Equipment Leasing & Finance Foundation

*Your Eye On The Future*

# 2005 State of the Industry

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

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

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


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*The Equipment Leasing and Finance Foundation wishes to express appreciation to the following companies for providing the sponsorship to support development of the 2005 State of the Industry Report:*

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*Your Eye On The Future*

# 2005 State of the Industry

Prepared by:

FINANCIAL INSTITUTIONS CONSULTING, INC.

October 2005

# State of the Industry 2005

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Equipment Leasing &
Finance Foundation
*Your Eye On The Future*

October 2005

Dear Equipment Lease Finance Experts,

I am pleased to provide you with this copy of the Equipment Leasing & Finance Foundation's 2005 State of the Industry Report. With its focus on the future, I'm certain you'll agree that this Report is an invaluable strategic planning tool.

The Report is the product of an exhaustive review and analysis of leasing industry information sources, including ELA's 2005 Survey of Industry Activity, government data, independent research and interviews with key executives in all the major leasing industry segments. It provides a comprehensive portrait of the leasing and finance industry in the near term.

The annual State of the Industry Report is a centerpiece among the many forward-looking research products the Foundation provides. Just recently the Foundation debuted:
*Long-Term Trends in Healthcare and Their Impact on the Leasing Industry*
*Knocking Down (Great) Walls: Identifying Factors for Success in the Chinese Equipment Leasing Market*
*Credit Risk: Contract Characteristics for Success*
In early 2006, we'll be releasing *Why Diversity Ensures Success* and *The Response to Customer Default: Captive vs. Finance Leases.*

None of these ambitious projects would be possible without your generous support. The Foundation is funded entirely by individuals and companies within the equipment leasing industry, those who—like you—understand that their donations to the Foundation are an investment in the industry and in their own businesses.

As you read and use this Report, I hope you'll keep in mind that your contribution helped to create it, and that your continued generosity will help the Equipment Leasing & Finance Foundation provide you with a glimpse of the future, long into the future. Please visit the Foundation's website at www.leasefoundation.org for more information on the Foundation's products and mission.

Sincerely,

Joe Lane

Joseph C. Lane
Chairman, Equipment Leasing & Finance Foundation
Vice Chairman
GE Technology

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October 23, 2005

Dear Equipment Leasing Association Member,

On behalf of Accenture and SAP, we are pleased to announce the availability of the 2005 State of the Industry Report published by the Equipment Leasing and Finance Foundation. The 2005 Report includes analysis of the ELA's Annual Survey of Industry Activity, independent research, economic data, and government data as well as interviews with key leasing executives in all of the major Leasing and Loan Industry segments.

One of the primary conclusions of the 2005 Report states that:
"…even in a growing market, lessors that fail to provide value beyond money-over-money will be prone to failure. As markets change with increasing rapidity, lessors must continually evaluate changing demand and anticipate customers' needs. Those that are able to do so will prosper while others become marginalized or disappear."

Helping businesses differentiate themselves in the marketplace and anticipate customer needs are hallmarks of SAP's Leasing and Loan solution combined with Accenture's High Performance assets. SAP Leasing streamlines your business processes – in all phases of the leasing and loan life cycle – and it delivers dependable business intelligence to guide business decisions. Accenture's research into the anatomy of a High Performance Business concludes that there are three mandates for the future: differentiation to customers, simplification of business processes and technology enablers, and flawless execution of core capabilities. Together Accenture and SAP provide the intelligence to anticipate customer needs and the ability to differentiate in the marketplace.

For 2005, the Foundation strives to be Your Eye on the Future, through development of future focused research, studies and articles. The Foundation offers a wealth of information on the equipment lease financing industry. We applaud the Foundation's work helping to shape the future, and it is indeed an honor to be co-sponsors of one of the most important studies published by the Foundation each year.

Should you have any questions about the Study, Accenture or SAP, please contact Scott Thacker, Partner, Accenture Financial Services Solutions Group at 703-629-3692 or at scott.a.thacker@accenture.com.

Very truly yours,

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# PREFACE

The Equipment Leasing and Finance Foundation (the Foundation) 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 the industry based on responses to the Equipment Leasing Association's (ELA) 2005 Survey of Industry Activity (the Survey) and, using this and other information, project and discuss future implications for the industry.

FIC is a management consulting firm focusing on bank and non-bank financial services. We work with clients on strategic issues related to increasing growth and productivity. Beyond commercial finance and leasing, our areas of expertise include the middle market and small business segments and wealth management. While most of our work is U.S. based, we have completed project in close to 20 other countries.

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 14 industry experts representing a cross-section of lessor types, ticket sizes, and industry vendors.

The Survey reflects fiscal year-end 2004 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 2005. However, some industry sectors, equipment types, and leasing products remain weak.

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

**James Ambrose** - *GE Healthcare Financial Services*
**Michael Brown** - *CIT*
**Gary Corr** - *Orix Financial Services Inc.*
**David Davis** - *1st Source Aircraft Finance*
**Major Horton** - *Dell Financial Services*
**Michael Humphreys** - *Microsoft Capital*
**Joseph Lane** - *GE Technology Finance*
**James McGrane** - *US Express Leasing, Inc.*
**Deborah Monosson** - *Boston Financial & Equity*
**Dennis Neumann** - *Bank of New York*
**Richard Remiker** - *Merrill Lynch Capital*
**James Renner** - *Wells Fargo Equipment Finance*
**David Smith** - *CitiCapital*
**Scott Thacker** - *Accenture*

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 operate as 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 leasing market 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 market segment.

In this year's Report, we present sidebar analyses of some of the critical issues impacting the industry and offer our perspective on potential opportunities arising from these issues. We title these sidebars:

**Succeeding in the Global Economy** - While government statistics indicate that U.S. manufacturing remains healthy, some developing countries, such as China, are increasing their manufacturing base at a phenomenal rate. These rapidly growing economies require equipment and the capital to finance it. We look at some of the basics that lessors must consider before expanding overseas.

**The Middle-Ticket Squeeze** - As opportunities for large-ticket players decrease, many of those players are moving down into the middle-ticket arena. At the same time, small-ticket players are leveraging their technological efficiency to move up market, encroaching into the lower-end of the middle-ticket space. We look at what players must do to survive in this segment.

**What Happened to Large-Ticket** - As a result of Basel II, as well as accounting and regulatory changes, large-ticket volume has declined sharply. We look at why this happened, the likelihood of its making a comeback, and the opportunities that remain in this segment.

As strategy consultants to the leaders in the financial services industry, throughout this Report, we offer our perspective on how the critical issues identified may impact the leasing industry. Where possible, we provide 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 economists expect the economy to expand through at least 2006, the leasing industry continues to confront a number of challenging issues while it seeks new opportunities for growth. From our analysis of ELA's Survey of Industry Activity (the Survey) and our discussions with industry leaders, a number of key messages emerge:

*New business volume improved in 2004 and continued to improve through 2005*. Despite another sharp drop in large-ticket volume, Survey respondents reported an 11.7 percent increase in new business volume in 2004. Our interviews with leasing executives as well as our review of available quarterly data indicates that volume continued to improve through the second quarter of 2005. Further, most economists anticipate continued growth in capital expenditures through 2006.

*Capital appears plentiful*. Financing by venture and private equity firms, combined with a renewed expansion of the capital markets and an apparent increase in banks' willingness to lend to the industry has contributed to the abundance of low-cost capital. However, in many lessors' view, there is still too much capital chasing too few deals. In turn, this excess of capital is contributing to the industry's pricing pressures.

*Margin compression worsened*. Due to intense competition and an overabundance of capital in the market, lessors have been unable to increase pricing enough to compensate for their increased cost of funds. As a result, pre-tax spreads declined and, although net income increased, Return on Equity (ROE) declined from 2003 and Return on Assets (ROA) remained unchanged.

Some lessors, however, have identified niche markets that allow them to increase pricing and improve profitability. While the types of niches vary (equipment type, end-user industry segment, customer credit grade, etc.), the message from these players was similar: employ a targeted approach, develop an expertise, and be ready to move if the market changes.

*In all likelihood, the large-ticket market segment is permanently changed*. The impact of recent legislative, regulatory, and accounting changes, coupled with the impact of Basel II, have permanently reduced or eliminated many cross-border and leveraged lease transactions. In a view echoed by most interviewees, one executive said, "It's gone and it's not coming back." However, opportunities continue in the large-ticket segment. There remains a need for large-ticket equipment and the capital to finance it. In the near-term, however, many large-ticket categories, such as aircraft and marine, remain slow. The industry should expect that, because of these changes, average transaction sizes will decrease and large-ticket leasing will once again depend on "traditional" equipment finance deals.

*The competitive environment continues to change*. Although Banks reported only a small increase in new business volume and lost market share to Independents, this was likely due to the decline in large ticket volume experienced by a small number of the largest Banks. In our view, banks will continue their emphasis on leasing, aligning their leasing units more closely with the commercial bank. Bank lessors will continue to increase their focus on existing customers and will increasingly work to develop banking relationships with non-bank customers. Banks have already started to use the leasing unit as a way to extend their footprint out of their local geography.

Independent, Financial Services firms (Independents) reported significant improvement over previous years. New business volume increased sharply and lessors enjoyed adequate and more cost-effective funding. The most successful Independents, aside from the two largest (GE Capital and CIT), appear to have found success by developing a niche or niches and focusing their efforts on developing expertise and creating a compelling value proposition for the customer. Most industry experts expect that the "barbell" trend will continue, with two very large lessors on one end, many small lessors on the other end and few, if any, in-between. As one executive noted, "Independents that get too big are either bought out, or collapse under their own weight."

Captives appear to be continuing to increase their focus on financing their parents' products. We expect Captives will focus on becoming completely integrated with the parent's sales channel with the goal of capturing 100 percent of the potential financing opportunities. As one Captive executive put it, "Success for us is if we finance every piece of equipment that rolls off the assembly line."

As the economy continues to expand, and with it the demand for equipment, opportunities for lessors will also increase. However, the changing market and an increasingly savvy customer mean that even in a growing market, lessors that fail to provide value beyond money-over-money will be prone to failure. As markets change with increasing rapidity, lessors must continually evaluate changing demand and anticipate customers' needs. Those that are able to do so will prosper while others become marginalized or disappear.

# LEASING INDUSTRY OVERVIEW

Overall, the leasing industry appears to have recovered from several years of slow or negative growth. The U.S. economy continued to expand through the second quarter of 2005. Economists project real GDP growth of 3.4 percent in 2005 and similar growth in 2006.

The National Association for Business Economics (NABE) projects growth in business investment in fixed assets (BFI), one of the industry's primary drivers, to outpace overall economic growth, the result of pent-up demand and solid corporate profits. They do not expect increasing interest rates to significantly impact this growth. Changes in some other industry drivers, however, may have permanently changed the leasing landscape.

