State of the Industry 2004
The premier provider of industry research.

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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The Equipment Leasing and Finance Foundation wishes to express appreciation to the following company for providing the sponsorship to support development of the 2004 State of the Industry Report:

SAP
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October 2004

Dear Equipment Lease Finance Experts,

I am pleased to provide you with this copy of the Equipment Leasing & Finance Foundation’s 2004 State of the Industry Report. Because the State of the Industry may be the most important leasing-related report you’ll read this year, I urge you to go through it carefully, and use it as an aid in your strategic planning.

Like every Foundation initiative, the Report focuses on the future. It combines analyses of ELA’s 2004 Survey of Industry Activity, independent research and government data, with interviews with key leasing executives in all major industry segments to provide a comprehensive picture of the industry in the near-term. The Report is an invaluable tool to help you move your company forward.

The annual State of the Industry Report is just one example of your Foundation contributions at work for you. All of our forward-looking research products, from the Industry Future Council Report to the recently released Indicators of Success Report are made possible by your generous donations. You see, the Foundation is funded entirely by contributions from companies and individuals across the equipment leasing and finance industry. Our donors understand that they are investing in the leasing industry, and in their own companies.

If you agree that the State of the Industry Report and other Foundation publications are valuable to your business, I ask you to continue to contribute to the Equipment & Finance Foundation. Please visit the Foundation’s Website at www.leasefoundation.org to learn more about what the Foundation provides for you.

Sincerely,

James R. Renner
Chairman
Equipment Leasing & Finance Foundation
Dear Equipment Leasing Association Member,

“To provide future-oriented, in-depth, independent research for the equipment leasing industry”

You may recognize the words above. It’s the mission of the Equipment Leasing and Finance Foundation.

As Chief Executive Officer of SAP America, Inc., I appreciate our company’s opportunity to support the Foundation’s critical mission and, in particular, to provide sponsorship for its 2004 State of the Industry Report.

The Foundation’s activities, as evidenced in this fact-rich report, help SAP gain a greater understanding of the issues facing you and your colleagues. Those activities also help us maintain our position as a leading provider of enterprise applications to the Equipment Leasing and Finance industry.

Did you notice the word “future-oriented” in the Foundation’s mission statement? That word is particularly relevant to all that SAP does to help its customers create sustainable competitive advantage and operational excellence.

Whether it’s flexible, service-oriented architectures or solutions for regulatory compliance, our own mission is one that is, without question, progressive and “future-oriented.” We provide the tools that rationalize business processes, create new efficiencies, service customers, and enable truly “adaptive organizations.”

Now, I would like to ask a favor of you that is in the spirit and substance of the State of the Industry Report. Tell us how we’re doing and how we can improve.

Please use the following e-mail address, AFL.America@sap.com, and let me know how we can be an even more effective business partner in your industry. I look forward to reading your e-mails.

And, again, please accept my personal thanks for this important sponsorship opportunity.

Best regards,

Bill McDermott
CEO and President
SAP America, Inc.
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) 2004 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, middle market and small business financial services, commercial cards, and the affluent market. In addition to our U.S.-based experience, we have successfully conducted engagements in the E.U. as well as a number of emerging markets, including Bangladesh, Egypt, and Indonesia.

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 industry experts. FIC conducted in-depth interviews with 19 industry experts representing a cross-section of lessor types, ticket sizes, and industry vendors.

The Survey reflects fiscal year-end 2003 performance. Therefore, it cannot present a fully accurate picture of the leasing industry today. Overall, business investment in equipment continued to increase through the first half of 2004. However, some industry sectors, equipment types, and leasing products remain weak.

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:

James S. Beard – Caterpillar Financial Services Corporation
Laird M. Boulden – RBS Lombard, Inc.
Douglas H. Bowers – Bank of America
Edward Castagna – Nassau Asset Management
Edward A. Dahlka, Jr. – LaSalle National Leasing Corp.
David E. Harmon – El Camino Resources, Ltd
Robert J. Hunter – CitiCapital
David A. Merrill – Fifth Third Leasing Company
Ronald Riecks – CIT Equipment Finance
Irving H Rothman – HP Financial Services
Gary R. Shivers – Marlin Leasing Corporation
David H. Smith – CitiCapital
Charles C Thomas – IBM Global Financing
John F. Unchester – Chase Equipment Leasing
Richard A. Venturi – SAP America, Inc.
William H. Verhelle – First American Equipment Finance
Lawrence A. Watts III – Bank of America
William T. Zadrozny – Siemens Financial Services, Inc.
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.

The lessor types analyzed in this report fall into three categories: Banks (either separately-operating subsidiary or integrated), Captives, and Independent, Financial Services lessors.

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

Bank 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 lessors are the subsidiaries of dealers or manufacturing companies. At least 50 percent of the lease portfolio consists of products produced by its parent and/or affiliates. They may also finance other companies' products.

Independent, Financial Services lessors are usually finance companies offering leases directly to businesses and are not affiliated with any particular manufacturer or dealer; alternatively, an Independent 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-ticket ($250,000-$5 million), and large-ticket (over $5 million).

We begin this report with an overview of the leasing industry, including an estimate of the size of the equipment leasing market, and analysis of the dynamics impacting industry drivers and related implications.

Following the industry overview, we present an analysis of the Survey of Industry Activity. This discussion highlights a number of important areas, including: new business origination, profitability and funding, credit quality, and operations. In addition, our analysis discusses current performance, ongoing challenges, and potential opportunities by lessor type and transaction size.

New in this year’s Report, we profile two Independent Financial Services lessors that have built successful businesses despite an increasingly difficult environment for smaller lessors:

- **Marlin Leasing** - In November 2003, Marlin Leasing launched the first public offering of a leasing company in a number of years. In a recent press release, it announced record earnings for the second quarter of 2004.

- **First American Equipment Finance** – Ranked one of the fastest growing privately-held companies in the U.S. by *Inc Magazine*, First American has achieved its success in part through its unconventional sales-and-service model.

In addition, we profile a Bank lessor, **Chase Equipment Leasing**, that has demonstrated its ability to break through internal organizational barriers in order to effectively cross-sell leasing to its existing customers.
Our purpose for including these company profiles in this year’s Report is to highlight that opportunities continue to exist for companies that are able to “think outside the box” in developing their value proposition and effectively execute the tactical steps required to deliver it.

As strategy consultants to the leaders in the financial services industry, we have, throughout this report, offered our perspective on how the critical issues identified may impact the leasing industry. Where possible, we have offered insights into how best practice players are reacting and what lessors can do to create opportunities in the market today.

**Financial Institutions Consulting**

Charles B. Wendel, President
Matthew L. Harvey, Senior Engagement Manager
EXECUTIVE SUMMARY

While many economists now project strong growth in the production and sale of equipment, the leasing industry remains challenged by competitive, legislative, and regulatory issues. From our analysis of the Survey and our interviews with industry leaders, several key messages emerge:

Leasing volume and penetration declined in 2003 – Despite an overall increase in business investment in equipment, respondents to this year’s Survey reported a year-over-year decrease in volume. In addition to a sharp decline in large-ticket volume, low interest rates and bonus-depreciation rules may have reduced the attractiveness of leasing versus buying, reducing the use of leasing as an equipment financing vehicle.

However, many expect both volume and penetration to improve – In addition to anticipated increases in equipment investment, many industry insiders expect that both increasing interest rates and the expiration of bonus depreciation will contribute to an overall improvement in new business origination.

Profitability improved through operational efficiency – Although both new business volume and average pre-tax spreads dropped, this year’s respondents reported improved profitability. Return on Equity (ROE), Return on Assets (ROA), and Net Income Before Taxes (NIBT) improved significantly over the previous year, the result of reduced operating costs and improved credit quality.

The competitive environment has changed – The industry’s competitive environment has changed due to the commoditization of the leasing product, as well as Banks’ increasing cross-sell capabilities. The customer access advantage that both Banks and Captives possess will become increasingly difficult for Independents to overcome. As their cost of acquiring customers becomes prohibitive, Independents will become more niche-oriented, or will focus on operating captive and vendor programs on a branded or private-label basis.

Some non-bank lessors express the view that Banks are not necessarily long-term players and are likely to exit the leasing industry if “things get tough.” Our sense is that banks view leasing as an important cross-sell and growth opportunity. Most Banks are now in leasing to stay.

However, the adoption of the Basel II Capital Accords may significantly impact Banks’ competitive capabilities in the leasing industry. Although lessors remain unsure of the specific impact, the Accord could increase Banks’ cost of capital for leasing transactions.

The large-ticket segment remains distressed – Legislative, regulatory, and accounting issues will profoundly impact the industry, particularly the large-ticket segment, in the near-term.

Recent changes in the accounting treatment of Variable Interest Entities (VIE) (also called Special Purpose Entities [SPE]) and residual guarantees have reduced the use of synthetic leases as well as the use of Commercial Paper conduits for funding. In addition, negative public perception of VIE/SPEs has contributed to the decrease in highly-structured transactions.
Pending legislation may reduce or eliminate sale/leaseback transactions with tax-exempt entities, further reducing volume in the large-ticket segment.

Beyond legislative and accounting issues, large-ticket volume is also suffering from cyclical slowdowns in commercial aircraft and railcars. As a result of sharply reduced volume in the segment, many large-ticket players are increasing their efforts in the middle-ticket. The increased competition in the middle-ticket is contributing to the decline in pricing and yields.

Despite the continuing challenges, growth opportunities exist for lessors that have identified and articulated their value propositions and aligned their organizations to deliver their “solutions” efficiently. Those players lacking a clear market, product, and channel focus will see their performance steadily deteriorate.
LEASING INDUSTRY OVERVIEW

Overall, the equipment leasing industry appears to be recovering from several years of slow or negative growth. Through the first half of 2004, the continuing economic expansion appears to have halted the three-year decline in business investment in equipment. Many economists expect improvement in business investment during the second half of the year.

Changes in the primary industry drivers have significantly affected segments of the industry. The uptrend in the economy, the key driver, has positively impacted the industry. However, recent legislative issues have altered the viability of some products. A stronger competitive environment has further limited the ability of certain lessor types to compete effectively.

Market Size

About ten years ago, the U.S. Department of Commerce estimated that leasing finances approximately 30 percent of new equipment investment. While industry executives believe that statistic remained relatively consistent until last year, many believe that several factors caused leasing penetration to decline in 2003.

A number of leasing executives believe that record low interest rates, along with increased front-loaded depreciation benefits allowed by the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Bonus Depreciation) may have significantly reduced the benefits of leasing versus buying. These factors, along with a substantial decline in high-dollar commercial aircraft, reduced the lease penetration rate in 2003.

The Commerce Department’s calculation of the 2003 Gross Domestic Product (GDP) reported a slight increase in Business Fixed Investment in Computers and Equipment (BFI). However, as shown in Figure 1, FIC estimates that the overall leasing market shrank to approximately $194 billion. This is due to lower leasing

![Figure 1](image-url)

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1 We estimate leasing volume based on the cost of new equipment, excluding non-embedded software. We do not include the value of used equipment or lease renewals. We also do not include the value of non-equipment lease transactions.
penetration as well as to the drop in volume in commercial aircraft.

Through second quarter 2004, the Commerce Department reported annualized BFI of $735 billion\(^2\), a nearly ten percent increase over the previous year. FIC estimates that leasing penetration will improve slightly, as rising interest rates increase the attractiveness of leasing over buying. We estimate total leasing volume at approximately $220 billion in 2004.

As shown in Figure 2, GDP data for second quarter 2004 indicates that “other equipment” (including furniture and fixtures, agricultural machinery, and construction equipment) will grow 14.3 percent over 2003. Transportation and computer equipment will also show strong growth, increasing 14.1 percent and 12.2 percent, respectively, over the previous year. Non-computer-related IT equipment (including communications, medical, and office equipment) shows the least growth, less than four percent.

One factor that may impact 2004 leasing volume involves the large cash position of many U.S. companies. In a recent survey of over 400 large corporations, Fitch Ratings reported that, due to a large increase in cash reserves, Corporate America has enough cash on hand to fund its capital expenditures for over a year.\(^3\) A number of Captive leasing executives believe that, particularly for smaller ticket transactions, companies are likely to use cash to purchase equipment. However, this should be a short-term trend as companies run-off their cash positions to normal levels.

For 2005, the National Association for Business Economics (NABE) projects a nine percent increase\(^4\) in BFI to over $800 billion. We believe that a continuing rise in interest rates as well as the end of Bonus Depreciation (currently scheduled to expire December 31, 2004) will continue to increase the percentage of new equipment financed through leasing. We project that total leasing volume will approach $248 billion in 2005.


\(^3\) FitchRatings: U.S. Corporate Credit Recovery Gathers Momentum, July 13, 2004

\(^4\) National Association for Business Economics: NABE Outlook, May 2004
Estimates of future growth are, by definition, uncertain. Any number of events, some economic and some political, can derail economic growth.

**Market Drivers**

At its annual meeting earlier this year, the Industry Future Council identified a number of key industry drivers, among them:

- Economic Conditions
- Legislative, Regulatory, and Accounting Issues
- Funding Access
- Competitive Environment

**Economic Conditions**

Many analysts agree that economic conditions, particularly business fixed investment in equipment (BFI) and interest rates, drive the industry.

In a July 2004 press release, NABE projects continuing strong demand for capital equipment. In a survey of its members, 61 percent of respondents expect to increase their firm’s capital spending in the coming year. Other indices, including the U.S. Department of Commerce’s reports on Manufacturing and Trade Inventory and Sales, indicate the potential for continued economic improvement.

