The Council indicated this ranking would be most interesting to watch for evolutionary change.

Returns

Returns are generally expected to improve. The primary driver will be improved operational efficiency, as opposed to improving market size or conditions. More Lessors expect their increase in business volume to come from market share than from market expansion.

The People

Diversity

Prompted by a unanimous view that the leasing industry lacks sufficient diversity among its population, the Council spent an entire session discussing both the current situation and expectations for the future. Traditionally dominated by white males – many of whom were the "founding fathers" of an entrepreneurial industry – lessors have evolved along with a maturing industry.

Nearly every participating Council member described active efforts to recruit and attract people representing a broader diversity of race, gender, geographic background and experience. Not only seen as an appropriate effort, the achievement of greater diversity was described as creating a richer, more creative and responsive environment within the respective companies.

Opportunity

As the industry matures, consolidates, and becomes more "bi-polar," with large institutions at one extreme and very small entrepreneurial players at the other, several factors and trends create challenge for identifying and attracting new talent to leasing. Whereas many of those who started in the industry 20 or more years ago were attracted to the boundless, unstructured opportunity to try new things, and to operate in an intentionally unstructured environment, today's reality includes people from different parts of a parent company being transferred into the leasing activity, with full intention of transferring out again as their career path requires continuing diversification of experience. Some leasing companies operate with a governance structure where reporting lines are vertically aligned with their discipline within the overall parent organization (legal, credit, treasury, tax, etc.), creating a challenge for the leasing identity to take root.

Generally, the Council members feel that opportunity was broader, and delivered earlier in people's careers in the past, and that today's environment requires more structure and less ability to offer unstructured challenge at an early stage. Consequently, exacerbated by an increasing demand among new talent to define a clear career path, these factors are creating a greater challenge for attracting and developing people who define themselves as leasing professionals. Leasing is viewed more as a product than as a career, an industry, or an identity. While some recent start-ups and new players are creating a sort of re-birth of entrepreneurialism, the majority (by number) of potential candidates unfortunately perceive leasing as an industry with ill-defined and limited overall "opportunity." This will become an increasingly important dynamic in the future, as the generation of "founders" leaves the industry, and the bi-polar trend continues.

The Future: Not A Singular Vision

Leasing's future appears to be directed at doing things differently as well as doing different things. When leasing companies are created now, they are likely to be built around new efficiencies in doing what leasing has done traditionally. Tax and accounting regulation will continue to provide challenges to lease structures, and the creativity of the industry will be tested constantly. This, of course, is the industry's past as well as its future.

Innovation has been a hallmark of the leasing industry since its foundation, and the future will belong to those who continue to embrace the value of creativity in both what they do, and how they do it. "This forces you into thinking about how to create a competitive edge," said one lessor. Throughout the history of leasing in the U.S., changes in tax laws, accounting rules, documentation requirements and access to capital have inspired constant evolution and creativity in deal structures as well as in the manner and method of conducting business. The Council feels that the primary emphasis of today's innovation is focused on process, support systems, automation and leveraging human talent with technology. The ability to process applications, provide approval in minutes, and complete documentation immediately is no longer an innovative differentiator – it is the standard in small ticket leasing. The requirement that systems be "open and transparent", so lessees and lessors are both able to see and track their assets in real-time has become the standard. Automated bid analysis and comparison has become more prevalent, requiring an interactive pricing and bidding process.

Meanwhile, certain tools for access to capital, such as securitization conduits, are seeing such lowered volume that liquidity premiums are actually raising the resulting cost of funding for those relying on them. The Council sees room for creative solutions in funding.

In summary, the Industry Future Council concluded that current conditions provide reason for optimism in certain segments, but concern in others – particularly in large ticket segment. As rates increase, pricing will also, though there could be pressure on spreads during the period of change. Consolidation will continue to restrict the number of lessors, creating opportunity for a new wave of creativity and innovation to provide differentiation. But regardless of change in conditions, the traditional resilience and creativity, which has characterized the business since its inception, is expected to provide new solutions for the leasing industry – an important source of capital for America's growth.

For more information about the equipment lease financing industry visit, www.leasefoundation.org

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