### Market Size

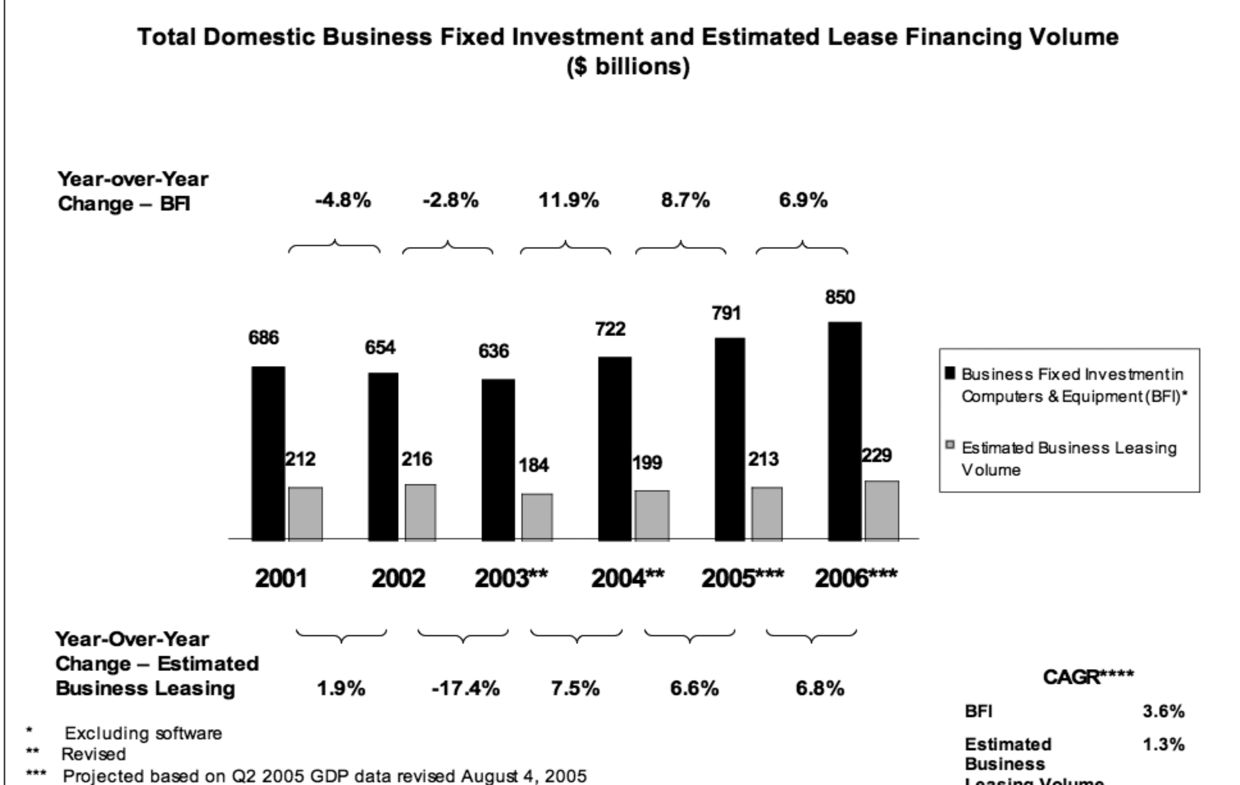
In last year's State of the Industry Report, we estimated that the percentage of equipment financed by leasing had declined to below 30 percent in 2003 for a number of reasons, including:

- Record-low interest rates
- Bonus depreciation
- Decline in large-ticket transactions

A number of industry experts believe that penetration declined further in 2004 and continues to decline in 2005. In their view, the repeal of bonus depreciation did not significantly increase leasing volume (as many had anticipated) and the negative impact of regulatory and accounting changes on the large-ticket segment has outweighed any benefit from rising interest rates. As a result, we estimate that, in 2005, leasing penetration remains below 30 percent in the range of 27-28 percent. Due to the decline in penetration, the projected compound annual growth rate for leasing from 2001 through 2006 is 1.3 percent, versus 3.6 percent for BFI.

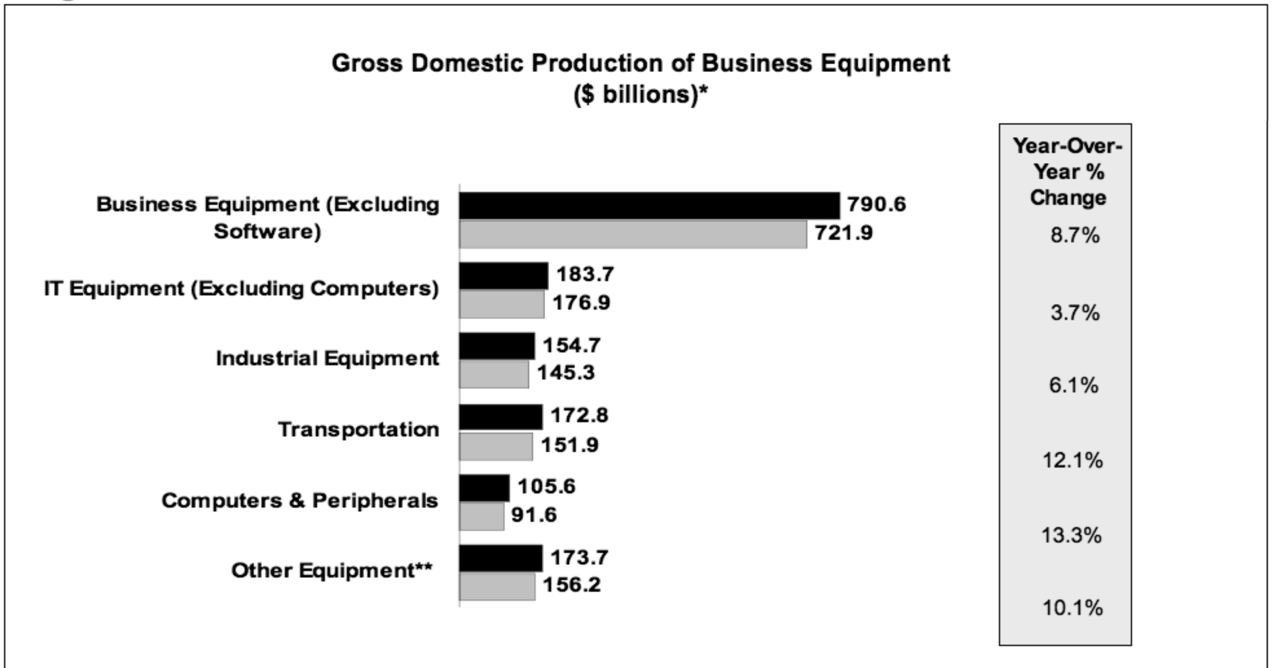
As shown in Figure 1, based on annualized

**Figure 1**




* Excluding software
** Revised
*** Projected based on Q2 2005 GDP data revised August 4, 2005
**** Compounded Annual Growth Rate
Source: Equipment Leasing Association, U.S. Department of Commerce Bureau of Economic Analysis, National Association for Business Economics, FIC Analysis

Figure 2




* May not total due to rounding
** Other equipment includes: furniture and fixtures, agricultural, construction, mining and oilfield, and service machinery
*** Annualized Q2 2005 GDP, Revised August 4, 2005
Source: US Department of Commerce Bureau of Economic Analysis

second quarter GDP estimates, BFI in 2005 will increase to approximately $791 billion. Given the reduced penetration, we estimate total leasing volume at approximately $213 billion for the year.

In 2006, economists project a nearly seven percent increase in BFI, to approximately $850 billion. We estimate that total leasing volume for the period will increase to $229 billion, with no further decline in penetration

As shown in Figure 2, GDP data for the second quarter of 2005 indicates that computers and transportation equipment will experience significant growth over 2004 (13.3 percent and 12.1 percent, respectively). GDP data further indicates that "other equipment, " which includes agricultural and construction equipment, will grow by just over 10 percent in 2005. Non-computer IT equipment (including medical, communications and office equipment) shows the least growth, less than four percent.

Estimates of future growth are, by definition, uncertain. Any number of events, economic or political, can impact future growth.

**Market Drivers**

At the Equipment Leasing & Finance Foundation's Industry Future Council meeting this year, industry leaders identified four primary drivers of the leasing industry:

- Economic Conditions
- Legislative, Regulatory, and Accounting Issues
- The Marketplace/Competitive Environment
- Human Capital

***Economic Conditions***

As has always been the case, the demand for equipment and the availability of capital drive leasing industry volume. In its most recent Outlook report, NABE projects continued strong growth in BFI through 2006[1]. In addition, 75 percent of the economists surveyed believe that interest rates, while increasing, will remain low through the end of 2006[2], indicating that there will be adequate capital available to fund new equipment purchases.

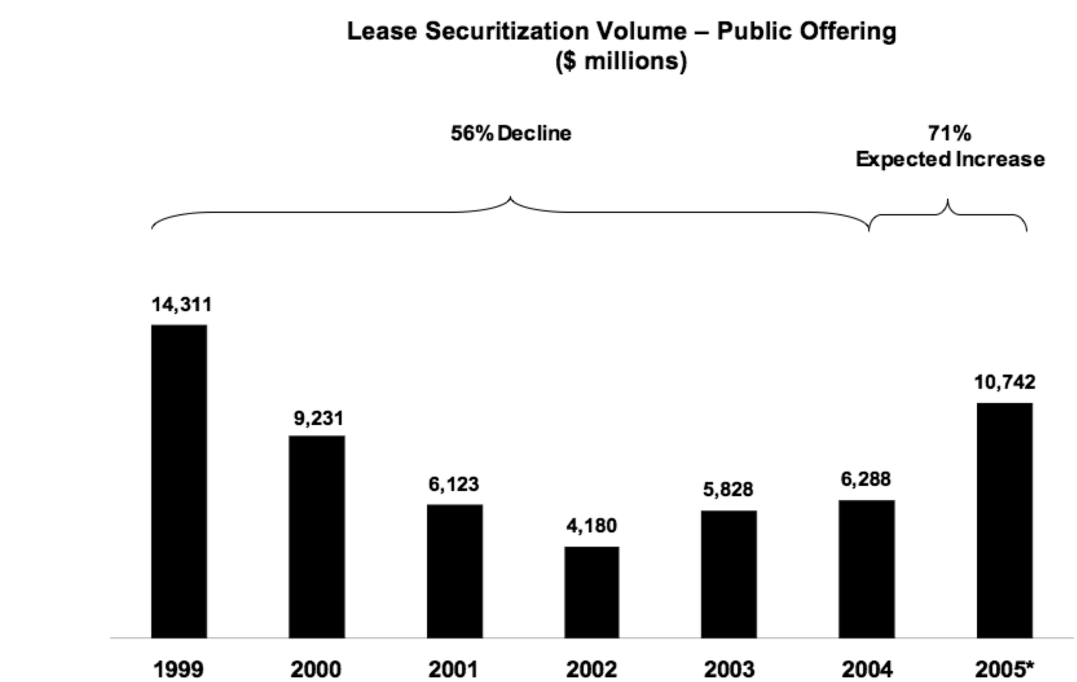
As noted above, any number of events can potentially impact the economy and the demand for equipment. A number of executives we interviewed expressed concern about the near-term impact of Hurricane Katrina on the national economy. Most believe that the direct economic impact of the disaster will be regionally contained and may, in fact, fuel demand for equipment related to the cleanup and reconstruction of the region as well as to the repair of its infrastructure. The issue may be whether this demand is captured by aggressive and opportunistic entrepreneurs versus more established players.