Even after the Federal Reserve’s 25 bps increase in short-term interest rates in late June, rates remain among the lowest levels in decades. While generally viewed as beneficial for the economy by lowering businesses’ and consumers’ cost to borrow, low interest rates can reduce the demand for leasing. One widely seen benefit of leasing versus borrowing is that by factoring in the equipment’s residual value, the monthly payments and the effective interest rate on a lease are generally less than a loan. As interest rates decline, the impact of the residual value on the monthly payment decreases, particularly for technology and other equipment with little residual value. This equipment makes up almost 30 percent of the Survey’s new business volume. However, as interest rates increase, the lease-versus-borrow benefit should become clearer.

**Legislative, Regulatory, and Accounting Issues**

While interviewees did not report significant difficulties resulting from FASB Interpretation Numbers (FIN) 45 and 46 (related to accounting for lease-related guarantees and variable interest entities, respectively), a number of pending legislative, regulatory, and accounting issues currently impact the industry or may do so in the future. Most significantly, pending budget legislation has effectively ended all cross-border sale-leaseback transactions. In addition, Basel II and the perennially imminent conversion to International Accounting Standards will impact many segments of the leasing industry.

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6 National Association for Business Economics: *NABE Panel: This Economy is Strong*, July 2004
The most significant issue resulting from FIN 46, Consolidation of Variable Interest Entities (VIE) may be perceptual rather than procedural. VIEs (also known as Special Purpose Entities) have legitimate uses in structured finance. However, the collapse of Enron and its alleged use of VIEs to fraudulently manipulate its books have created wariness at many publicly-traded companies concerning any type of off-balance sheet accounting vehicle. As a result, many large-ticket lessors have reported a significant decline in synthetic leasing volume.

In addition, FIN 46 may have reduced the use of Commercial Paper conduits. Under FIN 46, either the sponsoring bank or the third-party first-loss provider must report the entity on its balance sheet, making the conduits a less-attractive financing mechanism. According to the Federal Reserve, non-financial Commercial Paper outstandings have declined nearly 25 percent since the beginning of 2003.

Legislation pending in both the U.S. House of Representatives and the U.S. Senate seem likely to end, or severely limit the benefits of, sale/leaseback transactions with tax-indifferent parties. These arrangements, which involve an investor purchasing an existing asset of a tax-exempt entity and then leasing it back to the entity, take advantage of depreciation-related tax benefits. Some Congressional leaders view this as only a tax-related transaction with no economic benefit. Since both the House and Senate versions of the legislation are retroactive, activity in this area has virtually ceased.

On July 27, 2004, central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries formally endorsed the new capital adequacy framework commonly known as Basel II. The new framework expands on existing capital adequacy requirements and adds a coverage element for operational risk.

While U.S. regulators limit mandatory compliance to banks with assets exceeding $250 billion or foreign assets exceeding $10 billion, E.U. regulators have indicated that they will require most banks as well as commercial finance companies operating within the E.U. to comply with Basel II requirements. U.S. regulators will require any bank adopting Basel II to use the most advanced of the three methods for calculating risk and reserving capital. The Foundation publication, The Basel II Accord: What Does It Mean for the North American Leasing Market? provides an excellent explanation of the Accord and its potential impact on the leasing industry.

A number of leasing executives believe that they will benefit from the implementation of Basel II, either through a reduced cost of capital or through an increase in competitors’ cost of capital. However, executives of smaller lessors that depend on bank credit for funding believe that their overall cost of funding will increase. Executives also emphasized the data gathering and reporting complexities inherent in Basel II compliance.

For a number of years, the leasing industry has been discussing the adoption of International Accounting Standards (IAS), particularly related to defining operating versus finance leases. In September 2002, the Financial Accounting Standards Board (FASB) and the International
Accounting Standards Board (IASB) signed a Memorandum of Understanding agreeing to “make their existing financial reporting standards fully compatible as soon as practical.”

FASB identified a number of differences between U.S. GAAP and International Financial Reporting Standards (IFRS) that it believed it could either reduce or eliminate in the short-term. It has set September 30, 2004 as the target date for issuing final statements covering those differences. The issues discussed in the short-term convergence project did not include leasing-specific accounting differences. FASB and IASB have agreed to continue resolving differences through joint projects beginning in 2005.

One primary issue for the leasing industry is International Accounting Standard (IAS) 17, which narrows the definition of an operating lease. Under IAS 17, a lease is classified as a finance lease if it transfers substantially all the risks and rewards of ownership. While this definition is very similar to GAAP, IFRS is a principle-based rather than rule-based system. Therefore, it is the intent of the transaction, not its form, which dictates its treatment. As such, many transactions currently considered operating leases may need to be treated as finance leases, recorded on the lessee’s balance sheet as an equipment asset and financing liability. The lessee would receive tax benefits for depreciation and interest expense, not for rental payments.

The ELA identifies tax treatment and balance sheet management among the top reasons that companies choose an operating lease over a finance lease or loan. In restricting the ability to structure transactions as operating leases, the adoption of International Accounting Standards may further erode the benefits of leasing.

**Funding Access**

Most industry insiders agreed that there is an excess of capital in the market. In the words of one lessor, “Our biggest problem is too much capital chasing too few deals.” While Banks typically have the funding advantage, some other lessors also have ready access to low-cost funding. Captives with financially strong parents, as well as a few highly rated Independents, often obtain lower-cost funding through the commercial paper or debt markets. For other players, while some sources are more difficult to access, funding is available, although at a higher cost.

The ability to access low-cost deposits gives bank-owned lessors a funding advantage over other lessor types. Over the past three years, the economic downturn and unstable investment climate have contributed to an increase in bank deposits, ultimately increasing the funds available for investment. Although deposit growth has slowed in the past six months, many banks continue to focus on asset growth. Given the abundance of capital, and recognizing the profit and customer-retention potential of leasing, many banks are increasing the resources available to their leasing units.

Captives with investment-grade parents and investment-grade lessors such as GE and CIT also have access to ample capital through the commercial paper and debt markets. As noted above, FIN 46 may have reduced the attractiveness of low-cost commercial paper as a financing option, causing companies to turn to the more expensive bond and securitization markets. Figure 3 shows that Survey respondents’ use of Commercial Paper Conduits declined by nearly 25
percent, from 59.5 to 45.0 percent of total securitization volume. As noted elsewhere in this Report, Independent, Financial Services and Captives reported a smaller year-over-year decrease in funding costs than did Bank lessors, indicating increased usage of more expensive funding sources.

Interviewees from smaller Independent, Financial Services lessors believe that they have sufficient access to capital. However, they noted that their access to the debt and securitization markets is generally limited, leaving them dependent on bank credit or venture capital.

Since peaking in 1999, volume in public offerings of lease-backed securitized assets declined nearly 60 percent through the end of 2003 (Figure 4). Through the end of second quarter 2004, volume is on track to decline an additional 53 percent. However, as indicated in Figure 3, Survey respondents shifted securitization volume from Commercial Paper Conduits to Public Offerings and, particularly, Private Placements.

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8 Note that Survey data is dollar-weighted. Therefore, cost of funds data for Independent, Financial Services lessors is reflective of the largest players in the category.

9 In Figure 4, 2004 estimated volume represents annualized June 30, 2004 data.
According to industry analysts, the market has restricted Public Offerings to only those lessors with sterling track records and strong management teams. In recent years, the failure of a number of commercial finance companies caused issue pricing to incorporate not only the underlying securitized asset, but also the credit and experience of the issuer. For many, the cost of securitizing leasing assets through Public Offerings became prohibitive. However, since the SEC does not regulate Private Placements (sales to small groups of private investors) these types of transactions are often a less expensive and more available alternative.

However, adequate (albeit more expensive) funding appears to be available through bank credit and venture capitalists. While at present, well-qualified lessors have access to sufficient bank credit, many interviewees believe that banks may consider the entire industry unattractive if they experience even a few losses. In addition, as consolidation in the banking industry continues, lessors relying on multiple banks for credit may find themselves forced to establish new bank relationships. For example, a lessor with credit lines at two merging banks may find the new entity is unwilling to extend the same amount of credit the lessor had with the two pre-merged banks. For the lessor, one plus one may equal something less than two.

**Competitive Environment**

Consolidation continues to impact the competitive landscape. Big Banks’ growing dominance of the industry, as well as large Independent, Financial Services firms’ acquisition of portfolios and smaller competitors, continue to contribute to the “Whale and Minnow” syndrome. In addition, Captives appear to be increasing their focus on the parents’ products and either exiting or reducing their activity in outside non-core financing.

**Banks**

In recent years, Banks have doubled their leasing market share. Their renewed emphasis on growth and the capture of an increased share of customer wallet, in addition to accounting and regulatory changes, points to Banks increasing their impact on the leasing industry in the future. However, discontinuities around Bank consolidation may offer competitors some limited opportunities.

According to the Survey, Banks’ share of the leasing market (by new business volume) more than doubled from 21 percent to 44 percent between 1997 and 2003\(^\text{10}\). Banks’ success appears to be at the expense of Independent, Financial Services lessors. Over the same period, their market share declined from 61 percent to 30 percent while Captives’ share remained relatively constant.

Banks’ success at the expense of Independent, Financial Services lessors indicates that their share increase is due to a customer relationship advantage, not just to a cost of funds advantage. Banks have an existing financial services-based relationship with nearly every potential lessee in the country. It has only been recently, however, that most have focused on leveraging this relationship advantage. In comparison, Captives base their relationship with the customer on the equipment sale; Independent, Financial Services lessors have no natural basis for a relationship and must instead “hunt” for each new customer.

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\(^{10}\) Survey 1998 and 2004
In 1999, few of the Bank lessors we interviewed for that year’s *State of the Industry Report* had developed a marketing focus on existing bank customers. Some executives of bank-owned lessors went so far as to state that they explicitly avoided bank customers because of internal difficulties in dealing with the bank relationship manager (RM) and the commercial banking organization. Typically, in the lessors’ view, the RM did not understand leasing. Most important, the bank did not compensate him/her for selling a lease to a customer. On the other hand, bankers were well compensated for selling a term loan or line of credit. In some instances, the RMs’ personal economic interests took precedence over what may have been best for the customer.

Given that environment, many Bank lessors believed it was more effective for them to build their own sales force and sell directly rather than try to sell through internal customers. However, in the past two years, a number of factors have caused a marked shift in attitude and practice at many bank-owned lessors:

- For the bank parent:
  - Fewer organic growth opportunities
  - Greater understanding of leasing’s profitability
  - Greater appreciation of the customer-retention value of leasing

- For the bank-owned lessor:
  - Reduced growth rate in a slow market
  - Mandate from bank parent to improve cross-sell rate

Banks have pursued a number of approaches to encourage cross-sell. A few have made organizational changes designed to improve senior management responsiveness and accountability. Several of the largest banks operate with both leasing and the middle market reporting to the same senior executive. At least one major bank has separated out its small-ticket operation, putting it in the small business organization.

Furthermore, many banks have changed their compensation policies to shadow leasing revenue back to the RM. In addition, improvements in MIS at some banks give the relationship manager a detailed understanding of the profitability of a lease versus a loan. Since leases often generate higher profitability than loans, giving the RM access to profitability data (as well as compensating him or her for overall customer profitability) can turn that traditional banker from a gatekeeper/barrier to a champion of the leasing product.

Product simplicity is also important for improving leasing’s “share of mind” with the RM. With a few notable exceptions, many Bank lessors focus primarily on cash flow lending rather than on collateral valuations, and, thereby, take little residual risk. This limited scope further increases the similarity between leasing and traditional equipment finance and may simplify product training for the RM. Given the increasing number of products that banks require RMs to sell, lessors recognize the importance of product simplicity.

Bank lessors’ cross-sell success varies widely (Figure 5). At one extreme, Bank E sees only 10 percent of its deals flowing from the commercial bank. At the other extreme, Bank D views itself
as a “captive of the parent company” and, therefore, depends entirely on bank-generated leads. Other banks cited show percentages approaching the 50 percent range. We see banks becoming increasingly skilled at cross-selling leasing into their existing customer base, offering price and convenience as their value proposition. This emphasis will result in the percentage of lease deals originated from bank customers exceeding current levels.

Given the depth of their overall customer relationships, particularly with small- and medium-sized companies, Banks lessors hold a natural and, in some instances, overwhelming advantage in accessing the customer.

In addition to banks’ enhanced focus on increasing their share of customer wallet, many of the legislative and regulatory changes described above may contribute to their increasing dominance of the leasing industry.

As a result of these regulatory and accounting changes, industry experts believe that lease transactions will increasingly resemble traditional loans. Competitive advantages related to product innovation and deal structuring may be disappearing, reducing lessors’ ability to differentiate themselves by anything other than their cost of capital, risk-adjusted price, and a relationship-based sale. As capital cost and pricing become the main differentiators, access to reliable, low-cost capital and the ability to effectively deploy it rapidly become dominant competitive advantages. Top banks both have access to capital and know how to deploy it.

Independent, Financial Services

It is within the Independent, Financial Services lessor type that the dichotomy between large and small players is most striking. As shown in Figure 6, the number of Independent, Financial Services lessors in the Monitor 100 (by assets) declined 35 percent between 1993 and 2003.\textsuperscript{11} Between 1997 (earliest available data) and 2003, the number of Independent, Financial Services members in the ELA increased from 283 to 287 while their percentage of new business volume generated declined over 50 percent.

\textsuperscript{11} Monitor 100, 1994 and 2004
Given that the two largest Independent, Financial Services lessors generated over 32 percent of all new business volume in 2003, the trends represented in Figure 6 indicate that many, if not most, Independents have become smaller, niche players over the past ten years. As one executive stated, “Independents disappear one of two ways: either they are badly run and go out of business, or they are successful and get acquired.”

Executives of Independent, Financial Services firms state that they compete both on service and by targeting market niches that larger players overlook, such as vendor programs for smaller manufacturers and dealers. Since they are typically unable to compete against larger players on price, Independents compete on the customer experience they provide. To interviewees, “good service” means providing an outstanding customer experience. One-page applications, low documentation, rapid turnaround, and a single point of contact within the company are elements that Independents consider important to customers.

**Captives**

Typically, Captive lessors’ competitive advantage rests in their ability to wrap the financing with the equipment purchase at point-of-sale and in their knowledge of the equipment for both calculating residuals and for disposition or remarketing. While Captives offer a variety of reasons for extending their activities beyond their parent’s products, a number of Captives have recognized that they generally have little value proposition outside of their parent’s asset class; many have pulled back from general leasing.

This year’s Survey reports that nearly 40 percent of new business volume originated either in a captive or vendor program -- that is, the customer arranged financing at the same time he/she purchased the equipment. That percentage increases significantly for small- and micro-ticket transactions. Equipment purchasers, particularly on the lower end, seem to appreciate the convenience of wrapping the equipment purchase and the financing into one transaction with one person. In addition, a number of manufacturers, most notably in the auto industry, offer

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exceptional rates or terms in order to encourage the sale of the equipment, making the captive finance option even more attractive to customers.

Captives’ equipment knowledge gives them the advantage not only in calculating residuals, but also in structuring replacement, removal, or remarketing deals with the customer. As one Captive leasing executive noted, “Who else but the manufacturer would be in a position to remove and remarket 5,000 desktop computers coming off lease in ten countries for the same client at the same time. You cannot take a PC from Germany and sell it in Ohio. Only the manufacturer can handle that.” In addition, some Captive lessors work with the design and manufacturing people to correct design issues that can hamper refurbishing or reselling equipment.

For a variety of reasons, some Captives have extended their equipment finance activities beyond their parent’s products. Most Captives will finance competitors’ equipment packaged along with their own. For example, if a customer is purchasing an IT project comprised of 1,000 PCs from Company X and 150 servers from Company Y, Company X’s Captive is likely to finance the entire project. Over the past several years, a number of Captives have moved beyond financing core equipment and developed significant general leasing businesses. For some of the largest, non-captive activities generate up to 50 percent of new business volume. Among the reasons industry executives give for expanding beyond pure captive leasing include diversifying the Captive’s portfolio and providing an investment vehicle for excess capital.

However, a number of Captives, including Boeing Capital, have recently reversed course, returning to their core practice of financing their parent’s equipment. In addition, a number of equipment makers have left the financing business completely, including Bombardier, IKON, and OCE.
ANALYSIS OF THE SURVEY OF INDUSTRY ACTIVITY

This year’s Survey of Industry Activity represents 135 survey responses from 128 companies. A number of companies provided separate surveys for each line of business. Each year’s Survey asks respondents for current and prior year data; data charts comparing two years’ data only include respondents providing information for both years. Since the respondent set varies each year, it is not possible to compare absolute numbers between different years’ Survey Reports. However, the Survey Administrator, PricewaterhouseCoopers, analyzed data from a number of years and determined that the relative data (for example, percentage of new business volume generated by a specific lessor type, or percentage of new business originated through a certain channel) is statistically accurate. Therefore, some of our analysis of the Survey relies on relative, not absolute, data.

We have organized our analysis of this year’s Survey into the following major components:

- Overall Industry
- Lessor Profitability
- Transaction Size Profitability

In addition to providing data by lessor type and transaction size, this year’s survey provides data by lessor size (by annual volume). This Report does not provide separate analysis by lessor size. However, since much of the Survey data is dollar-weighted (meaning that the largest-volume lessors heavily influence the results), there are times when analysis by lessor size can provide additional insight into the data’s meaning. In those cases, we incorporate lessor size information into our explanation.

Overall Industry

Most interviewees indicated that business improved significantly in the second half of 2003. While new business volume, average pre-tax yield, and average pre-tax spread all declined, profitability, measured by Return on Equity (ROE), Return on Assets (ROA), and Net Income Before Taxes (NIBT) as a percent of revenue all increased. This increase in profitability, despite the decline in both volume and margins, indicates that lessors continued to streamline operations and improve efficiency.

Our discussion of the overall industry includes analysis of the following areas:

- New Business Origination
- Profitability and Funding
- Portfolio/Credit Quality
- Operations

New Business Origination

For the fiscal year ended 2003, respondents reported a 3.9 percent decline in new business volume (Figure 7). Not surprisingly, large lessors (those with annual volume exceeding $1
billion) contributed the largest share of new business, 83.1 percent. Volume for large lessors declined 3.5 percent. The smallest lessors, those with annual volume less than $50 million, posted a 3.2 percent volume increase, although they contributed less than one percent of total new business volume.

By channel, new business volume changed little from 2002 (see Figure 8).

Vendor and captive programs generated approximately 40 percent of new business in both 2002 and 2003. Approximately 53 percent of new business was originated directly and seven percent was originated through third parties. Large lessors, those with annual volume exceeding $1 billion, generated only four percent of their new business through third-party relationships. Lessors with annual volume less than $1 billion generated, on average, 21 percent of their new business through third parties.

As shown in Figure 9, the top five end-user industries generated nearly 60 percent of new business volume, a less than one percent decline from the previous year. New business volume from three of the top five end-user industries — industrial/manufacturing, wholesale/retail, and construction — declined, while volume from trucking and non-health-related services increased. Overall, transportation services, bus/transit systems, and...
Federal, state, and local governments generated the largest year-over-year percentage increases. Air transportation, mining/oil and gas, and utilities posted the largest year-over-year percentage declines.

The five largest equipment categories generated over 52 percent of new business volume in 2003, virtually unchanged from the previous year (Figure 10). Volume increased in computers, trucks and trailers, and construction equipment. Volume in aircraft and railroad equipment, both large ticket categories, declined over the previous year. As Figure 10 shows, with one exception, the largest year-over-year changes in volume occurred in some of the smallest equipment categories. Volume in materials handling equipment, representing 3.5 percent of this year’s total new business volume, dropped nearly 39 percent from 2002.

### Figure 9

**2003 New Business Volume by End-User Industry**

<table>
<thead>
<tr>
<th>End-User Industry</th>
<th>2003</th>
<th>2002</th>
<th>% of Total Volume</th>
<th>% of Total Volume</th>
<th>Change 2002 to 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Manufacturing</td>
<td>14.4%</td>
<td>14.4%</td>
<td>28.1%</td>
<td>28.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Other Non-Health Services</td>
<td>13.4%</td>
<td>13.4%</td>
<td>26.8%</td>
<td>26.8%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Wholesale/Retail</td>
<td>12.6%</td>
<td>12.6%</td>
<td>24.9%</td>
<td>24.9%</td>
<td>0%</td>
</tr>
<tr>
<td>Construction</td>
<td>11.3%</td>
<td>11.3%</td>
<td>22.9%</td>
<td>22.9%</td>
<td>0%</td>
</tr>
<tr>
<td>Truck Transportation</td>
<td>7.2%</td>
<td>7.2%</td>
<td>14.5%</td>
<td>14.5%</td>
<td>0.3%</td>
</tr>
</tbody>
</table>

Note: Trend data is provided only for respondents who reported both years of data.


### Figure 10

**2003 New Business Volume by Equipment Type**

<table>
<thead>
<tr>
<th>Equipment Type</th>
<th>2003</th>
<th>2002</th>
<th>% of Total Volume</th>
<th>Change 2002 to 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer Equipment</td>
<td>17.6%</td>
<td>17.6%</td>
<td>35.7%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Aircraft</td>
<td>11.0%</td>
<td>11.0%</td>
<td>21.9%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Truck &amp; Trailers</td>
<td>8.3%</td>
<td>8.3%</td>
<td>16.2%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Construction</td>
<td>6.8%</td>
<td>6.8%</td>
<td>13.1%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Railroad</td>
<td>1.4%</td>
<td>1.4%</td>
<td>2.7%</td>
<td>-0.1%</td>
</tr>
</tbody>
</table>

Note: Trend data is provided only for respondents who reported both years of data.

Industry Perspective and Potential Implications

Industry leaders believe that, as in 2002, much of the investment in new equipment in 2003 replaced aging or outdated equipment. In their view, manufacturers and other companies have sufficient capacity to meet foreseeable demand and do not need to add additional capacity. In addition, legislation impacting sale/leasebacks could permanently eliminate volume related to these transactions.

Potential Implications

Slow growth in total leasing volume means that the focus becomes taking market share from competitors. Therefore, a lessor must develop a realistic value proposition based upon its internal capabilities and effectively communicate that value proposition to its target customers. Successful lessors also recognize that not all customers value the same characteristics. For example, some customers value low price above all else while others may be more interested in service or convenience, with low price playing a secondary role in the decision.

Profitability and Funding

Overall, profitability improved significantly. As shown in Figure 11, Net Income Before Taxes (NIBT) as a percentage of Total Revenue grew to nearly 23 percent, a 39 percent improvement over the previous year and its highest in five years. ROA increased 42 percent to match the five-year high of 1.7 percent in 2000. ROE improved 27 percent over the previous year to 14.3 percent.

Declining costs, rather than increasing revenues, were primarily responsible for this year’s improved profitability. While the average cost of funds fell nearly 30 percent (Figure 12), lessors were less successful than in previous years at maintaining pricing. The average pre-tax spread declined 30 bps over 2002, a 7.1 percent decline. As a result, lessors earned...
less revenue per deal than they did in the previous year. Despite the decline in revenue, lessors posted solid profits, indicating a more-than-compensating decline in operating costs.

Figure 13 shows pre-tax yield, cost of funds, and pre-tax spread by lessor size. On average, smaller lessors appear to be able to generate higher prices, more than offsetting their cost of funds disadvantage. However, despite their higher average pre-tax spread, the profitability of smaller lessors (depicted by NIBT as a percentage of total revenue) was substantially lower than that of larger lessors. The difference in profitability indicates that some small lessors have failed to achieve significant economies of scale.

A combination of increased regulatory and investor scrutiny and the anticipation of increasing interest rates appears to have changed the way lessors manage debt. Figure 14 illustrates the five-year history for two key coverage ratios: short-term debt as a percentage of assets and long-term debt as a percentage of liabilities. Since 2001, lessors have significantly decreased their short-term borrowing (most likely Commercial Paper) and increased their long-term debt. Regulation and investors’ lack of comfort with off-balance sheet liabilities helped push lessors out of the short-
As an added benefit, lessors may have been able to lock in historically low interest rates before 2004’s increases.

Industry Perspective and Potential Implications

According to industry executives, a combination of rising interest rates and increasing competition have caused pre-tax spreads to continue shrinking through the first half of 2004. Typically, lessors have been unable to pass interest rates hikes on to the client for a variety of reasons. On the small-ticket side, the rate card system creates delays in passing on rate increases. Many lessors traditionally update rate cards only quarterly or semi-annually, creating the possibility of a three- to six-month delay in increasing pricing. Middle-ticket lessors face increasing competition from large-ticket players that are hunting down-market. Typically, these Bank competitors have very low cost-of-funds as well as the possibility of making up any profits lost by undercutting competitors’ pricing through other parts of the client relationship.

Potential Implications

In recent years, a number of industries, from technology to airlines, have found customers increasingly unwilling to accept price increases without a corresponding increase in value. Lessors, particularly non-bank lessors unable to wrap a suite of products into a relationship, must continue to improve operating efficiency and innovate ways to improve the customer experience.
Portfolio/Credit Quality

Overall, portfolio quality improved significantly in 2003. Respondents reported that the percentage of delinquencies (receivables aged 31-days and greater) declined over 17 percent from 2002 (Figure 15). In addition, receivables aged over 90-days declined over 26 percent. However, as Figure 16 shows, portfolio quality of smaller lessors appears to be substantially below the quality of large players. While Bank lessors generating annual volume from $50-250 million bear primary responsibility for receivables aged over 90-days within that lessor size, portfolio quality is similar among lessor types within each other lessor size.

Charge-offs declined from 2002, although they remained above previous years’ levels (Figure 17). The Survey reports that the smallest lessors, those generating annual volume less than $50 million, charged off just over two percent of their average net lease receivables, compared with about one percent for larger lessors.
Industry Perspective and Potential Implications

Leasing executives agreed that portfolio quality continued to improve through the first half of 2004. As one executive pointed out, “As the economy improves, so does credit quality. And we saw continued improvement in the economy so far this year.”

2003’s very high delinquency rate among lessors generating between $50 – 250 million in annual volume appears to result in part from portfolio issues among Bank lessors in this segment. Aside from those specific cases, small lessors typically experience higher delinquencies than do larger lessors. Reasons include:

- Underwriting – Smaller lessors may not have the resources to develop or purchase sophisticated underwriting and credit scoring capabilities. Therefore, they may approve deals that lessors with more sophisticated processes would reject or structure more rigorously.

- Collections – Small lessors may devote fewer resources to collections activities than do larger lessors, choosing instead to concentrate on building volume. In addition, technology to create an efficient collections process is expensive and may be out of reach of the smallest lessors. As a result, customers may fall delinquent simply because no one is asking them to pay.

Potential Implications

- In an environment in which portfolio quality is improving due to macroeconomic factors but where growth is proving increasingly difficult to achieve, there may be a tendency to “buy” growth at the expense of credit quality. Lessors must avoid impulses to loosen credit standards. Further, in light of the continued decline in spreads, even small credit mistakes can hit the bottom line hard. Comments from industry executives suggest that some players may be doing “crazy” things to build volume.