A recent report by Deloitte Research states that, historically, natural disasters have had a positive long-term economic impact[3]. As an example, Deloitte notes that the 1989 Northridge earthquake in Los Angeles led to the rebuilding of bridges statewide. However, with Katrina, they also noted that the increase in energy costs may reduce national GDP growth by .5 to 1 percent through the end of 2005 with much of the impact felt in the retail and consumer goods sectors.

Conversely, the Business Roundtable, an association of 160 CEOs of leading corporations employing 10 million people and generating $4 trillion in annual revenue, recently released a survey of its members indicating that few expect any significant long-term impact from Katrina. The survey reports that only 14 percent of Business Roundtable members have reconsidered plans to expand capital spending over the next twelve months. Most of those reconsidering expressed their intent to leave capital spending at current levels; only one percent indicated intent to reduce capital spending[4].

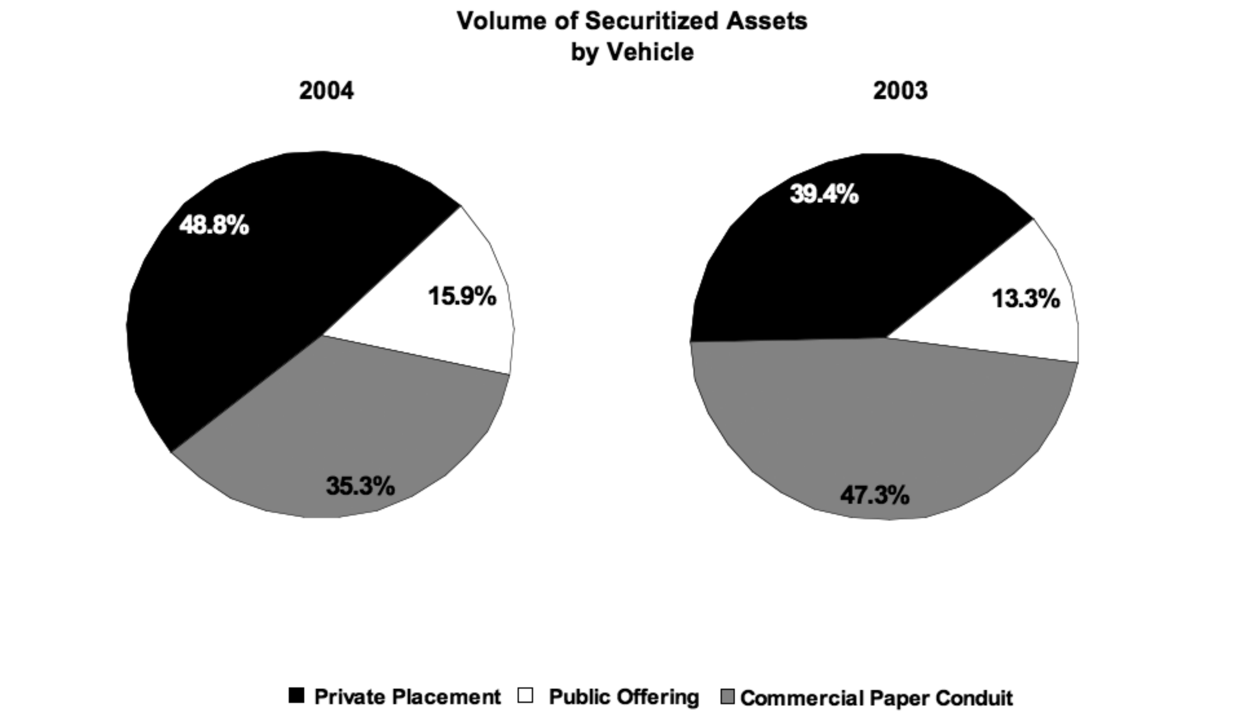
As the recent bankruptcies of Delta and Northwest Airlines indicate, higher energy prices have hurt the already troubled airline industry, likely prolonging weakness in the commercial aircraft market. However, the increased price of fuel is unlikely to have a direct negative impact on other fuel intensive equipment such as trucks and construction equipment. Although the trucking industry will be impacted by any slowdown in the shipment of manufactured goods, virtually all transport companies include a fuel escalation

**Figure 3**




•Estimated – based on six-month figures
Source: Asset-Backed Alert

Figure 4




Source: 2005 ELA Survey of Industry Activity

clause in their shipping contracts, passing fuel price increases directly to the shipper. In addition, the demand for construction equipment related to the cleanup and rebuilding effort from hurricanes Katrina and Rita should more than offset any weakness resulting from higher fuel costs.

Over the past several years, concerns about the availability and cost of funding have plagued the leasing industry. Today, industry experts agree that there may be an excess of capital in the market. Many executives commented that the industry is "awash in capital," contributing to the existing pressure on pricing and spreads.

As Figure 3 indicates, the securitization market appears to be returning to near its pre-2000 levels. Based on the first six-months activity, total volume for the year could exceed $10 billion. As shown in Figure 4, however, players appear to be increasingly opting for private placement of their offering, avoiding much of the regulatory oversight associated with public offerings.

Bank credit also remains an important source of funding for the industry. Leasing executives report that banks appear to be more willing to lend to lessors than they have been in recent years. In their view, this renewed willingness to extend credit to the industry represents banks' desire to grow assets as well as their increased comfort with the health of the industry.

Private equity and hedge funds also became an important source of capital in 2004. Executives noted that these funds either financed or purchased a number of leasing companies during the year. However, in the words of one executive, "This is not a repeat of the dot-com days when venture firms handed out money to anyone who asked. Today, these firms are looking for strong management, a solid business plan, and positive results. The second round of funding is not guaranteed this time around."

***Legislative, Regulatory, and Accounting Issues***

In 2004, changes in the legal, regulatory, and accounting environments may have permanently altered the industry. Tax law changes impacted cross-border and other types of structured deals, and the continued emphasis on simplicity and transparency has made lessees wary of any off-balance sheet structuring. In addition, as Banks began implementing Basel II, they found that, under its risk/capital requirements, many of their leveraged transactions no longer made economic sense. These changes led to a sharp decline in large-ticket volume, volume that some lessors believe may not recover in the near- or medium-term.

The recent changes in U.S. federal tax law retroactively impacted the taxation of cross-border and LILO/SILO transactions. Under the new law, certain tax benefits are restricted, effectively eliminating the economic attractiveness of these vehicles. In addition, the law was implemented retroactively, opening past transactions to potential additional taxation.

Fallout from Enron and other corporate scandals continues to impact large-ticket leasing, as it has in the past few years. Executives stated that lessees, particularly publicly traded companies, continue to avoid any type of off-balance sheet transactions. In the words of one leasing executive, "Most lessees are opting for the most simple, transparent structure. And that is typically a loan."

In 2004, the industry began experiencing the implications of Basel II. As discussed in our sidebar related to the large-ticket segment, Basel II had a profound impact on the viability of large-ticket leveraged leases.

Again this year, leasing executives have discussed the adoption of International Accounting Standards (IAS), as a pending issue for the industry, particularly related to defining operating versus capital leases. Unlike previous years, however, lessors are discussing the issue as a near-term concern.

At issue is International Accounting Standard (IAS) 17, which narrows the definition of an operating lease. Under IAS 17, a lease is classified as a capital lease if it transfers substantially all the risks and rewards of ownership. While this definition is very similar to the U.S. Generally Accepted Accounting Practices (GAAP), International Financial Reporting Standards (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 would, under IAS rules, be treated as capital 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.

In the view of a number of industry experts, micro- and small-ticket lessors will experience the greatest impact from these accounting changes. Under the IFRS rules, popular structures, such as "dollar-out" deals, would become, in effect, loans, extending the lessee's tax benefits over the useful life of the equipment rather than over the life of the lease.

### *The Marketplace/Competitive Environment*

Among the forces influencing the leasing marketplace, The 2005 Industry Future Council Report emphasizes that changes in the way lessors segment themselves may have a profound impact on the industry. In addition, globalization is also affecting the leasing marketplace, as is always the case, presenting both challenges and opportunities.

The "Whale and Minnow" syndrome continued to prevail as a number of last year's mega-bank mergers were completed. The outlook for Independent, Financial Services firms appears brighter while most Captives appear to continue focusing on their parents' products.

### The Marketplace

This year's Industry Future Council Report states that, "...lessors who once identified themselves by the size of their primary lease transactions will describe themselves according to their ownership or industry served." In the view of many leasing executives, this transition has already occurred, driven primarily by the unique competitive advantages lessors enjoy by virtue of their ownership structure. In the words of one lessor, "When we compete for a deal, we don't compete with a middle-ticket lessor, we compete with a Bank that has some specific advantages in winning that deal because it is a Bank. We rarely compete with captives; because their point of sale advantage means we never even see a deal that they want." We agree that segmentation by ownership may becoming more pronounced as banks move to absorb their leasing units into the general commercial bank, turning "leasing guys" into "bankers."

While there has been much talk of how U.S. manufacturing is disappearing to low-wage countries such as China and Vietnam, Department of Labor statistics show that between 1987 and 2003, U.S. manufacturing output increased by over 30 percent in real terms. However, over that same period, U.S. manufacturing shed millions of jobs. The inevitable conclusion is that manufacturers have increased their productivity through their use of technology. For the leasing industry, this translates into continuing opportunities within this sector.

In addition, continuing economic globalization offers opportunities for the leasing industry to significantly increase its total market. *The Globalist* reports manufactured exports from developing countries grew by over 11 percent annually between 1990 and 2003, compared with five percent annual growth over the same period from developed countries[5]. This rapid increase in manufactured exports from developing countries indicates a growing need for capital and equipment. As we highlight in our sidebar, our view is that with planning and due diligence, focused lessors will be successful in these markets.

## The Competitive Environment

The past year may have seen Banks lose some of their competitive advantage in light of stronger non-bank competition. At the same time, it appears that a number of Independents may have finally "got it right" and a number of Captives have indicated an increased willingness to "push product" for their parent.

### Banks

For the first time in a number of years, Banks' share of new business volume declined. Most leasing executives attribute this decline to the overall decline in large-ticket volume, a segment in which Banks traditionally were very involved. As Figure 5 shows, in 2002, large-ticket transactions comprised 38 percent of Bank leasing volume, by 2004, large-ticket represented less than 28 percent of Bank leasing volume.

Figure 5 also shows that, over the same period, Banks began moving down into the middle-ticket space. From 2002 to 2004, middle-ticket volume increased from 32.4 percent of Bank leasing volume to over 41 percent.