Operations

This year’s Survey reports data on a number of aspects related to lessors’ operations, including:

- Equipment Remarketing
- Application Processing/Approval
- Employee Distribution and Efficiency
- e-Commerce Activity

For most metrics, the Survey does not provide comparative prior year data. In some cases, we use data from the 2003 Survey (reporting fiscal year 2002 information) to infer potential trends. Since the 2003 Survey’s respondent set differs from this year’s Survey, absolute comparison is not possible.
Equipment Remarketing

Overall, respondents report that over 53 percent of equipment (by fair-market value [FMV] lease volume) is purchased by the original lessee. An additional 22 percent is re-leased (leases renewed) to the original lessee. Of the 25 percent of equipment (by FMV lease volume) that does not remain with the original lessee, approximately half is refurbished and sold through wholesalers and half is leased or sold to a different end-user. This year’s remarketing activity remains consistent with the activity reported in the 2003 Survey.

While the percentage of leases renewed (by FMV lease volume) is consistent by lessor size, the smallest lessors (those with annual volume less than $50 million) are most likely to sell off-lease equipment to the original lessor. They are also least likely to refurbish off-lease equipment and sell to wholesalers or lease or sell the equipment to a different end-user, probably because small lessors lack the capabilities and resources to refurbish equipment.

Application Processing/Approval

This year’s Survey reports data on numbers and dollar amounts of applications processed, approved, and booked or sold. Eighty-eight respondents provided data related to their application processing activities compared with 135 respondents overall (approximately 65 percent). Therefore, the numbers of applications and dollar amounts in Figures 18 and 19 represent less than 50 percent of total new business volume. However, the ratios and trends presented are directionally correct.

Overall, respondents approved over 76 percent of submitted applications (Figure 18). By comparison, respondents to the 2003 Survey reported approving just over 67 percent of submitted applications\textsuperscript{13}, indicating an improvement in the credit quality of applicants. By application dollars, this year’s respondents reported approving approximately 72 percent (Figure

\textsuperscript{13} As noted elsewhere, the respondent sets for the 2003 and 2004 Surveys differ. Comparisons are directionally correct.
19), compared with just over 50 percent reported in last year’s Survey, again indicating a significant improvement in the quality of deals that lessors are receiving.

As Figure 18 shows, the smallest lessors (those with annual volume less than $50 million) reported a 91.5 percent approval rate, significantly higher than that reported by larger lessors. However, by application dollars (Figure 19) the smallest lessors’ approval rate is less than 60 percent, indicating that these lessors typically reject larger dollar deals. As also shown in Figure 18, the smallest lessors lost significantly more deals (by number of applications) than did larger lessors\(^\text{14}\). The percentage of deals lost by number of applications is significantly smaller than the percentage of deals lost by application dollars (Figure 19); hence, the deals lost by small lessors are typically smaller dollar deals.

\(^{14}\) We define lost deals as the difference between applications approved and applications booked and funded or sold.
Industry Perspective and Potential Implications

Overall, data related to application processing reinforce what most lessors have told us: that the economy has improved, and with it, credit quality. As long as lessors are not compromising credit quality to generate additional business, the increase in approvals is good news for the industry. It means lessors are seeing a larger number of better-quality deals.

However, lessors should also consider the amount and nature of deals lost. We define a lost deal as a deal for which a potential lessee submitted an application and the lessor processed and approved the application, but the deal was never booked and funded or sold. The lessee did not close that transaction, at least not with the same lessor. As shown in Figures 18 and 19, nearly 22 percent of both the applications submitted and the dollars submitted were lost.

While much of this “lost” volume probably remains within the leasing industry (i.e., another lessor gave that customer a better deal), clearly a certain amount of it leaves the industry altogether. We believe that the individual lessor, as well as the overall industry, should want to know where these lost deals went and why.

Potential Implications

The best players will continue to look for ways to do more with less, even as the economy picks up. Over the past several years, many of these lessors have, in the words of one manager, “...already cut every ounce of fat out of operations. If we cut anymore, we will be cutting muscle.” If this is true, the best players will look for other areas in which to achieve operational efficiencies, and stemming the flow of “deals that got away” will certainly be one obvious area.

Lessors that can perform honest post mortems on lost deals and use their findings to improve their products, service, and operations should see a rapid return on their investment. Because of the investment in sales and processing, a dollar of saved business is worth significantly more than a dollar of new business. Responding to why the customer left can quickly add to the bottom line.

Operational Efficiency/Productivity

Despite the decline in overall volume, lessors responding to this year’s Survey reported operating with approximately the same number of employees as in the previous year (less than one percent decrease). However, as Figure 20 shows, between 2002 and 2003, respondents reallocated employees (partly in response to economic conditions).

In order to maintain portfolio quality in the slow economy, respondents increased the human resources dedicated to collections from 4.2 to 6.2 percent of total full-time equivalent employees (FTE), a 47.5 percent increase, and portfolio management activities from 1.3 to 2.1 percent of total FTEs, a 61.5 percent increase. However, lessors appear to have reallocated those resources
from customer service activities, reducing customer service FTEs from 16.9 to 14.5 percent of the total, a decrease of over 14 percent.

Respondents generated less volume than the previous year with virtual the same number of staff. Because of that, operational efficiency (defined as dollars per FTE) generally declined (Figure 21\textsuperscript{15}). However, as

Figure 21 also shows, respondents reduced non-employee-related expenses (Operating Expenses and Depreciation per FTE) in order to generate higher Net Income (after taxes) than the previous year.

Figure 22 illustrates significant differences in New Business Volume per Sales FTE and New Business Volume per Credit Approval FTE between larger and smaller lessors. One factor explaining these differences is the segment in which a lessor operates. Because of the large amounts of capital required to fund middle- and large-ticket transactions, smaller lessors typically work in the micro- and small-ticket arenas which, by nature, generate fewer dollars per deal and require more staff to

\textsuperscript{15} Figure 21 compares 2004 Survey data with 2003 Survey data. As noted elsewhere, comparisons are directionally correct.
The text content appears to be discussing the operational efficiency and e-commerce activities in the equipment leasing and finance industry. It highlights that larger lessors are more likely to operate in the middle- and large-ticket segments due to access to required capital. This allows them to generate higher volume with fewer people than smaller ticket segments.

Technology is another reason larger lessors generate higher productivity per FTE in the credit approval area. Larger lessors are more likely to invest resources in credit scoring and auto-decisioning technology, increasing underwriter productivity.

**e-Commerce Activities**

Overall, only about one-third of respondents reported engaging in e-commerce activities, defined in the Survey Questionnaire as “business that is transacted electronically via the Internet, including any marketing, transaction processing, and customer service activities.” As Figure 23 depicts, larger lessors are more likely to engage in this type of activity, probably due to the resources required to construct and maintain an e-commerce infrastructure.

Of the Survey respondents engaging in e-commerce, 68 percent reported originating some new business volume via the Internet. As Figure 23 shows, those
lessors originated eight percent of their new business via e-commerce, a 31 percent increase over the previous year.

For those respondents engaging in e-commerce, front-end processing and end-user marketing were the most common activities, with nearly 70 percent of companies engaged in e-commerce reporting activity in these areas (Figure 24). While many interviewees discussed the importance of online customer service, relatively few lessors offer anything other than the ability to view payments and payment history. In addition, few lessors offer online asset management capabilities, another function that many interviewees describe as important to customers.

While the percentage of new business directly originated via the Internet is relatively low, the volume of new business facilitated by the Internet may be substantial. As shown in Figure 25, over 50 percent of Captives engage in e-commerce. They are also the lessor type most likely to directly originate new business via the Web, likely through point-of-sale financing of online purchases.
Industry Perspective and Potential Implications

In addition to originating new business directly via the Internet, many vendor and captive programs provide salespeople and dealers with Internet-based tools that allow them to give customers real-time pricing and, in some cases, decisioning information. Many programs also offer vendors and dealers online transaction processing and credit decisioning, providing rapid turnaround for their customers. While these tools may not create “new” business, they decrease the cost of generating existing business while enhancing the customer experience.

A number of years ago, many anticipated that the Internet would significantly change the way business is conducted. Banks talked about closing branches as customers transacted via online banking, and lessors built “Web Portals” through which, they believed, new business would flow with little or no effort on their part. Clearly, today’s reality is somewhat different. Lessors have found the Internet a much more effective tool for customer service and transaction processing than for generating new sales.

Potential Implications

Given the reality that many customers expect to have the capability to interact with their business partners online, it is surprising that only one-third of respondents report doing so. While lessors may have been reluctant in a difficult business environment to invest the capital required to build online capabilities, we believe that those lessors that offer multiple sales and service channels operate with a strong advantage over those that do not.

Lessor Profitability

Banks and Captives continue to take market share at the expense of Independent, Financial Services lessors. As shown in Figure 26, Independent’s share of new business volume has declined from nearly 53 percent in 1999 to less than 30 percent in 200316, a nearly 44 percent decline in share. Over the same period, Banks increased their share of new business by almost 60 percent and Captives increased theirs by almost 40 percent.

Over the past five years, Banks have consistently earned higher NIBT than other lessor types (Figure 27)17. However, as Figure 27 also shows, Captives have provided the highest return on investment (both ROA and ROE) over the same period and their earnings (NIBT) are only slightly lower than Banks’.

Banks

Bank lessors continue to grow their market share and generate respectable earnings for their parents. However, despite their increasing dominance of the industry, some believe that they will

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16 The data shown in Figure 26 is from each year’s Survey. As noted elsewhere, the respondent set differs for each year.
17 The data shown in Figure 27 is from each year’s Survey. As noted elsewhere, the respondent set differs for each year.
face significant challenges in the coming years. Nevertheless, we believe that Banks are more committed than ever to the leasing industry.

Bank respondents to this year’s Survey generated nearly 44 percent of new business, a 4.3 percent increase over the previous year for this year’s respondents (Figure 28). As in past years, Banks typically originate most of their new business volume directly. They also actively purchase business through brokers and other third-party sources (Figure 29).

Most Bank lessors receive their capital through their parent’s treasury department, typically funded by low-cost retail and business deposits. Not surprisingly, Banks enjoy the lowest cost of funds of any lessor type (Figure 30). However, for a number of reasons, Banks’ pricing (reflected by average pre-tax yield) is also low, earning them the lowest average pre-tax spread.

Figure 27

Figure 28 compares year-over-year data for the same respondent set.
Figure 28

2003 Total New Business Volume by Lessor Type
($ billions)

<table>
<thead>
<tr>
<th>% of Total</th>
<th>Total</th>
<th>Banks</th>
<th>Captives</th>
<th>Independent, Financial Services</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>110.5</td>
<td>48.4</td>
<td>29.4</td>
<td>32.7</td>
</tr>
<tr>
<td></td>
<td>115.0</td>
<td>46.4</td>
<td>29.4</td>
<td>39.2</td>
</tr>
</tbody>
</table>

Year-Over-Year

% of Total Volume

-3.9% 4.3% 0.1% -16.6%

Source: 2004 ELA Survey of Industry Activity

Figure 29

Total New Business Volume by Origination Channel by Lessor Type

<table>
<thead>
<tr>
<th>% of Total Volume</th>
<th>Banks</th>
<th>Captives</th>
<th>Independent, Financial Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>43.8%</td>
<td>62.5%</td>
<td>8.9%</td>
<td>11.8%</td>
</tr>
<tr>
<td>40.3%</td>
<td>56.4%</td>
<td>0.8%</td>
<td>14.4%</td>
</tr>
<tr>
<td>26.6%</td>
<td>8.9%</td>
<td>10.6%</td>
<td>3.4%</td>
</tr>
<tr>
<td>25.6%</td>
<td>87.7%</td>
<td>0.9%</td>
<td>21.9%</td>
</tr>
<tr>
<td>29.6%</td>
<td>76.0%</td>
<td>15.1%</td>
<td>23.8%</td>
</tr>
<tr>
<td>34.1%</td>
<td>80.4%</td>
<td>4.4%</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Source: 2004 ELA Survey of Industry Activity
One reason for this year’s Bank respondent’s low yields is that the majority identify themselves as operating predominantly in the middle-ticket segment. As discussed in a later section, middle-ticket transactions average the lowest yields and spreads of any segment. In addition, only about 50 percent of Banks report being active in micro- and small-ticket (compared with 81.8 and 76.5 percent for Captives and Independents respectively), the segments generating the highest yields and spreads. Another reason for the low yields earned by Banks may be that, as they work to increase their penetration into the parents’ customer base, they are pricing leasing transactions based upon the overall customer relationship -- in effect, taking into consideration the revenues and profitability generated from a customer across the institution.

Relative to other lessor types, Bank respondents to this year’s Survey generate a higher percentage of their total revenues directly from lease and loan activities (Figure 31). They produce only 5.3 percent of revenues from fees and other non-lease-related revenues, compared with 14 percent for Captives and over 15% for Independent, Financial Services lessors.

This year’s Bank respondents report the highest percentage of net earning assets (93.9 percent compared with 75.8 and 81.8 percent for Captives and Independents, respectively) to total assets. They also reported that off-balance sheet items, such as syndicated and securitized assets, comprise only 3.4 percent of total assets under management. This is compared with 11 percent for Captives and 36 percent for Independents.