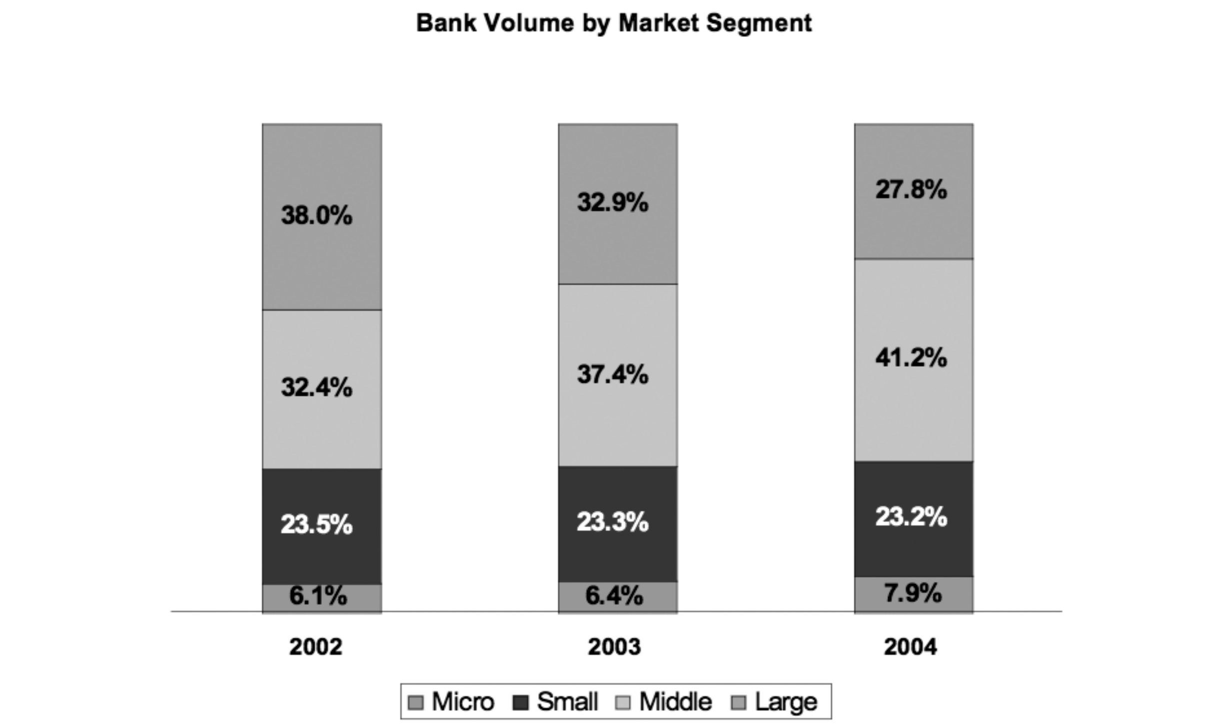
To be successful in the already crowded middle-ticket space, Bank lessors must leverage the presumed relationship advantage that they have with their parent's commercial customers. Attempting to operate independently of the bank franchise will likely result in the Bank lessor becoming a "me too" player, competing primarily on price.

Overall, we have seen Bank-owned lessors continue to increase their focus on existing customers. While, initially, senior management may have mandated this focus, many Bank lessors admit that it is easier to compete when you have an existing relationship with the lessee. One Bank executive we spoke with indicated that the percentage of his new business volume generated from existing customers is running about 10 percent ahead of where it was a year ago.

In addition to its relationship advantage with existing customers, the Bank's cost of funds is a key competitive advantage. Banks typically employ low-cost deposits to fund their lending/leasing operations.

However, Banks also have some significant disadvantages. In addition to increasing regulatory scrutiny and the implications of Basel II, most Banks will usually only consider the highest rated credits, and they are typically unwilling to take more than a token residual position, often less than 10 percent. These are areas where a focused Independent can carve out a profitable niche.

Figure 5




Source: 2005 ELA Survey of Industry Activity

## Independent, Financial Services

In the past year, Independents appear to have won the market share lost by Banks, as they improved their strategic focus. In our conversations with small and mid-sized Independents, management echoed that theme. We repeatedly heard phrases such as "focused," "targeted," and "niche" to describe their approach.

The Independents' competitive advantage typically lies in their underwriting skills and their asset management capabilities. Some Independents cite their service and flexibility as additional advantages.

Successful Independents that we spoke with understood their competitive advantages and created targeted approaches to exploit them. One independent business head discussed how, at the beginning of 2005, he implemented a strategy that targets several equipment types that Banks typically avoid, aiming at credits that are just below Banks' comfort zone. As a result, new business volume has improved dramatically, and pricing and spreads increased as well.

Independents of all size have been successful in the vendor space. Operating vendor programs allows the Independent to reduce one of its most expensive cost components, origination. While large lessors focus on achieving economies of scale through nationwide vendor/dealer programs, one small Independent we spoke with described his niche approach. His company develops relationships with small groups of vendor/dealers located within the same geographic region. The lessor will create a program for that group of vendors with specific service levels included in the contract. The geographic proximity of the dealers both reduces costs and saves the account manager time. This lessor stated that he has experienced strong continual growth since founding the company only a few years ago.

The two disadvantages facing Independents center on their cost of origination and the availability and cost of funding. While Banks can generate deals from their existing customers and Captives enjoy their point-of-sale advantage, in contrast, Independents must rely either on internal sales officers or outside brokers for customers. While lessors can reduce expenses to some degree by focusing on vendor business, the high cost of origination will continue to put Independents at a disadvantage.

As discussed earlier, an abundance of low-cost capital exists in the market, and Independents appear to have sufficient funding at a competitive cost. However, many lessors easily recollect an entirely different situation just a few years ago when funding was scarce and expensive for all but the largest Independents. Independents should begin positioning themselves now to ensure their continued access to funding if, and when, the excess capital leaves the market.

One Independent that has had consistent access to the capital markets when others have not stated that planning is the key to getting and keeping access to funding. In his words, "Start from the first day you open your doors to build the track record, transparent operation, and strong financial reporting that Wall Street demands, even if you never plan to go public. It will give you a significant advantage over other lessors in obtaining scarce funding."

### Captives

Captives enjoy three nearly insurmountable advantages over other players: their ability to bundle the equipment and financing at point-of-sale, their knowledge of the equipment for calculating residuals, and their asset management capabilities. While most Captives concentrate on financing only their parent's products, a number of Captives have broadened the scope of their operations to include a variety of manufacturers. With a few exceptions, however, those Captives financing a broader range of manufacturers rarely venture outside their industry. Many of the Captives that attempted to become generalist equipment lessors, such as Boeing Capital and UPS Capital, have since abandoned or limited that approach.

This year's Survey indicates that over 43 percent of new business volume was originated through either a captive or a vendor program, meaning that the end user arranged financing at the point-of-sale. In the small- and micro-ticket segments, the percentage of equipment sold with point-of-sale financing exceeds 70 percent. The challenge for the Captive is to fully integrate the financing with the equipment sale, creating an environment in which it becomes second nature for the equipment sales person to incorporate the financing into his/her quote. Captives that stand out in that regard include Dell and Caterpillar.

In this year's Survey, as in the past, Captives report a much higher credit approval rate versus other lessor types, approving 89 percent of submitted applications (compared with 68 percent for both Banks and Independents). In the view of many leasing executives, Captives' equipment knowledge and asset management capabilities allow them to approve more marginal credits without significantly increasing their risk. As one executive noted, "If a lessee defaults, the Captive is in the best position to grab the equipment, refurbish it, and then sell it through their own network. In all likelihood, they will lose little if anything from that default."

One challenge for Captives is to balance their credit/risk responsibilities against their mission to support and facilitate the sale of their parents' product. As a result, few, if any, Captives have any reporting responsibility to the sales organization. According to most executives, conflicts are few and those that do arise are often resolved through recourse or other arrangements that protect the Captive's portfolio quality.

[1]National Association for Business Economics: *NABE Outlook, May 2005*
[2]National Association for Business Economics: *NABE Industry Survey, July 2005*
[3]Deloitte Research: *Why Katrina Won't Sink the U.S. Economy, September 2005*
[4]Business Roundtable: *CEO Economic Outlook Survey, September 21, 2005*
[5]The Globalist, *The Truth about Global Manufacturing Exports, September 6, 2005*

# ANALYSIS OF THE SURVEY OF INDUSTRY ACTIVITY

This year's ELA Survey includes 142 survey responses from 130 companies. Five companies provided separate surveys for their various lines of business.

Each year's Survey asks respondents for current and prior year data; unless otherwise indicated 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 representing 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:

- The Overall Industry
- Lessor Profitability
- Market Segment Profitability

In addition to providing data by lessor type and transaction size, this year's survey provides data by lessor size (by annual volume). In some cases, analysis by lessor size provides additional insight into the data's meaning. In those cases, we incorporate lessor size into our analysis.

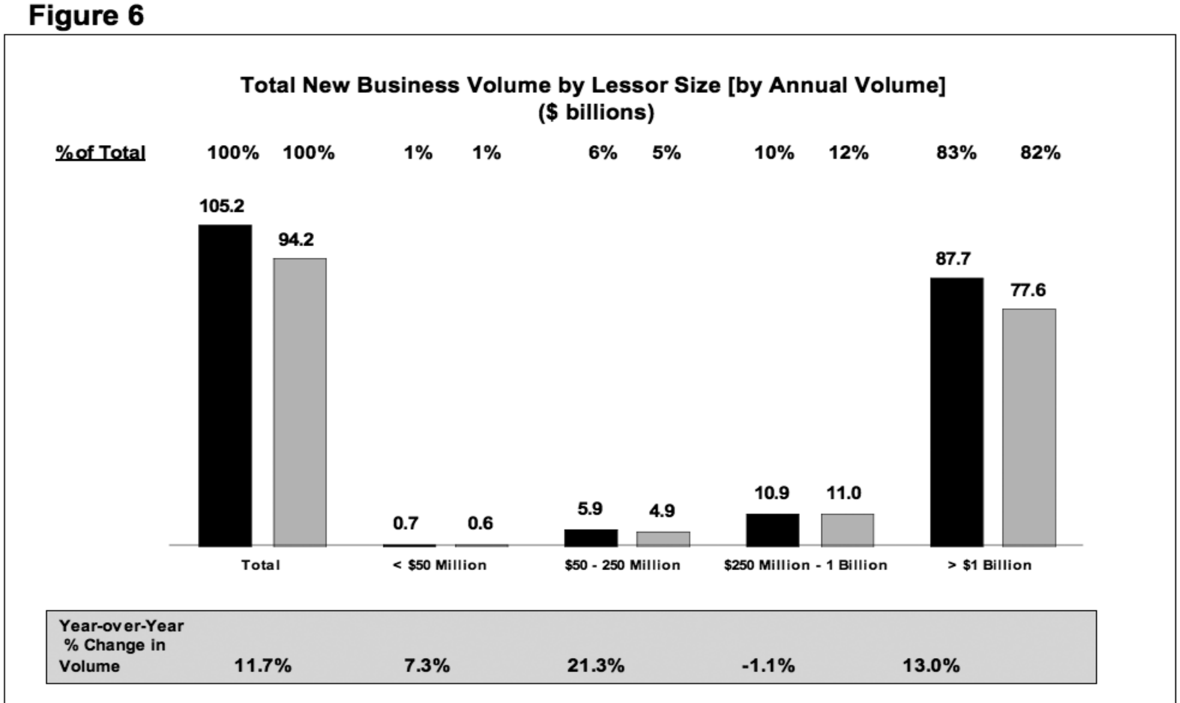
### The Overall Industry

Overall, Survey respondents reported growth in 2004, as new business volume increased. While pre-tax yields improved slightly, spreads continued to shrink due to an increase in the cost of funds. Net income increased significantly over the previous year; however, (ROE) declined and (ROA) remained unchanged. Credit quality also improved, with both delinquencies and median charge-offs declining over 2003. Operational efficiency improved as lessors increased volume without increasing staffing.