Figure 32 shows that over 40 percent of Bank respondents’ revenues go to interest expense. Although they report the lowest debt levels (debt represents 58.8 percent of total liabilities and net worth for Banks, compared with 80.2 percent for Captives and 61.1 percent for Independents), Banks, as in other years, report significantly higher interest expense than other lessor types. Given that inter-company borrowings represent nearly three-quarters of Bank respondents’ debt, most of their interest expense appears to be transfer payments to the parent that include treasury costs and other services.
Figure 31

Revenue Components by Lessor Type

<table>
<thead>
<tr>
<th>Lessor Type</th>
<th>Other Revenues</th>
<th>Excess Residual Values Received</th>
<th>Loan and Lease Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>83.4%</td>
<td>4.6%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Banks</td>
<td>91.3%</td>
<td>3.4%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Captives</td>
<td>82.7%</td>
<td>3.3%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Independent, Financial Services</td>
<td>77.2%</td>
<td>7.6%</td>
<td>15.2%</td>
</tr>
</tbody>
</table>

Source: 2004 ELA Survey of Industry Activity

Figure 32

Expense Components and Net Income as a Percentage of Total Revenue by Lessor Type

<table>
<thead>
<tr>
<th>Expense Component</th>
<th>Overall</th>
<th>Banks</th>
<th>Captives</th>
<th>Independent, Financial Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income After Taxes</td>
<td>15.1%</td>
<td>16.4%</td>
<td>16.7%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Provision for Income Taxes</td>
<td>4.6%</td>
<td>7.6%</td>
<td>4.9%</td>
<td>24.9%</td>
</tr>
<tr>
<td>SG&amp;A Expense</td>
<td>20.7%</td>
<td>16.7%</td>
<td>20.1%</td>
<td></td>
</tr>
<tr>
<td>Provision for Bad Debt</td>
<td>10.2%</td>
<td>11.5%</td>
<td>5.8%</td>
<td>14.7%</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>29.5%</td>
<td>40.4%</td>
<td>33.3%</td>
<td>32.6%</td>
</tr>
<tr>
<td>Depreciation</td>
<td>19.9%</td>
<td>7.4%</td>
<td></td>
<td>13.8%</td>
</tr>
</tbody>
</table>

Source: 2004 ELA Survey of Industry Activity
This year’s Bank respondents report the highest percentage of receivables aged past 31-days (Figure 33). In addition, they report the highest percentage of receivables over 90-days past due. Banks’ charge-offs averaged 1.2 percent of their full year average net lease receivables balance, compared with 1.4 percent for Captives and 1.1 percent for Independents. However, as noted above in the section related to portfolio and credit quality, there appear to be a few smaller Bank lessors (annual revenues less than $250 million) with significant portfolio issues that skew overall Bank delinquency data for the worse.

As discussed earlier in this Report, Banks have become increasingly focused on cross-selling leasing to their parents’ existing customer base. While this is one market advantage that Bank lessors are working to exploit, they also face a number of challenges in other areas.

A number of Banks generated significant volume through sale/leaseback transactions with tax-exempt entities. In addition, many have also traditionally been active in other areas of the large-ticket segment, such as synthetic leasing and large-ticket equipment such as railcars and commercial airliners. Interviewees noted that the declines in these markets, cyclical in the case of railcars and commercial airliners and likely permanent in the other cases, have forced them to become more active in the middle-ticket segment. At issue for these lessors is whether this segment is large enough to make up the volume lost in the large-ticket segment.

While a number of executives believe that Basel II poses no significant problems for Bank lessors, others feel there may be significant issues. According to some executives, leasing transactions do not fit cleanly into the banking transactions that the Accord defines for purposes of calculating risk and applying the appropriate regulatory capital. The implications around this lack of clarity range from difficulty in programming Basel II-compliant risk calculating software to the potential that all lease transactions may require 100 percent regulatory capital. In the words of one executive, “If transactions require 100 percent capital backing them, leasing, at least in RAROC terms, ceases to be an attractive business.”
Several executives of Independent lessors discussed what they view as the commercial banks’ traditional commitment to the leasing industry. In the words of one, “Banks have historically gotten into leasing when things were good and they had extra capital and gotten out when something went wrong. It will be the same thing this time around, one big hit and banks will pull out again.” Our discussions with senior executives from Bank lessors, as well as our client work with both banks and bank-owned leasing companies, indicate that this scenario will not play out as it has in the past.

Banks have recognized leasing as an income generator and a customer retention tool, not just as a way to deploy excess capital. While banks may see their available capital decline if depositors leave for better yielding investments, they recognize that leasing earns a better return on that capital than does traditional commercial lending. We believe that banks place a greater importance on leasing than ever and that they are in this industry to stay.

### Breaking Down the Barriers:
**Cross-Sell at Chase Equipment Leasing**

Over the past several years, bank-owned lessors have increased their focus on selling internally to existing bank customers. For many, this represents a significant strategic shift; for some, it is nearly counter-cultural. In our view, Chase Equipment Leasing (Chase Leasing) has built a successful cross-sell model, offering some lessons for other bank-owned leasing organizations:

- The banker is the leasing customer. In most organizations, it is the banker who has primary contact with the customer, and who has significant influence over the products and solutions the customer buys. This means that leasing must first sell its product, as well as its service quality, to the banker. If the banker does not understand why leasing benefits his/her customer, or does not believe the leasing organization will improve his/her customer relationship, the banker is unlikely to recommend leasing to the customer.

- Building a good working relationship between the banker and the leasing product specialist is critical for success.

- People do what you pay them to do. As clichéd as this sounds, it is an often-overlooked truism when companies develop their compensation plans. If a bank lessor wants to encourage intra-organizational partnering, it must build a compensation plan that puts as much weight on referring business to other parts of the organization (and following-up to make sure those referrals are acted upon) as it does on winning a deal. Ultimately, the banker’s personal incentives must neutralize the preference for any specific product and instead compensate him or her for the overall profitability of
the relationship.

- Align the leasing company with the part of the bank that provides the greatest opportunities. It is much easier to integrate leasing as a product and to align strategies and compensation when leasing and that banking unit with the most leasing potential report within the same structure. In some cases, this may even require creating two or more leasing organizations. One bank we know (not Chase), with a substantial small-ticket leasing business in addition to its middle- and large-ticket business, separated its small-ticket group and embedded it into the small business unit. Since most small-ticket customers are small businesses, the bank felt the growth and revenue benefits of this move outweighed the cost of creating a separate business unit.

**Background**

Chase Equipment Leasing is a subsidiary of J.P. Morgan Chase and is the combined business of Banc One Leasing and J.P. Morgan Leasing. Specializing in middle- and large-ticket transactions, Chase Leasing originates nearly $1.5 billion annually, almost entirely with existing bank customers and prospects.

**Success**

While most banks today talk about the importance of cross-selling leasing to their existing customers, few have developed a consistent, successful strategy for doing so. As noted in Figure 5, most of the largest bank-owned lessors generate less than 50 percent of their volume from cross-sell. This is a significant improvement over several years ago, when some of the largest bank-owned lessors generated virtually no volume from bank customers. However, it is far from where senior bank management wants its cross-sell percentages to be.

Bank lessors typically cite internal barriers for their lack of cross-sell. Chase however has developed a strategy (and the infrastructure to support it) to break down internal barriers and work with bankers (called Client Managers at Chase) to deliver the best products for both the customer and the bank.

**Elements of Success**

Executives at Chase note that it takes time to fully develop a culture that encourages and supports the level of cross-sell it has achieved. Chase began developing its cross-sell strategy in 1995 and, as one manager noted, “it has taken us a lot of time to get where we are.”

Chase’s strategy consists of three main elements:

- Embed leasing in the organization that provides the most opportunities
- Design a compensation plan that rewards partnering
- Create a sales and marketing strategy that supports cross-sell
Embed in the Organization That Provides the Most Opportunities

Chase Leasing is part of J.P. Morgan Chase’s Commercial Bank, which serves middle market companies with annual revenues from $10 million up to $2 billion. Before the Bank One merger, the Commercial Bank served over 12,000 middle market customers; post-merger, that number exceeds 30,000. Chase Leasing estimates that it generates as much as 60 percent of its business through the Commercial Bank, with the remaining 40 percent split evenly between the Corporate and Private Banks.

By embedding itself into the Commercial Bank, Chase Leasing believes that it can more effectively align itself with its biggest customers, the Client Managers (CM). In addition, since Chase Leasing’s performance rolls up into the Commercial Bank, senior managers of that organization have a stake in facilitating the leasing organization’s success. Over time, leasing has become integrated into the Commercial Bank as a banking “product” like credit or treasury management. Leasing specialists are considered “product bankers,” brought in by the CM when a lease is the product best suited to the customer’s needs.

Design a Compensation Plan That Rewards Partnering

One Chase Leasing executive stated, “Someone coming here from another lessor would probably need to adjust their sales technique to be successful.” That is because Chase Leasing has created a culture where, in one executive’s words, “You don’t have to win every deal.” What that means is that the overarching consideration is: What is best for the client?

To support that philosophy, Chase has developed a compensation structure that is based as much on partnering as on personal achievement. Chase bases a portion of the leasing product specialist’s incentive compensation on both the quantity and quality of referrals made to other business units. It bases the balance of incentive compensation on the leasing deals closed by the product specialist.

Create a Sales and Marketing Strategy That Supports Cross-Sell

Again, the focus is on aligning all aspects of the organization to support the cross-sell strategy. According to management, Chase Leasing began by hiring former bankers as leasing specialist. “We found that bankers understood working together much better than did leasing people.”

Under Chase’s strategy, the CM is the customer, not the end-user. One executive explains, “We focus on getting the CM to understand the benefits to both the customer and the bank of leasing versus a loan. We also work on getting them to recognize where leasing might be an appropriate product. We build relationships with the CM, so that when the CM recognizes a potential leasing opportunity, he knows that he can call in the guy who understands the leasing product and trust him with that customer.”
Implications for the Industry

As senior bank management intensifies its focus on cross-sell and bank-owned lessors improve their capabilities in that area, the implications for the leasing industry may be significant. As noted earlier in this Report, the growing dominance of Banks in the leasing industry has come predominantly at the expense of Independent, Financial Services lessors. We believe that the growing trend towards integrating leasing as another banking product to sell to customers will potentially impact all lessor types.

Independent, Financial Services – This lessor type has already been significantly impacted by the increasing dominance of bank-owned lessors. Every potential lessee has an existing banking relationship. As Banks improve their cross-sell capabilities, Independent lessors may find themselves in an increasingly competitive situation, as lessees and Banks work within a closed loop. Only those deals in equipment classes that many Banks avoid or downplay, such as high-tech, may be available to Independents.

Captives – While Captives will likely remain secure in “true” captive transactions, those originating business outside of their parents’ products may find opportunities diminished. We do not believe that bank-owned lessors can match the point-of-sale or equipment knowledge advantage held by Captives. However, outside of the specific captive-equipment linked transaction, Captive lessors may find it difficult to prove their advantage.

Banks – Bank-owned lessors that continue to operate with an “independent lessor” model may find themselves at a competitive disadvantage on two fronts. Like Independent, Financial Services lessors, they may find it difficult to attract new business as Banks employing a strong cross-sell model get “first dibs” on potential lessees. The Bank may find itself at a competitive disadvantage as customers considering one-stop shopping for their financial solutions increasingly choose those Banks most able to provide total relationship solutions at relationship pricing.

Concluding Thoughts

Executives at Chase Leasing noted two important caveats to building a successful cross-sell organization. First, senior management, both in the leasing company and in the bank, must commit to the strategy. Noting the difficulty in operating both a cross-sell and independent strategy within the same organization, Chase management states, “It is important to resist the urge to go outside the bank if you are not making your numbers. It is very difficult to be successful at both internal sales and outside sales.”

The second caveat is that the bank has to be large enough to support an internal leasing organization. With over $1 trillion in assets and 30,000-plus middle market clients, J.P. Morgan Chase is clearly large enough to do so. Smaller banks must evaluate the potential of their existing customer base to support a leasing organization. If it cannot, and the bank cannot articulate a compelling value proposition for generating business outside of the bank, it may want to consider outsourcing its leasing operations.
Captives

The advantages afforded by their point-of-sale presence and indigenous equipment knowledge continue to contribute to Captives’ success in the industry. Given their five-year market share growth (Figure 26) and their superior profitability (Figure 27), Captives appear to be the best performing lessor type overall. However, we also share the view of a number of industry leaders that Captives have little to offer outside of their immediate domain and should resist the temptation to try, as one executive said, “to grow up to be another G.E. Capital.”

As shown in Figure 28, this year’s Captive lessors generated over 26 percent of total new business volume, a slight increase over the previous year for the same respondents. They generated over 98 percent of their new business volume either directly to end-customers or through dealers and manufacturer representatives (Figure 29). Volume described in Figure 29 as sourced through third parties may represent deals originated by independent dealers selling equipment manufactured by the Captive’s parent. In some cases, for Captives also engaged in financing equipment unrelated to their parent’s activities, third-party volume may represent deals purchased to grow volume or diversify the portfolio.

Captive respondents have the highest average cost of funds of the three lessor types (Figure 30). The average cost of funds for this year’s Captive respondents declined 60 bps, less than the 100 bps and 80 bps declines in average cost of funds for Banks and Independents, respectively. Captives’ pricing, represented by average pre-tax yield, declined 110 bps, resulting in a 50 bps decline in average pre-tax spread. For this year’s Captive respondents, the decline in average cost of funds was less substantial than for the overall industry (110 bps for the industry overall, see Figure 12), perhaps indicating that difficulties in the manufacturing sector have negatively impacted Captives’ ability to borrow at the best rates. However, Captives’ pricing declined less than for the overall industry (140 bps decline for the industry overall, see Figure 12). This less-than-average price decline could result from a decrease in the use of financing to help drive sales. Finance rate reductions or interest-free periods are often used to stimulate sales. While these types of promotions may negatively affect a manufacturer’s captive finance unit, the margin on equipment sales typically drives the highest percentage of most manufacturers’ profitability, making the sale of the product more important than the financing income generated.

Lease and loan revenue contributed nearly 83 percent of this year’s Captive respondents’ total revenue (Figure 31). As a percentage of total revenues, revenue from excess residual values received was lower than for Banks and Independents. An analysis of the past five years’ Surveys of Industry Activity reveals that Captives typically earn less from excess residuals (as a percentage of total revenues) than do other lessor types. We believe this is important for two reasons:

1. It proves Captives’ expertise in their equipment area – Captives possess sufficient equipment knowledge to accurately assess residual values at end-of-lease. Accurate residual estimation gives the customer the best financing value, ensuring that he/she will be financing only the true value of the equipment. It also improves lessor profitability, generating revenue from the equipment across the life of the lease, rather than from excess residuals at the end of the lease.
2. It points to the stability of Captives’ earnings and profitability – As noted above, accurate residual estimation improves the Net Present Value (NPV) of the deal by increasing the revenue earned over the life of the lease and decreasing the revenue earned at the time of equipment disposition. Accurate residual estimation also improves the stability of the lease revenue stream by reducing the percentage of revenue that can be most easily impacted by outside influences. Income from excess residuals depends on the demand for and sales price of the equipment at the end of the lease. Many factors, such as economic conditions, technology advances, and competitors’ actions can affect both the sale price and the demand. A number of lessors that relied heavily on income from excess residuals for profitability (particularly in the technology sector) were forced to exit the industry when oversupply drove down the price of used equipment.

Captive respondents to this year’s survey generated higher after-tax income (as a percentage of total revenue) than the other two lessor types (Figure 32). Although Banks generated higher pre-tax income, they also have the highest effective tax rates, reducing their after-tax net below that of Captives. In most areas, Captives operate more efficiently than do Banks and Independents.

On a per FTE basis, Captive respondents outperform Banks and Independents in all areas except Net Earning Assets and Sales, General, and Administrative (SG&A) expense (Figure 34). Banks’ Net Earning Assets per FTE are higher than are Captives’ because net earning assets comprise a larger percentage of total assets for Banks than for Captives (93.0 percent versus 75.8 percent); conversely, operating leases comprise a larger percentage of Captives’ total assets (16.7 percent for Captives versus 3.3 percent for Banks).

A number of Captive interviewees discussed that lessor type’s traditionally higher-than-average SG&A expense per FTE. While they assured us that this expense was not representative of their individual salaries, none could offer an explanation as to why SG&A expense is as much as one-and-a-half times higher than for other lessor types. In our view, one possible explanation is that one or two large manufacturers may allocate significantly more costs to their Captive finance unit, increasing the average for the entire lessor type. If this is the case, then average profitability for

![Figure 34: Comparative Operational Efficiency by Lessor Type](image)
Captives may be significantly higher than the Survey data shows.

This year’s Captive respondents reported higher-than-average charge-offs in 2003 (Figure 33), resulting in relatively fewer non-accrual assets (as a percentage of receivables and non-accrual assets) than other lessor types (1.5 percent versus 4.2 percent for Banks and 2.5 percent for Independents).

One area of concern related to Captives’ portfolio quality emanates from possible tension between the manufacturing sales team and the finance underwriting team. Typically, equipment sales people receive incentive compensation based on their sales volume, and manufacturers typically earn higher margins on equipment sales than on financing. In the past, a tendency existed for the equipment sales people to push underwriters for credit approval on marginal deals.

However, Captive executives state that this is generally not an issue today. In addition to educating the sales force about credit policies, the best players provide the equipment sales people with tools to determine a prospect’s credit worthiness in advance, reducing the time spent on deals that will not make the underwriting cut. In addition, the recent economic slowdown has shown manufacturers how credit issues can impact their bottom line and their stock price. In the words of one, “They have seen the dark side of bad credit.”

As discussed earlier in this Report, a number of large Captives actively pursue business independent of their parents’ products. One reason for this is a desire to diversify the portfolio in order to mitigate the cyclical impact of one equipment type. Other reasons include the relatively high return on excess capital produced by equipment finance and a desire on the part of the finance unit to remain competitive by being involved in many aspects of finance.

A number of Captive interviewees share our view that they possess little competitive advantage outside of their own equipment type. Without their point-of-sale and equipment knowledge advantage, they are forced to compete directly with Banks and Independents on price and service. Finding non-core deals also requires the Captive to build an origination source outside
its point-of-sale channel. In recent years, a number of Captives, including Boeing Capital and U.P.S. Capital, have pulled back from the general equipment finance business, preferring to focus on the business they know best.

Independent, Financial Services

As discussed earlier, a relatively few very large companies and a larger number of relatively small companies comprise this group. In this year’s Survey, Independent, Financial Services lessors with annual revenues exceeding $1 billion represented less than eight percent of the Independent lessors surveyed (Figure 35). Yet, this small group of the largest companies generated over 85 percent of the lessor type’s new business volume. Since most of the data presented are dollar-weighted averages (that is, weighted toward lessors that generate the largest new business volume), the Survey results largely reflect the performance of these few lessors. Where possible, we provide analysis by lessor size (by annual volume) to portray as accurate a picture as possible.

Going Public: Marlin Leasing

At Marlin Leasing, as at other successful companies, day-to-day execution, rather than a “silver bullet,” drives results. With that perspective as a foundation, several key take-aways emerge from studying the company’s success:

- Lessors should look for ways to more effectively leverage existing data – Most companies capture vast amounts of data about customers and potential customers. However, many miss significant opportunities to enhance customer relationships because they lack the capability to turn that data into useful information.

- Leasing is a service business – Some lessors believe that they are in the business of financing equipment. Others, including Marlin executives, believe that equipment finance is a commodity, with pricing the only differentiator. In their view, service is the value-added that customers may be willing to pay for, and, therefore, Marlin views service as its real product.

- Management must continually plan for the future – Marlin’s consistent access to the capital markets, even after most other small lessors were locked out, is due, in part, to planning. The company started early to develop both the track record and the reporting systems that Wall Street demands.

Background

Marlin Leasing is the operating subsidiary of Marlin Business Services, Corp., a publicly-traded, independent lessor based in Mt. Laurel, New Jersey. The company focuses on originating
small-ticket transactions through a
network of nearly 7,700 small,
independent equipment dealers, lease
brokers, and, to a lesser extent, direct
solicitation to end customers. In
November 2003, Marlin successfully
launched its Initial Public Offering
(IPO), the first leasing company to do
so in several years.

Success

Since its founding in 1997, Marlin
has enjoyed substantial growth. The
company has processed over 225,000
applications and originated over
100,000 new leases. Although its
average transaction size is only
$8,000, the company has originated
over $500 million in assets. In July
2004, the company announced record
second quarter profits. It also
announced that, with the closing of its
latest securitization transaction, the
company gained access to “AAA”
funding rates, significantly improving
its borrowing costs.

Elements of Success

To compete as a mid-size player
(\textit{Monitor 100} ranks Marlin \#58 in
new business volume), Marlin
focuses on what it views as an
underserved segment: small and mid-
sized independent equipment dealers.
Marlin believes that large bank and
independent lessors overlook this
segment because it does not deliver
the high volume that large lessors
typically require. In addition, the
company asserts that its peers do not
possess the experience or technology
required to profitably service this
niche.

In the company’s view, a number of
factors differentiate it from
competitors and serve as the
foundations of success with this
segment, including:

- Effective use of proprietary sales
  management tools
- Enterprise-wide integration of
  information systems
- Comprehensive sales training and
  mentoring

In addition to technology, management
believes that it has created a strong
service culture within the company.
One executive summed up the company
philosophy by saying, “We are in the
service industry. Many lessors think
they are in the equipment finance
business, but financing/money is cheap
and easy to get. Customers want service
and convenience along with the
money.”

Effective Use of Proprietary Sales
Management Tools

Marlin deploys nearly 100 sales
account executives against an estimated
75,000 independent equipment dealers
selling the type of equipment it
finances (including copiers, telephone
systems, computers, and security
systems). To effectively focus sales
executives on the high-priority
prospects, Marlin has developed a
telephone-based direct marketing
platform that is, in its view, unique in
the industry.

The basis of the platform is the
company’s database of thousands of
prospects. Marlin developed and
updates this database with information
from numerous sources, including
third-party marketing services, industry organizations, trade shows, etc. Marlin’s typical target: dealers that have had limited access to lease finance programs.

The sales management application provides potential prospects to the sales executives for solicitation. In turn, they use sophisticated contact management software, including predictive dialing technology, to manage the solicitation campaign. The software allows the sales executive to manipulate the database, fax material and send emails to targets, produce correspondence and documents, track activity, and perform numerous other tasks.

These tools help to focus sales calling time on those prospects most likely to become origination sources. Once the dealer becomes an active deal source, the contact management tool tracks end-user activity, allowing the sales executives to effectively market directly to the end-user to generate additional sales and renewals.

Enterprise-Wide Integration of Information Systems

The lease transaction process allows lessors to capture significant amounts of information on both the customer and the origination source. In addition, after booking the lease, customer service and collection issues often yield valuable customer data. In Marlin’s view, its ability to effectively capture this data and, most importantly, disseminate it throughout the organization provides it a competitive advantage. By integrating its systems across the enterprise, Marlin aims to create an environment in which information captured in one functional area, such as customer service or collections, is available for use by other functional areas throughout the company.

Management states that its enterprise-wide integrated systems result in lower transaction costs, improved credit decisions, and more focused sales efforts.

Comprehensive Sales Training and Mentoring

Marlin believes that its sales executive training and mentoring program gives it an advantage in the market. Because of its extensive in-house training program, combined with its systematized sales approach, Marlin does not believe that prior leasing or financial services experience is necessary for new sales recruits.

Management states that new hires undergo an extensive 60-day training program shortly after starting. The program covers the fundamentals of leasing, the company’s origination and credit policies, and basic sales tools. New hires must pass an exam based on the training received. In addition, Marlin assigns an experienced sales executive to each new hire as a mentor and coach. In management’s view, the mentoring program helps share internal best practices and proven sales techniques.
Implications for the Industry

Despite Wall Street’s skepticism of the leasing industry overall, and small Independent lessors in particular, Marlin Leasing has been able to consistently access the securitization market and had a successful IPO. Management cites several factors that contributed to the company’s acceptance on the Street:

- **Strong track record** – Both Marlin Leasing and its senior managers showed a consistent record of success. Without a strong management team and several years of strong growth and excellent asset quality, lessors will find limited, if any, ability to access debt and equity markets.

- **Strong reporting capabilities** – Sophisticated and readily-accessible MIS systems provide analysts with the data they need to provide accurate evaluations of Marlin’s performance. Companies lacking strong reporting capabilities and meaningful historic data will continue to be excluded from the capital markets.

- **Increased analyst industry knowledge** – Analysts have become more knowledgeable about the leasing industry and leasing products, enabling them to make more critical assessments of players in the industry.

Concluding Thoughts

The ability to fund through the capital markets, by either issuing debt or securitizing assets, can shrink the cost of funds disadvantage faced by many small independents. Companies hoping to access the debt or securitization markets should begin early to build their systems and credibility to suit the Street. In addition, the industry as a whole must rigorously work together to help prevent a small number of “bad apples” from tainting the entire industry.

Overall, Independent, Financial Services lessors’ market share declined by almost 44 percent over the past five years (Figure 26)\(^\text{19}\). And, while pricing and spreads are strong, Independents’ high cost structure makes them the least profitable lessor type. In order to survive, small Independents will become increasingly niche-oriented. In order to thrive, large Independents will increasingly focus on providing private-label “captive” programs for manufacturers unwilling or unable to operate their own captive finance unit and on providing service bureau-type support for regional and community banks lacking internal leasing capabilities.

As Figure 28 shows, annual volume for the same respondents declined by more than 16 percent over the previous year, due primarily to a decline in large-ticket volume. The largest Independents originate most of their new business volume directly (Figure 35). Smaller lessors rely on brokers and vendor programs for volume.

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\(^{19}\) The data shown in Figure 26 is from each year’s Survey. As noted elsewhere, the respondent set differs for each year.
Overall, Independents are the least profitable lessor type (Figure 27). For both the most recent year and as an average of the past five years, Independents trailed Banks and Captives in terms of both NIBT and ROE. By size, the largest Independents generated more income as a percentage of revenues than did smaller companies (Figure 36). However, the smallest Independents outperform in terms of return on investment (ROE and ROA).

Figure 36

![Independent, Financial Services Profitability Ratios by Lessor Size (Annual Volume)]

While their funding costs are as much as 50 percent higher than the largest Independents, small lessors price as much as 50 to 100 percent higher. As Figure 37 shows, average pre-tax spreads for lessors in the two smaller segments are 5.6 and 8.3 percent respectively, nearly double the spreads of the two larger segments. The pricing and spreads enjoyed by the smallest lessor types could reinforce their view that customers are willing to pay for “boutique” service. However, another possible explanation is that smaller lessors are more willing to take less sterling credits. The delinquencies and charge-offs of smaller Independents support this explanation.

Overall, Independent, Financial Services lessors are the most likely of any lessor type to generate revenue through either excess residual values or fees (Figure 31). While the largest lessors typically drive
results for the lessor type, the percentage of revenue derived from leases and loans, excess residuals, and fees, portfolio sales, etc., is relatively consistent by size of lessor (Figure 38).

Because (unlike Banks and Captives) they have no inherent customer base, Independents report the highest overall SG&A expense (Figure 32). Within the lessor type, SG&A expense as a percentage of revenues declines significantly between the smaller and larger lessors, as their size enables larger lessors to distribute fixed costs over higher revenues (Figure 39). As Figure 39 also shows, the largest Independents incur substantially higher interest costs than do smaller lessors — nearly double. However, analysis of the Independents’ balance sheets by lessor size shows that most of the largest lessors’ liabilities (nearly 80 percent) represent inter-company borrowings. Therefore, it is probable that part of large Independents’ interest expense represents internal transfer payments.

Figure 40 illustrates a number of measures of operational efficiency, based on dollars per FTE. In most areas, the largest lessors appear to operate the most efficiently. Using
New Business Volume per FTE as an example, a lessor must have a baseline number of people in order to originate its first dollar of new business. Since it does not need to double its headcount to double its volume, every additional dollar of new business volume improves its per-FTE performance.