Our analysis of the overall industry focuses on the following areas:

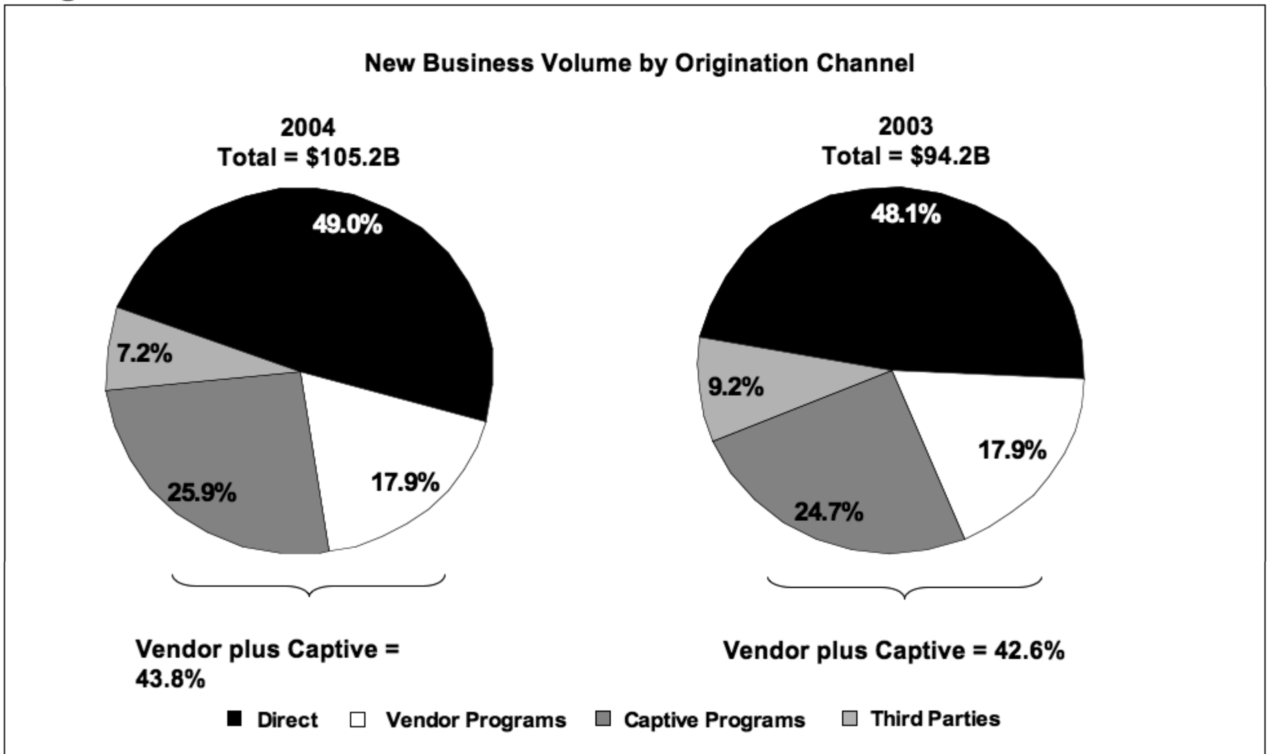
- New Business Origination
- Profitability and Funding
- Portfolio/Credit Quality
- Operations

**Figure 6**



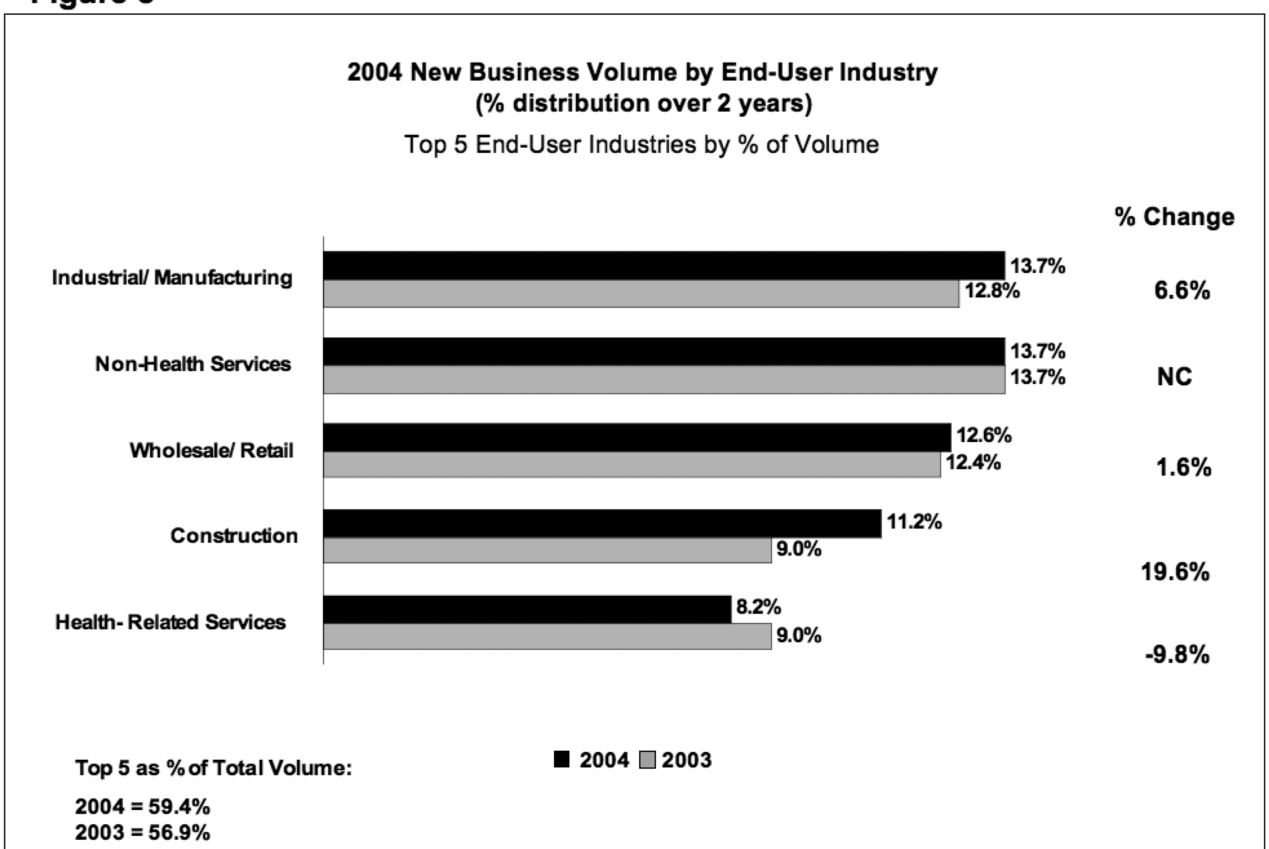

Source: 2005 ELA Survey of Industry Activity

**Figure 7**




Source: 2005 ELA Survey of Industry Activity

**Figure 8**




Note: Trend data is provided only for respondents who reported both years of data
Source: 2005 ELA Survey of Industry Activity

*New Business Origination*

This year's respondents reported an 11.7 percent increase in new business volume over 2003. As shown in Figure 6, the largest lessors, those with over $1 billion in annual volume, contributed 83 percent of total new business volume. These lessors reported a 13 percent increase in volume over 2003. With the exception of lessors with volume between $250 million and $1 billion, lessors of all sizes reported significant growth over the previous year.

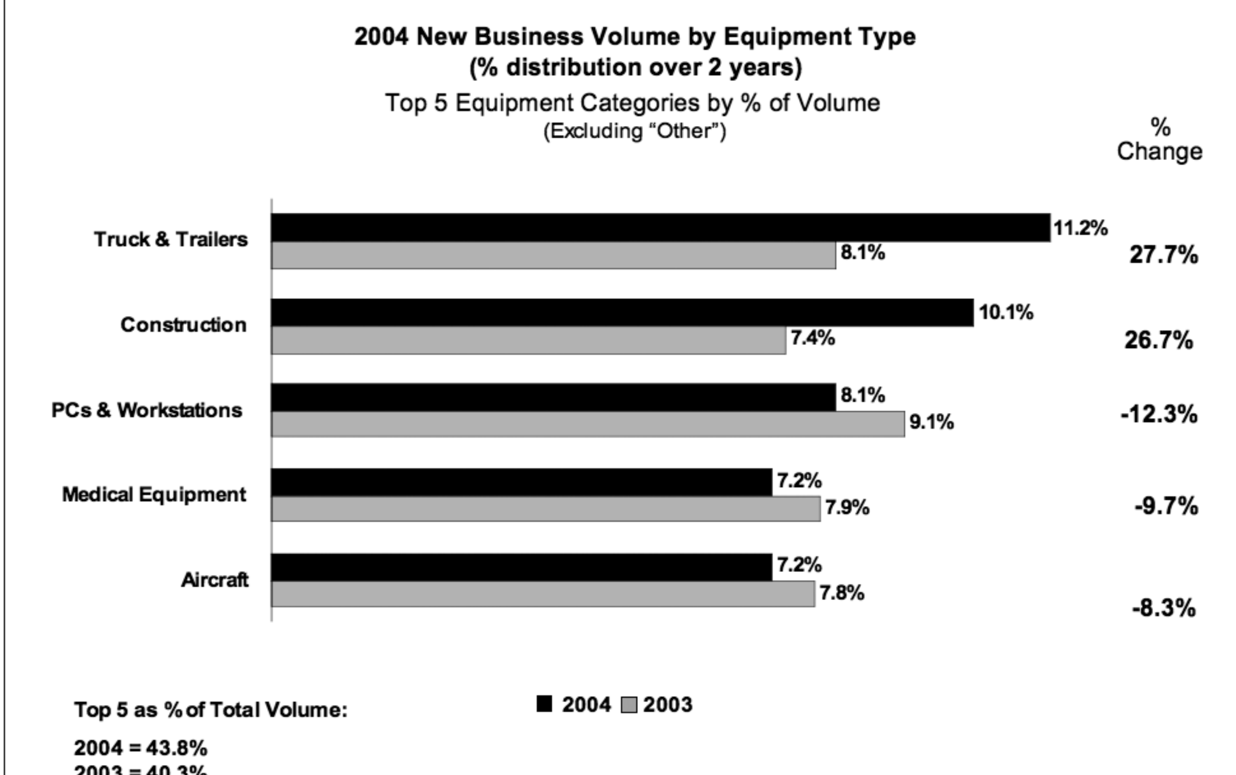
As Figure 7 shows, origination by channel changed little from 2003. Nearly half of all new business volume is originated directly. Volume originated through captive and vendor channels increased slightly, from 42.6 to 43.8 percent. Business originated through third parties declined by two percent from 9.2 to 7.2 percent of total volume.

Five end-user industries generated nearly 60 percent of all new business volume. As shown in Figure 8, new business volume from the construction industry increased significantly. Only the health-related services industry showed a decrease in leasing activity, potentially due to anticipated restrictions on the allowance of tax benefits to lessors resulting from finance transactions with "tax disinterested" entities, such as not-for-profit hospitals.

As Figure 9 shows, the five largest equipment categories generated over 40 percent of total new business volume. Of the five categories, only trucks and construction equipment showed increases over the prior year. The remaining categories, computers, medical equipment, and aircraft all declined. Industry leaders speculate that, as the price of computers declines, business may prefer cash purchases rather than financing.

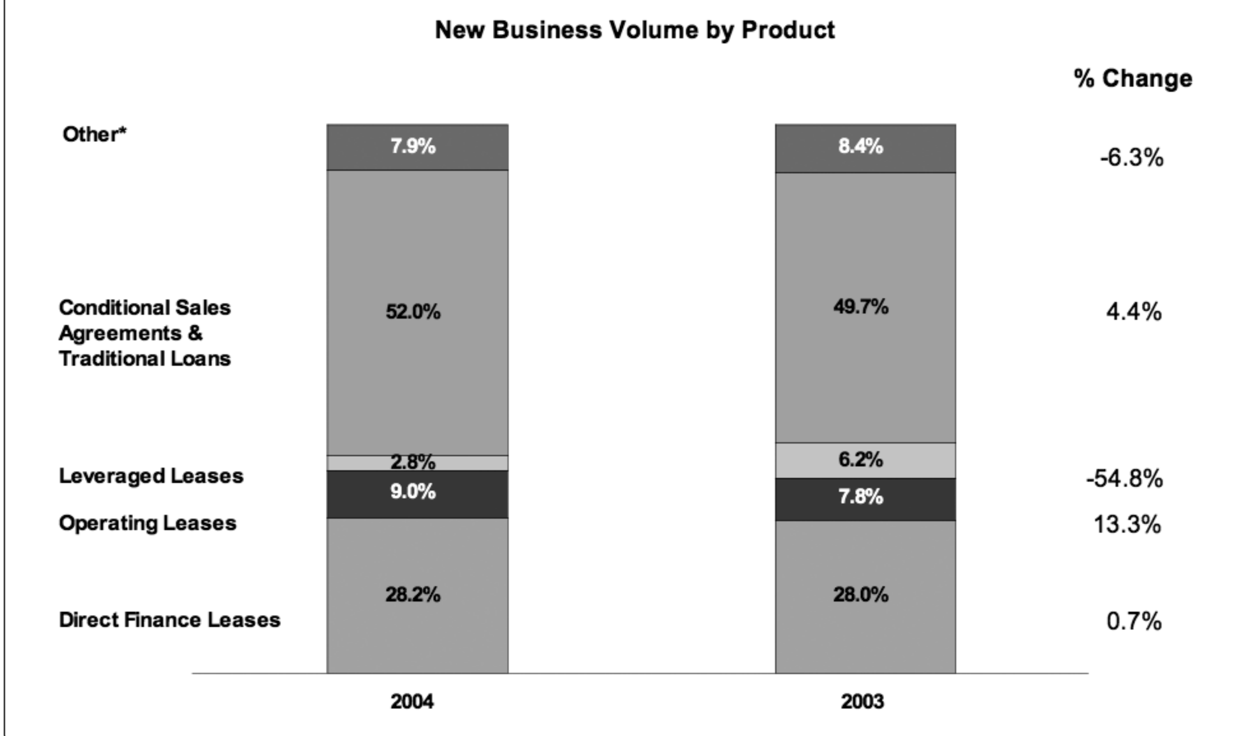
Given recent regulatory and accounting changes, it is not surprising that the use of leveraged lease products declined. As Figure 10 shows, new business volume booked as leveraged leases declined by nearly 55 percent from 2003. Over

**Figure 9**




Note: Trend data is provided only for respondents who reported both years of data
Source: 2005 ELA Survey of Industry Activity

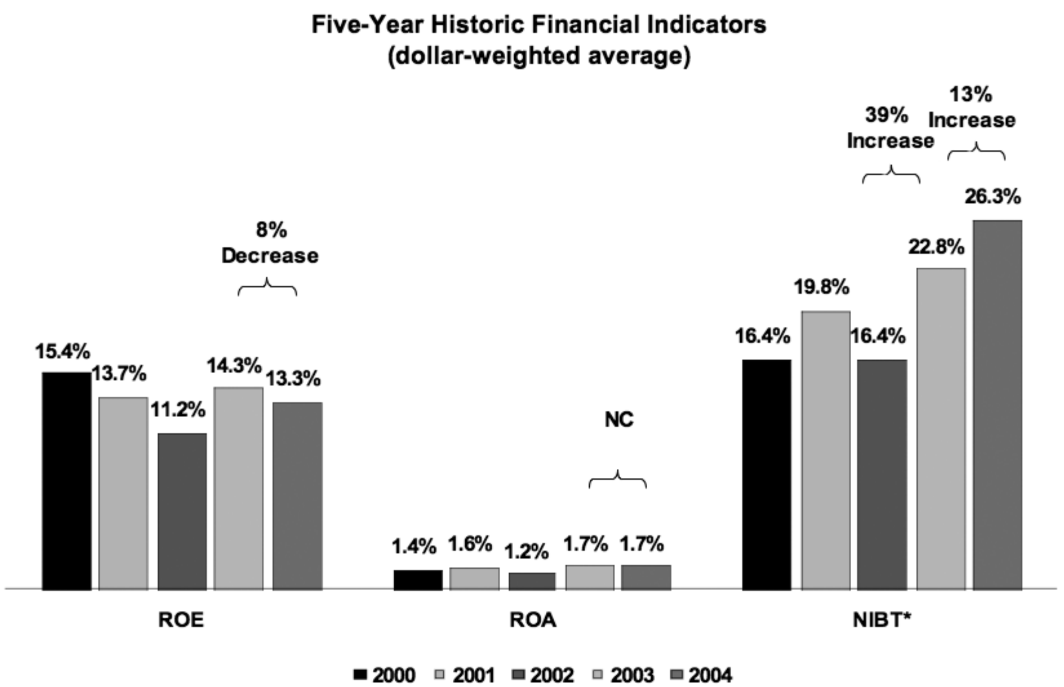
**Figure 10**




* Other includes Off-Balance Sheet Loans, Tax-Exempt Leases, Joint Ventures, Partnerships, etc.

Source: 2005 ELA Survey of Industry Activity

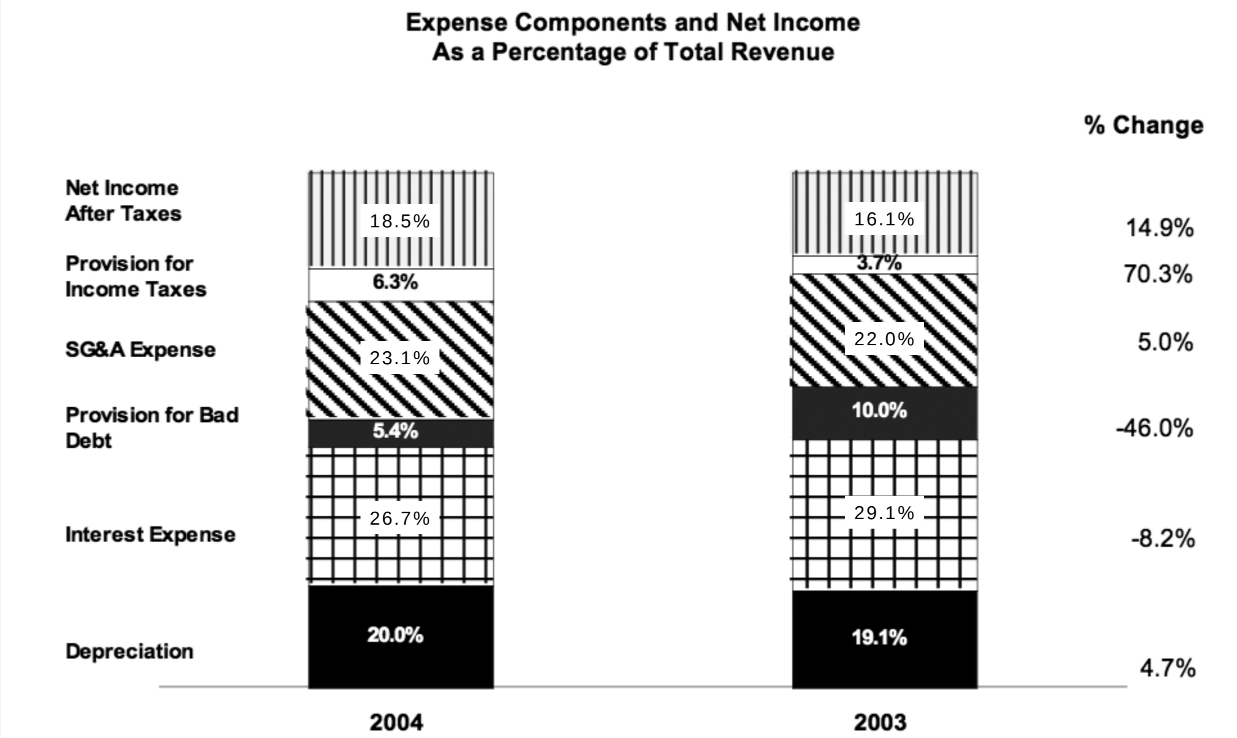
**Figure 11**




* As a percentage of total revenue

Source: 2005 ELA Survey of Industry Activity

**Figure 12**




Source: 2005 ELA Survey of Industry Activity

the same period, new business volume booked as operating leases and conditional sales/loans both increased, likely reflecting lessors desire for transparency.

***Industry Perspective and Potential Implications***

As the economy expands, the demand for equipment and leasing will continue to increase. However, changes in the legal or accounting environment as well as in other economic variables can dramatically change the attractiveness of a particular industry, equipment type, or even product.

***Potential Implications***

➩ While growth in overall volume is likely to continue, lessors will need to react quickly to changes that may impact only specific markets, for example, a specific equipment type or industry. This is particularly true for smaller lessors that, in order to effectively compete, have focused their efforts and built expertise in one or two equipment categories or industry segments. Lacking diversity to insulate them from market shifts, these lessors must be able to anticipate changes in their markets and react before they are negatively impacted.

***Profitability and Funding***

While net income improved in 2004, profitability measured by ROE declined and ROA remained unchanged from the year before. Average pre-tax yield improved slightly, but pre-tax spread declined, driven by an increase in the cost of funds. As in past years, lessors appear to have improved net income through expense reduction and increased efficiency.

As shown in Figure 11, net income increased by 13 percent (to 26.3 percent of total revenue) versus a 39 percent increase the previous year. However, ROE declined by eight percent from 2003 to 13.3 percent and ROA remained unchanged at 1.7 percent. The decline in returns is largely due to shrinking spreads as the industry requires more capital versus last year to generate the same revenue. As Figure 12 indicates, this year's increase in net income resulted largely from decreases in provisions for bad debt and reduced interest expense. That net income increased at a slower rate than the previous year may indicate that lessors have less "fat" to cut. Lessors may become unable to increase net income without a significant improvement in spreads.

As Figure 13 shows, average pre-tax yield increased by over three percent from 2003. However, the 8.1 percent increase in the cost of funds drove pre-tax spread down by less than one percent. Figure 14 shows that the two smallest lessor groups, those with less than $50 million in annual volume and those with annual volume of $50-250 million, generated the highest yields, but also the highest cost of funds. Although these lessors earned pre-tax spreads in excess of five percent, their high cost structure resulted in below average net income.