Overall, Independent, Financial Services lessors have the lowest delinquencies of any lessor type (Figure 33). Again, it is the largest lessors that drive the low rate of overdue receivables. As shown in Figure 41, the two smaller volume segments show substantially higher delinquencies and non-accrual assets than larger lessors. As mentioned earlier, the credit quality of smaller Independents, along with their higher pricing, indicate that these lessors accept business that larger companies might turn away. This may be by choice, with these lessors believing that they possess some capability to mitigate the additional risk. Or, it may rise from necessity, in that these are the only deals that they can get. Based on their ROA and ROE (Figure 36) these lessors currently appear to be able to manage this additional risk.

Most believe that smaller Independents will survive as niche players. That niche can be either a market (smaller, independent dealers in the case of First American Equipment Finance)
or it can be an asset class where a boutique-like focus can create a significant competitive advantage. But, few believe there is much likelihood that many, if any, small Independents will grow to become large or even mid-size.

This year, for the first time, a number of executives spoke about a possible need for large Independents to change their strategy. Banks’ increasing cross-sell proficiency, asset-class knowledge, and capital availability are making direct origination more difficult for large Independents. A number of executives (from both Captive and Independent lessors) spoke of losing deals to Banks. As a result, some large Independents spoke of increasing their focus on building captive and vendor relationships.

In our view, this will be an increasing trend. Manufacturers recognize that, in many cases, point-of-sale financing is critical for product sales. They will increasingly recognize that equipment finance is not a core competency of a manufacturer. At the same time, large Independent lessors, seeking to decrease their origination costs, will begin to cede direct end-customer sales to Banks and focus instead on acquiring the point-of-sale advantage that Captives enjoy. The future may find an increasing number of “captive” finance units run by stand-alone commercial finance and leasing companies, either openly or as private-label programs.

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### On the Phone Again: First American Equipment Finance

While First American owes much of its success to its effective execution of a well-thought-out strategy, there are a number of lessons that others in the leasing industry can learn from the company:

- **Consider alternative origination and service models** – Customers of all sizes may be increasingly receptive to alternative sales and service channels. Today, many decision makers no longer have time for lengthy in-person sales pitches and may be satisfied with short, pointed calls or emails.

- **Best practices often come from outside the industry** – Top players in nearly every industry recognize that best practices may exist outside their sector. Lessors may consider looking to other industries to build a sales and service culture.

### Background

First American Equipment Finance (FAEF) is an independent, privately-held equipment finance company based in Rochester, New York. FAEF specializes in IT and office-related technology, focusing primarily on middle-ticket deals. The company has staked out a successful niche financing complex technology projects for upper-middle market customers.

### Success

Since its founding in 1996 by Bill Verhelle (formerly of Tokai Financial Services, now De Lage Landen) and Guy Klinger (formerly of Oliver-Allen), FAEF has enjoyed remarkable growth and success. It is currently the 92nd
The largest equipment leasing company in the United States, as ranked in the June 2004 Monitor 100. The company has grown its annual sales to over $100 million and has topped the list of fastest growing companies in Rochester since 2000. In 2001, Inc Magazine’s Inc 500 list of the fastest growing privately-held companies in the U.S. ranked FAEF third.

**Elements of Success**

As an independent lessor relying on bank credit for funding, FAEF knows it cannot compete solely based on price against Banks, most Captives, and large Independents such as GE and CIT. Instead, the company relies on its ability to deliver an exceptional customer experience to counter any funding disadvantage. As one executive noted, “Customer loyalty is the only defense against price competition. If we offer them [customers] the same experience as GE, but at a higher price, we will lose every time.”

To compete, FAEF has developed a sales and service model that it believes offers a superior customer experience at a competitive, though not always the lowest, price. The company believes that three key elements contribute to its ability to deliver its value proposition:

- Relationship-oriented customer service
- Lower-cost origination
- Out-of-industry recruiting

**Relationship-Oriented Customer Service**

FAEF’s service model ensures that its customers have a single point of contact within the organization. That contact, the Transaction Manager (TM), can answer questions and solve problems in a timely and effective manner. As one senior manager noted, “Our customers do not have to transfer between three or four inexperienced call center employees, just to find the person who may have the answer to their questions. If the TM doesn’t know the answer, he will find it and call the customer back.” In addition to customer service, the TM is responsible for helping monitor the client’s ongoing needs and working with the salesperson to generate additional sales. Management estimates that TMs play a significant role in 25-30 percent of the company’s sales.

The company takes a team approach to customer service. In addition to the TM (typically an MBA and often a CPA), the coverage team includes credit and administrative support as well as the original salesperson. FAEF believes that some customers have little affinity for leasing salespeople, sometimes viewing them as transaction -- rather than relationship -- oriented. But, management believes that it is important that the salesperson remain involved as an additional resource and to continually evaluate the customer’s needs. As an incentive to remain involved, the salesperson receives commissions on all incremental business sold to “his/her” customer during the life of the relationship.

While banks, lessors, and other financial services firms have attempted to “re-educate” their lower-value relationships to use non-personal channels to communicate and transact, FAEF has bet that some segments of the market will continue to demand and, more importantly, pay for high-touch relationship management.
Based on the company’s experience so far, it appears to have bet correctly. In 2000, the company, through its auditing firm, conducted a nationwide customer satisfaction survey. Remarkably, 67 percent of its customers responded to the survey. Of that group, 96 percent expressed overall satisfaction.

**Lower-Cost Origination**

With a need to manage costs as effectively as possible, FAEF has developed an origination model relatively unique to the leasing industry. The company believes that by clearly defining its target market and by building the richest prospect database possible, it can provide its telephone-based sales force the leverage needed to succeed.

Recognizing that its higher-cost business model depends on building relationships, FAEF does not pursue single-transaction business. The company has defined its target market as companies with a high likelihood of generating ongoing business -- those companies with the equipment needs and financial resources to provide a steady stream of deals. While it will not turn down single-transaction deals, FAEF has found that those customers typically do not appreciate and are unwilling to pay for the high level of ongoing service.

Supporting both its sales and service organizations, FAEF’s database of over 50,000 customers and prospects helps both the TM to manage the existing customer relationship and the salesperson to target high potential prospects. The system links with the company’s email and telephone system to capture all email correspondence and to log telephone calls between FAEF and the customer and/or prospect. In addition to records of all previous contacts and post mortems on lost deals, the database contains information related to the prospect’s existing leasing/financing relationships. In the company’s view, developing detailed market intelligence allows the sales force to concentrate on only the most likely prospects -- additional leverage that is critical for a telephone-based sales effort.

Not only does a telephone-based sales force help offset its higher cost service model, but, FAEF believes, it is a more efficient sales channel. Management estimates that a salesperson can call 25-30 prospects per day. Estimated salesperson-calling volume in the traditional (in-person calling) model ranges from one-to-three calls per day. While the percentage of bids that turn into deals is lower for FAEF than for lessors with more traditional sales models (20 percent vs. as high as 60+ percent), the ten-to-thirty fold increase in calling volume more than offsets the lower success rate.

Several years ago, FIC conducted a study of the characteristics of top sales performers in a number of Top 20 banks. The characteristic with the highest correlation was, perhaps not surprisingly, calling volume: the more calls the salesperson made, the more successful he/she was. First American’s growth in past years indicates that it understands the value of aggressive sales call goals.

**Out of Industry Recruiting**

First American believes that its practice of hiring from outside the leasing industry has given it an advantage in the market. Although new hires must often receive extensive training on the leasing
product, in the company’s view, the wealth of new ideas and best practices from outside the leasing industry pays for the training investment.

FAEF initially began hiring from outside the leasing industry when Verhelle and Klinger first formed the company. They found that the start-up organization could not afford to hire “leasing professionals.” As the company grew, it found that recruits from outside the leasing industry were better suited to its non-traditional business models and often brought with them ideas and best practices from other industries. Although the two founders “grew up” in the leasing world, they saw the value of bringing outsiders into the industry.

**Implications for the Industry**

As a smaller, privately-held independent, First American Equipment Finance recognized and responded to its competitive disadvantages. Yet, despite several years of contraction of overall equipment leasing and finance volume, FAEF has enjoyed enviable organic growth. Over the same period, volume at many of its larger competitors remained flat or grew only through acquisition.

We believe that the primary lesson for the leasing industry from First American’s success is that small, Independent, Financial Services lessors can successfully compete within their niche against Banks and Captives. The key is effective execution against the “basics:”

- **Pick your spot** – FAEF focuses on supporting complex technology projects for upper-middle market and very large corporate clients.
- **Create your value proposition** – Recognizing that it is unlikely to be highly-competitive on price, FAEF created a value proposition around its relationship-oriented customer service model.
- **Identify your most likely customers** – The company has identified and profiled those companies most likely to appreciate, and pay for, its value proposition.
- **Build the systems and tools to deliver** – First American designed its organizational structure to support its customer service model. It also provides tools to both its sales and service people to implement the company’s strategy.
- **Hire the people to support and improve the value proposition** – The company believes that its strategy of hiring from outside the leasing industry provides it with a continual flow of new ideas and cross-industry best practices.

**Concluding Thoughts**

First American’s approach is certainly not a template guaranteeing success. As with any model, execution is critical. In addition to effectively executing its strategy, First American has developed a culture where “out-of-the-box” thinking and innovation are celebrated.
Transaction Size Profitability

This year’s analysis of the leasing industry by transaction size assesses each ticket segment to identify some of its key characteristics and uncover drivers of profitability. One conclusion of our analysis is that lessor type is the dominant driver of profitability in the industry. As discussed in previous sections, factors such as cost of funds, access to customers, and operational efficiencies are inherently related to lessor type and little influenced by transaction size. In this section, we focus on the components of profitability and assess the skills required for success within each segment.

The defining characteristics of each transaction size can be indicative of the necessary competencies required to play in that segment. They include:

- **Micro-Ticket** – Among the characteristics defining this segment are: vendor/captive origination, high pricing/spread, and high delinquencies and charge-offs. Requirements for success include low-cost origination, highly-automated processes, and sophisticated portfolio management.

- **Small-Ticket** – As with the micro-ticket segment, key definers include: vendor/captive origination, high spreads, and high delinquencies and charge-offs. Keys to success in this segment are very similar to those of the micro-ticket segment: low-cost origination, highly-automated processes, and sophisticated portfolio management.

- **Middle-Ticket** – Narrow spreads and heavy competition define this transaction segment. Keys to success include low-cost origination, low cost of funds, and tight cost controls.

- **Large-Ticket** – This is a segment suffering the combined impact of a down business cycle and adverse legislative and regulatory activity. The few bright spots will experience significant competition. Flexibility, combined with low funding costs and low-cost access to customers will define this segment in the coming year.

**Micro-Ticket**

As shown in Figure 42, micro-ticket transactions contributed just 5.5 percent of respondents’ total volume, a 27.5 percent increase over the previous year. Overall, strong pricing and low cost contributed to impressive profitability. However, as noted above, the type of lessor operating in the segment often drives transaction size profitability. Effective captive and vendor programs and strong portfolio management skills are critical to success in the micro-ticket segment.
According to this year’s Survey, the micro-ticket segment relies heavily on the volatile computer market. Fifty-eight percent of new business volume in the micro-ticket segment came from PCs and workstations. When related hardware and software are included, that figure increases to nearly 70 percent. As Figure 43 illustrates, vendor and captive programs originated nearly 85 percent of new business volume. Brokers originated another 9.4 percent. Because of the cost, and the small per-unit contribution generated by these transactions, very little micro-ticket volume is originated directly.

Micro-ticket transactions generate extremely attractive yields and spreads as shown in Figure 44. While pricing declined slightly over the previous year, respondents reported that their average cost of funds declined more, generating higher spreads in 2003 than in 2002. Those involved in the micro-ticket segment reported low costs associated with serving this segment (Figure 45). In particular, respondents in this segment reported almost no depreciation expense, indicating that most transactions were finance leases or conditional sales, transferring effective ownership of the equipment and the associated depreciation expense to the lessee. Respondents active in this segment also reported very low interest costs and

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Figure 42

![Graph of 2003 Total New Business Volume by Transaction Size]($ billions)

- % of Total: 100.0% 100.0% 5.5% 4.2% 29.7% 28.5% 47.6% 46.5% 17.2% 20.9%
- Year-Over-Year % Change:
  - Total: -3.9%
  - Micro: 27.5%
  - Small: 0.2%
  - Middle: -1.6%
  - Large: -20.9%

Source: 2004 ELA Survey of Industry Activity

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Figure 43

![Graph of Total New Business Volume by Origination Channel by Transaction Size]

- Originated no new volume through vendor program.
- Source: 2004 ELA Survey of Industry Activity
Figure 44

Pre-Tax Yield, Cost of Funds & Pre-Tax Spread by Transaction Size

<table>
<thead>
<tr>
<th>Transaction Size</th>
<th>Average Pre-Tax Yield</th>
<th>Average Pre-Tax Spread</th>
<th>Average Cost of Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro</td>
<td>11.8%</td>
<td>8.2%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Small</td>
<td>12.0%</td>
<td>7.8%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Middle</td>
<td>6.8%</td>
<td>4.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Large</td>
<td>7.7%</td>
<td>3.7%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

Source: 2004 ELA Survey of Industry Activity

Figure 45

2003 Expenses as a Percentage of Total Revenue by Lessor Type

<table>
<thead>
<tr>
<th>Category</th>
<th>Overall</th>
<th>Micro</th>
<th>Small</th>
<th>Middle</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>80.3%</td>
<td>48.9%</td>
<td>77.2%</td>
<td>81.8%</td>
<td>80.3%</td>
</tr>
<tr>
<td>Sales, General, and Admin.</td>
<td>20.7%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provision for Bad Debt</td>
<td>10.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>29.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>19.9%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: 2004 ELA Survey of Industry Activity, FIC Analysis
higher-than-average provisions for bad debt (Figure 45). As discussed above, the low interest expense reported by respondents is likely more a function of the individual lessors involved in this segment than a characteristic of the segment itself. However, we believe that the high provision for bad debt is typical of the segment.

Micro- and small-ticket transactions typically involve small businesses, which are more susceptible to economic shocks than are larger concerns. Micro- and small-ticket segments experience higher delinquencies and higher charge-off rates than larger ticket segments (Figure 46). In addition to the nature of the entities involved in smaller ticket transactions (small businesses), the nature of the equipment and the economics of the transactions make it more likely for lessors to write-off delinquent deals in the smaller ticket segments than in the larger ones. As one executive noted, “A lessor is far more likely to work with a delinquent lessee of a locomotive or commercial jetliner than with someone who has fallen behind on payments on a copier. Writing off a copier is nothing, but a locomotive will hit the bottom line pretty hard.”

Because no one deal generates very much profit in the micro-ticket segment, a high-volume, low-per-transaction-cost operation is critical. Success in this segment requires an efficient origination source, such as a good broker network, or strong captive and vendor programs, able to generate a large volume of transactions with little cost. It also requires a highly automated transaction processing “factory,” able to process a high volume of deals with little human intervention, as well as sophisticated credit scoring capabilities to reduce delinquencies and charge-offs. On the back-end, a lessor that is successful in this segment must have an efficient collections process and sophisticated portfolio management capabilities.

**Small-Ticket**

This year, as in past years, the Survey asked lessors a number of questions specifically related to the small-ticket segment. Only two-thirds of respondents reported involvement in small-ticket leasing (Figure 47). Banks were the least likely to be involved, with nearly half of the Bank respondents indicating they are not involved in the segment. Reasons given for Banks’ low
involvement include the significant infrastructure investment and high headcount required to operate successfully. Banks not involved in this segment often have relationships established with other lessors to outsource small-ticket deals for their customers.

As Figure 42 shows, small-ticket transactions comprised nearly 30 percent of respondents’ total new business volume.

While less important than for micro-ticket transactions, vendor and captive programs (as well as brokers) represented important origination sources for small-ticket deals.

Respondents reported that pricing declined less than their average cost of funds, resulting in an increase in average pre-tax spreads over the previous year (Figure 44). However, in the first half of 2004, lessors involved in the segment report that, for various reasons, they are unable to increase pricing as rapidly as their cost of funds increases. As mentioned earlier in this Report, the rate-card system and increasing competition are two reasons for shrinking spreads in the small-ticket segment.

There are many similarities between the small- and micro-ticket segments. As shown in Figure 46, both segments experience charge-off rates significantly higher than both the middle- and large-ticket segments. Small-ticket transactions also have a higher rate of delinquency than large-ticket transactions.

Due to the small dollar amounts involved per deal, both micro- and small-ticket transactions depend on low-cost-per-transaction processing for profitability. However, despite the undisputed requirement for highly-automated processes to maximize segment profitability, many lessors are leaving money on the table. Figure 48 shows that only about 56 percent of lessors involved in small-ticket leasing credit score applications; less than 25 percent auto-decision applications.

By volume, lessors manually underwrote over 32 percent of small-ticket transactions in 2003. While this is a significant improvement over the previous year (in 2002, the same respondents reported manually underwriting nearly 60 percent [by volume] of small-ticket transactions), it is still far less than the segment’s economics would dictate. Virtually all small-ticket volume should involve some degree of credit scoring, and the percentage of volume that is auto-
decisioned should be well in excess of half. While smaller lessors may not have the resources to develop proprietary credit scoring and auto-decisioning models, the cost of “black box” applications from vendors continues to decline even as their reliability increases. We expect the volume of transactions scored and auto-decisioned to increase significantly in the next year.

Figure 49 shows the percentage of small-ticket applications approved (by lessor type). Captives, the most extensively involved in small-ticket leasing (Figure 47), approved the highest percentage of applications as well as the highest percentage of dollars submitted. Banks approved the lowest percentage. Overall, lessors lost nearly 27 percent of approved applications, representing over 36 percent of approved dollars.20 In terms of application dollars, Captives lost less than 10 percent of approved deals while Independents lost in excess of 60 percent (Figure 49). Banks lost just over 30 percent. In our view, these are significant metrics that warrant further investigation on the part of lessors and the industry. As discussed

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20 Lost deals refer to deals, both number of applications and dollars, which were approved but were not booked and funded or sold. These deals could have gone to another lessor or been financed by a method other than leasing, or the equipment transaction may not have occurred.
earlier in this Report, many of these deals may have been lost to another lessor, but some percentage may have gone outside the industry, with the equipment either purchased outright or financed through an alternate credit facility.

As with the micro-ticket segment, success in small-ticket leasing requires an effective “factory-like” approach that yields a low per-unit transaction cost. A low-cost origination source and sophisticated portfolio management are also essential. High volume and low per-unit cost are the keys to success in this segment.

Middle-Ticket

Middle-ticket transactions represented nearly 50 percent of respondents’ 2003 new business volume (Figure 42), showing a slight decline over the previous year. While nearly 60 percent of middle-market deals were originated directly (Figure 43), captive programs remain important to this segment, originating over 25 percent of respondents’ new business volume. Middle-ticket transactions commanded the smallest spreads, and lessors in this segment reported the highest cost structure. This segment will become an increasingly difficult place to play as large-ticket lessors move down-market looking for additional volume.

Lessors generate below-average NIBT on middle-ticket transactions and just average returns on investment, as measured in ROE and ROA (Figure 50). Figures 44 and 45 illustrate that, on average, lessors report the lowest spreads and the highest cost structure in this transaction segment.

Pricing of middle-ticket transactions declined more rapidly than respondents’ average cost of funds, squeezing pre-tax spreads (Figure 44). Accounting for the higher-than-average cost structure, respondents reported the highest depreciation expense for this segment (Figure 45), indicating that true leases represent a higher percentage of middle-ticket deals than for other segments. Aside from depreciation, middle-ticket transactions report a moderate cost structure.
While respondents reported that delinquencies were only slightly better than for small-ticket transactions (Figure 46), the charge-off rate improved significantly over smaller size transactions. Although not evident from the data, we believe that delinquency results for the segment may be influenced by problems faced by a specific lessor and that, excluding isolated issues, the delinquency rate for the segment is somewhat lower than indicated.

The middle-ticket arena will become an increasingly difficult segment in which to operate. Because of issues impacting the large-ticket segment, lessors in that segment are increasing their focus on the middle-ticket in order to replace volume. As competition in the middle-ticket segment increases, pricing and spreads will decline even as cost of funds increases. Those lessors with low-cost access to customers, such as Captives and Banks, and lessors with low funding costs will be in the best position to operate profitably in this segment. Strict cost control will also be critical to success as margins shrink.

**Large-Ticket**

This year’s respondents reported a sharp decline in large-ticket volume (Figure 42), due mostly to legislative and accounting issues as well as the cyclical nature of certain large-ticket equipment types. Respondents reported strong NIBT, but weak ROE and ROA (Figure 50).

Large-ticket volume suffered from both the business cycle and from legislative and accounting issues. As Figure 9 shows, the share of new volume for the air transportation industry, a major lessor of large-ticket assets, declined nearly 32 percent over the previous year. Figure 10 shows that the share of volume for aircraft volume, the second largest equipment category by volume, declined over eight percent from 2002. It also illustrates that railroad equipment, the fifth largest equipment category by volume, declined by nearly 24 percent from 2002. While these volume declines are substantial, most leasing executives agree that they represent cyclical declines and that volume in these areas will return.

However, as discussed earlier in this Report, a significant amount of the decline in large-ticket volume is due to legislative activity around sale/leaseback transactions. In addition, a number of lessors report a substantial decrease in transactions involving off-balance sheet transactions, particularly among large, publicly-traded lessees. Over time, the stigma associated with off-balance sheet financing may decrease; however, the volume associated with sale/leaseback transactions seems likely to be gone permanently.

Because of the decline in large-ticket volume, and the nature of that decline, many large-ticket lessors stated that they had already increased their activity in the middle-ticket arena or that they intended to do so in the near future. As one executive stated, “Since we can all count, on one hand, the large-ticket leveraged deals in the market today, we have no choice but to increase our activity in the middle-ticket segment. We are putting more resources into that segment and I know our competitors are doing the same.”

Over 80 percent of large-ticket deals are directly originated (Figure 43). In this transaction segment, more so than in others, deals sourced through third parties (7.1 percent of 2003 volume) likely means deals purchased through syndication, rather than originated through traditional
brokers. Pricing fell faster than did average cost of funds, eroding average pre-tax spreads (Figure 44). As shown in Figure 45, respondents reported that interest represented the largest expense item, nearly 40 percent of total revenues. Surprisingly, given recent bankruptcies in the airline industry, delinquencies (as measured by receivables exceeding 31-days or more past due) were less than one percent. This may indicate that lessors with exposure in the airline industry have already written off much of that exposure.

In our view, the large-ticket segment will become an increasingly difficult place to play. While lessors report that deals in corporate aircraft remain strong, they also report increased competition in that area as a number of large banks announce plans to enter that market. Even with record passenger levels, high fuel and labor costs continue to squeeze airlines. Given that, and the record number of aircraft sitting unused in the desert, it appears that it may be several years before commercial airliner volume improves.

We see lessors with low funding cost and low-cost origination sources remaining successful in this segment. However, we also see lessors looking down-market, to the middle-ticket segment, to make up the volume permanently lost due to legislative and regulatory action.

**CONCLUDING THOUGHTS**

The nature of leasing, as both a product and an industry, has shifted and continues to evolve. The economic difficulties of the past several years may have shrouded this evolution. However, the economic improvements of the past year have highlighted some fundamental changes in the nature of the industry: leasing as a product has become less distinguishable from other financing products, and the competitive environment has changed to overwhelmingly favor Banks and Captives.

Our interviews discussed how legislative, accounting, and regulatory activity is “genericizing” the leasing product. In the words of one senior executive, “In the wake of Enron and other accounting scandals, regulators and legislators are working to make every financial transaction as transparent as possible to investors. One of the hallmarks of leasing has always been its ability to innovate products that meet the financing, tax, and balance sheet needs of customers. That ability is being reduced. Eventually, leasing will be indistinguishable from any other bank loan. As that happens, Banks gain the competitive advantage.”

As leasing has become more commoditized, the nature of the competition has changed. Banks, with their access to inexpensive capital and a “captive” pool of customers, and Captives, with their point-of-sale origination advantage, are increasingly dominating the industry. We see Independents increasingly relegated to niche roles or acting as “service bureaus” for manufacturers unwilling, or unable, to operate their own captive programs.

One critical, unknown element potentially impacting the competitive environment is Basel II. How, and even when, the Accord will affect lessors is still an unknown. Many lessors believe that new capital requirements will have little impact on Banks and on the industry. Some,
however, expressed the view that Basel II could profoundly, and negatively, impact Banks’ activity in the leasing industry.

Even as the competitive environment evolves, today’s players must still heed the fundamentals of leasing. Those lessors that win will be those with access to affordable, reliable capital and best able to originate volume most cost-effectively, control operating costs, and tightly manage their portfolio. They must also deliver an outstanding customer experience.
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 earlier 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 biweekly newsletter on topics of critical importance to the industry that is read by over 4,000 financial services executives worldwide. You can view our most recent newsletter as well as subscribe to receive it at: www.imakenews.com/ficinc/

For additional information about research presented in this report, or to discuss how FIC might work with your firm, please contact:

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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 2004 SIA survey will have access to BOTH the Interactive 2004 and 2003 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.
Industry Future Council Report—
Each year, we gather dozens of the sharpest executives from around the industry, ask them pointed questions about leasing’s challenges and strengths, and let them engage in a freewheeling discussion about the near term future of leasing. The resulting Report offers a look at the influencing forces, variables and market-changing trends that signal the pace and direction of the business for the next couple of years. This is an invaluable strategic and tactical tool.

State of the Industry Report —
The report that puts meat on the statistical bones! Based on ELA and government data, and using interviews with diverse industry executives, this is the comprehensive annual report on the health and future of the industry. The in-depth analysis contains market segment trends and benchmarking statistics to help you size up your place in the market.

Journal of Equipment Lease Financing —
The only scholarly journal dedicated to equipment leasing! Published quarterly, the Journal spotlights research, case studies, trends and practical information through in-depth articles. Subscription info at www.leasefoundation.org

Stay Connected: Foundation Forecasts—
New this year! Forecasts is the Foundation’s bi-monthly e-newsletter. Forecasts brings you timely information on Foundation research, new products and fundraising highlights. Subscribe at the Foundation website today!

University and Academic Relations
The Foundation, always looking forward, works closely with academics to conduct research in the equipment lease financing industry. Foundation initiatives include:
• Funding research grants;
• Funding authorship honorariums;
• Academic professors serve on the Foundation Board of Trustees;
• Comprehensive statistical database of leasing transactions for research
• Case study development and teaching modules

Industry Studies—
Through the Foundation, industry leaders have access to the research tools that help them make wise decisions for their corporations and employees. Foundation commissioned research includes:
• New Capital Adequacy: Is Your Company Prepared for Basel II Implementation?
• New Indicators of Success Study
• Basel II Accords: Impact on the North American Leasing Market
• Securitization Marketplace
• Perfect Storms: Why Major Lessors Exited the Marketplace
• Case Studies: 7 Case Studies useful in corporate training...
and many others.

Website Resources
The Equipment Leasing and Finance Foundation website contains myriad research, statistical material, and industry related information for your use and exploration. All material mentioned above, and so much more, is available through the website, www.Leasefoundation.org
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