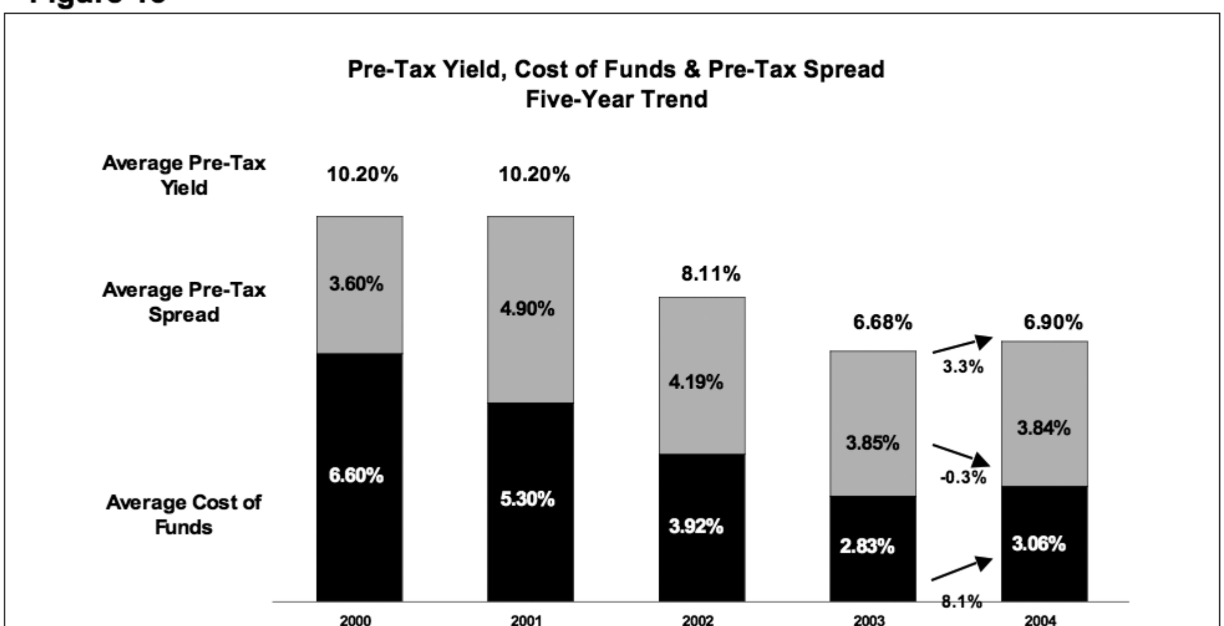
***Industry Perspective and Potential Implications***

According to industry experts, strong competition, fueled by an abundance of capital, has continued to keep pricing low, even with increasing cost of funds. As one executive stated, "There is too much money and too few deals, the best credits can virtually name their price." In addition, large-ticket players, typically Banks, have moved down market to make up for volume lost in their traditional segment. With their low cost of funds and the potential to earn additional revenue through a banking relationship with the customer, Banks are often willing to price deals lower than competitors.

***Potential Implications***

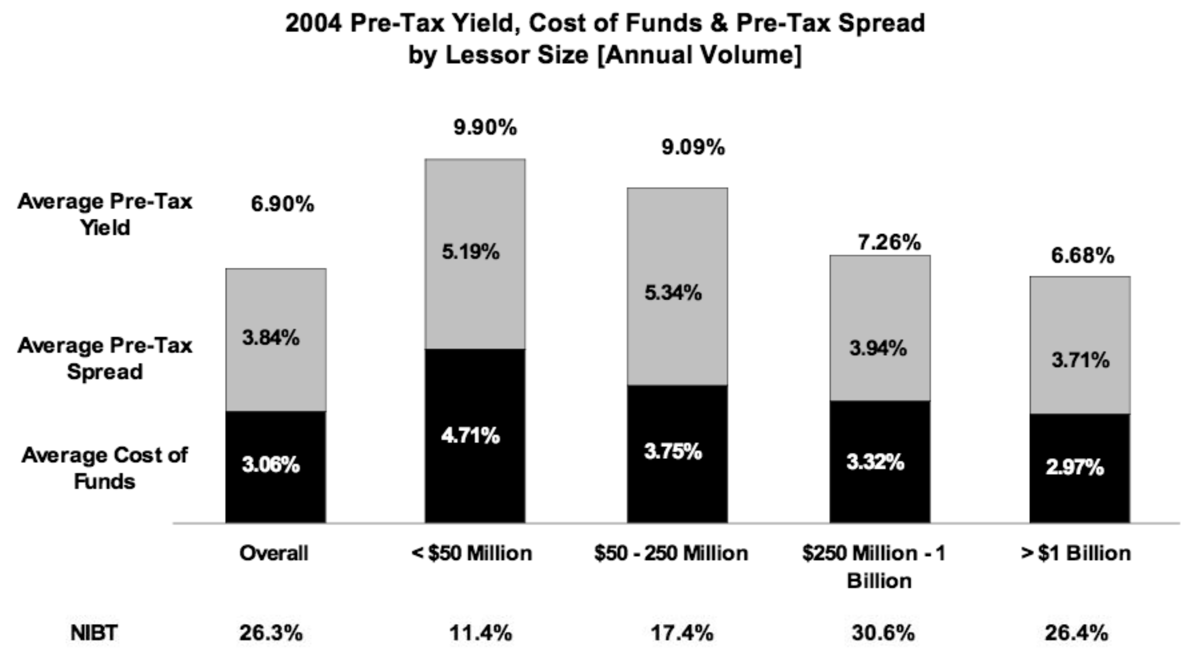
➩ While the best credit customers can "name their own price," companies with lower credit ratings appear willing to pay for access to capital. Success in serving lower-grade customers requires strong underwriting skills and excellent asset management capabilities. While strong underwriting will reduce the likelihood of default, the lessor's ability to reclaim and quickly remarket the asset will reduce its loss if a default does occur. One Bank lessor known to FIC has created a separately managed portfolio for lower grade deals. These deals require more

**Figure 13**



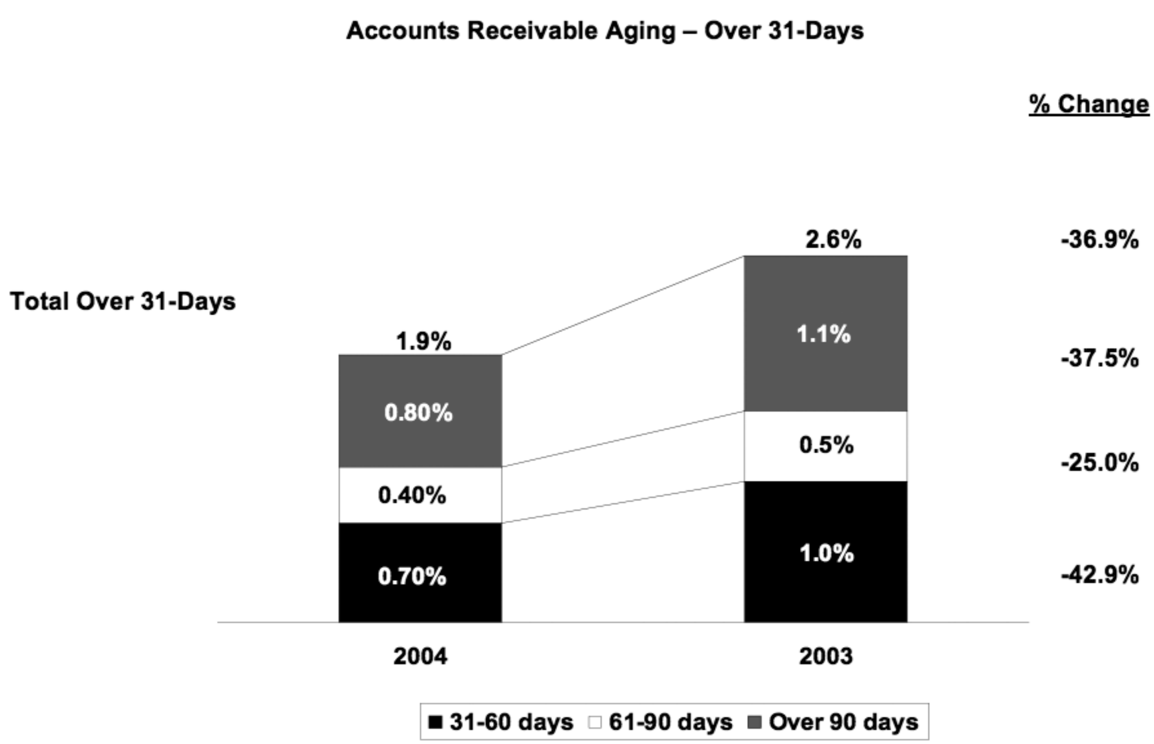

Source: 2005 ELA Survey of Industry Activity

## Figure 14



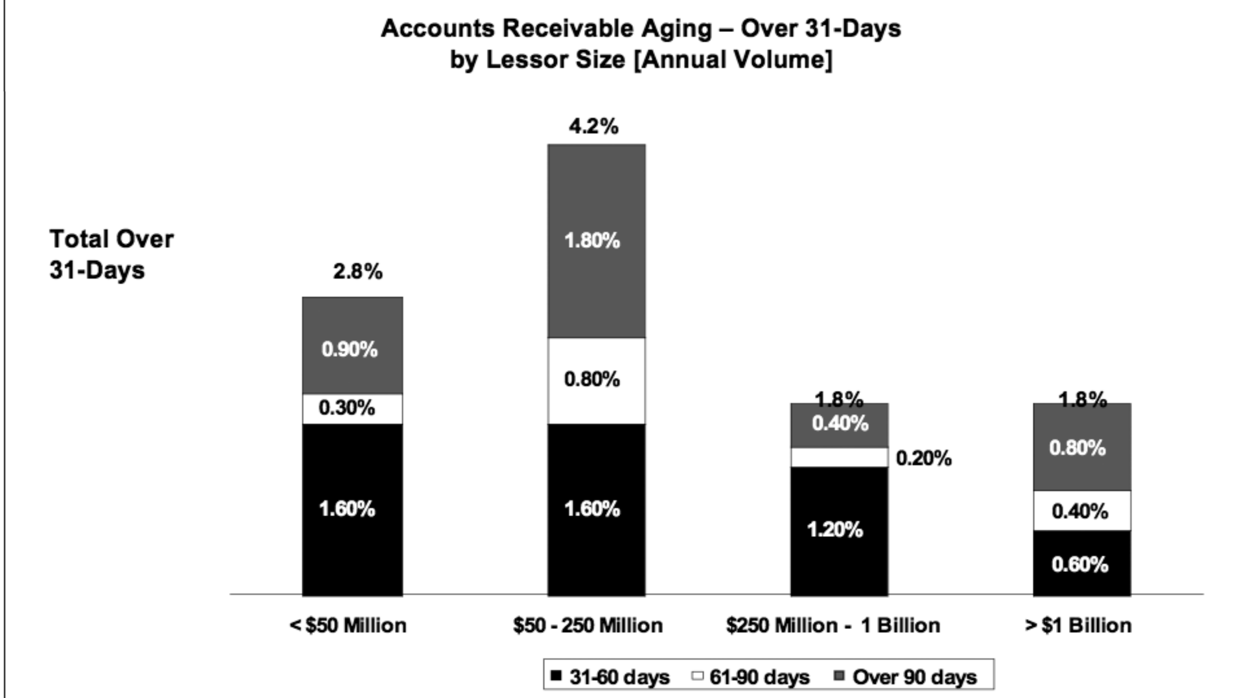

Source: 2005 ELA Survey of Industry Activity

## Figure 15




Source: 2005 ELA Survey of Industry Activity

Figure 16




Source: 2005 ELA Survey of Industry Activity

intense underwriting and are monitored more carefully than higher-grade deals. This approach has allowed the Bank to generate more volume and increase its yields without a significant increase in losses.

### *Portfolio/Credit Quality*

Overall, credit quality and portfolio performance improved over the previous year. As Figure 15 shows, delinquencies, measured as receivables over 31-days, declined by nearly 37 percent over 2003 to 1.9 percent. Receivables over 90-days decreased by almost 38 percent, to less than one percent. However, as Figure 16 shows, smaller lessors have the highest delinquency rates. This may indicate that smaller lessors have fewer resources dedicated to collections versus larger lessors. Another possible explanation is that smaller lessors have not been able to invest as heavily in underwriting technology (credit scoring, financial analysis packages, etc.) as have larger lessors.

Average charge-offs increased over the previous year, from 1.3 to 1.5 percent of net receivables (Figure 17). However, the median declined to .5 percent, indicating that a small number of lessors reported significant charge-offs.

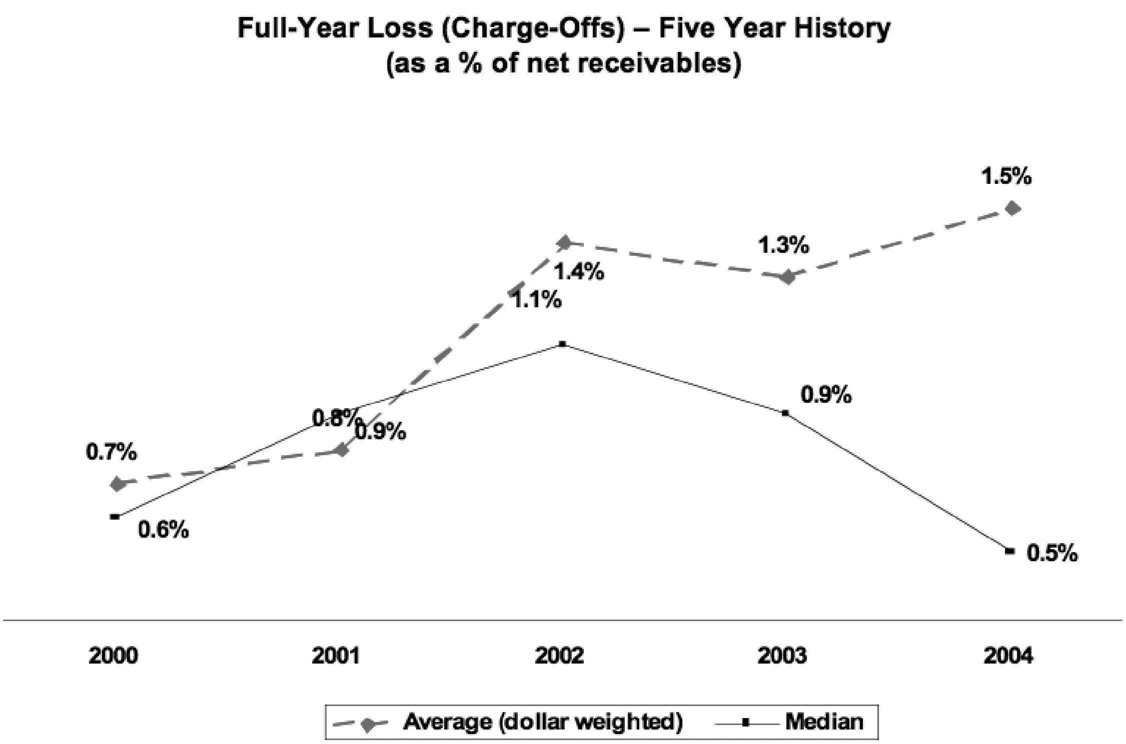
### *Industry Perspective and Potential Implications*

Credit quality typically improves as the economy improves. However, as shown in Figure 16, smaller lessors typically experience higher delinquencies and charge-offs versus larger lessors. As noted above, underwriting and collections capabilities may be at least partial explanations. Another factor impacting portfolio performance reflects the degree to which smaller lessors are more likely to be involved in the micro- and small-ticket segments than other players. By their nature, these segments typically experience the highest delinquency and default rates,' however, pricing for micro- and small-ticket transactions reflect the increased risk.

### *Potential Implications*

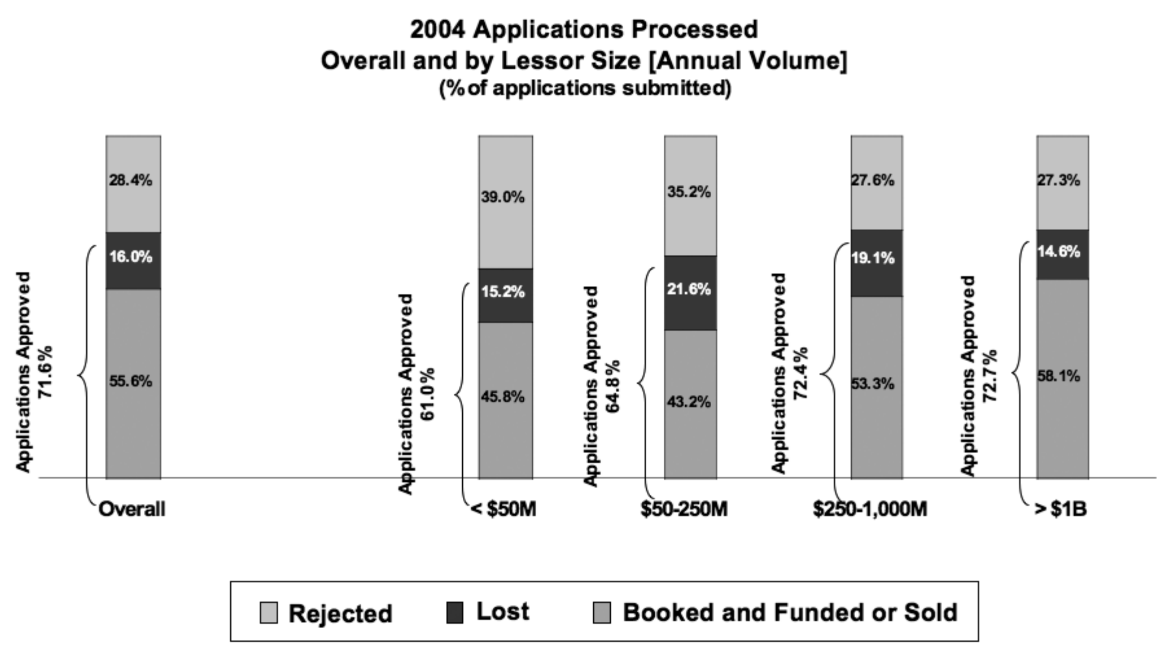
➩ In the current low-margin, highly competitive environment, lessors can often generate

## Figure 17




Source: 2005 ELA Survey of Industry Activity

## Figure 18




Source: 2005 ELA Survey of Industry Activity

higher yields and greater volume by hunting further down the food chain in terms of credit quality. While a number of lessors have developed the expertise to profitably operate in the sub-prime market, most lessors should be extremely cautious in doing so, remembering that even industry leaders have fallen because of credit issues. As noted above, the requirements to succeed in the sub-prime market include very strong underwriting experience and the capability to quickly reclaim assets and remarket them efficiently (meaning quickly and for market prices).

➭ Credit quality may be "as good as it gets" both for the leasing industry and financial services players overall. In many cases, lessors can expect higher delinquencies and charge-offs over the next 18-24 months. This means that net income and returns will need to rely further on interest spreads and cost efficiencies, difficult accomplishments for many.

### *Operations*

This year's Survey focuses on several aspects of lessor operations, including:

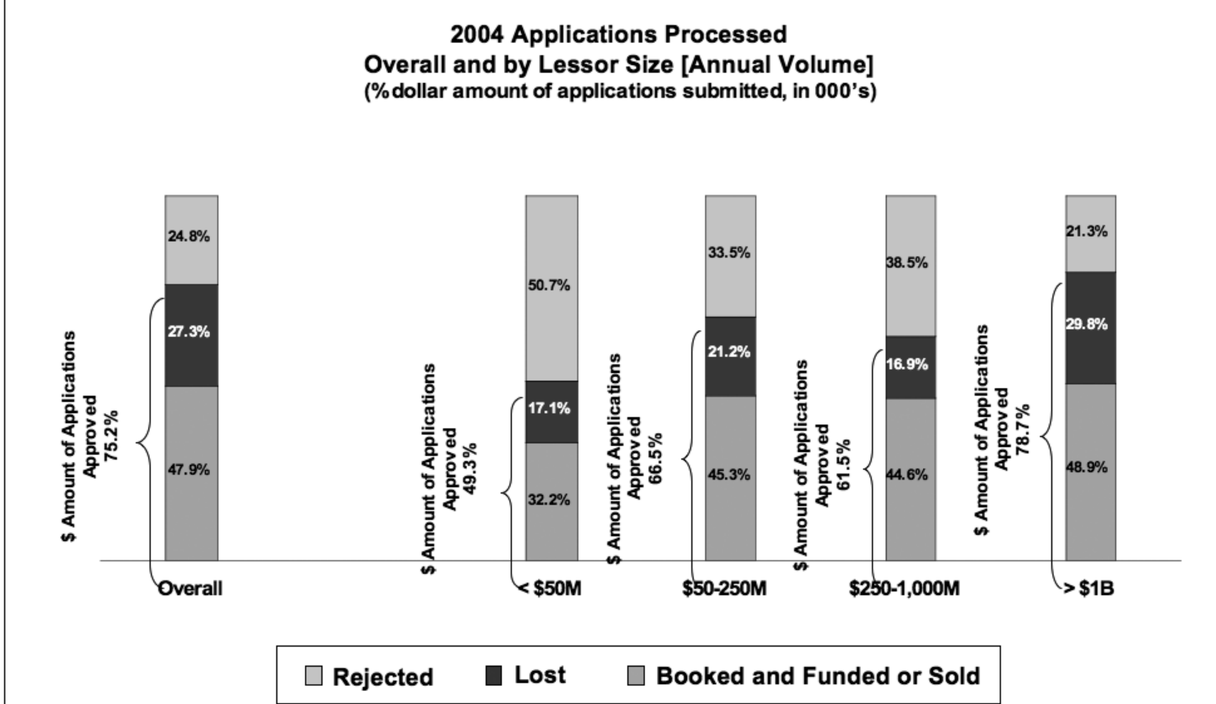
- Application processing
- Equipment remarketing
- Employee distribution
- Operational efficiency

### Application Processing

This year, 93 of the 142 respondents provided data related to applications submitted, approved, and booked then funded or sold. Therefore, the data in Figures 18 and 19 represents approximately 60 percent of total new business volume, providing directionally correct ratio and trend insights.

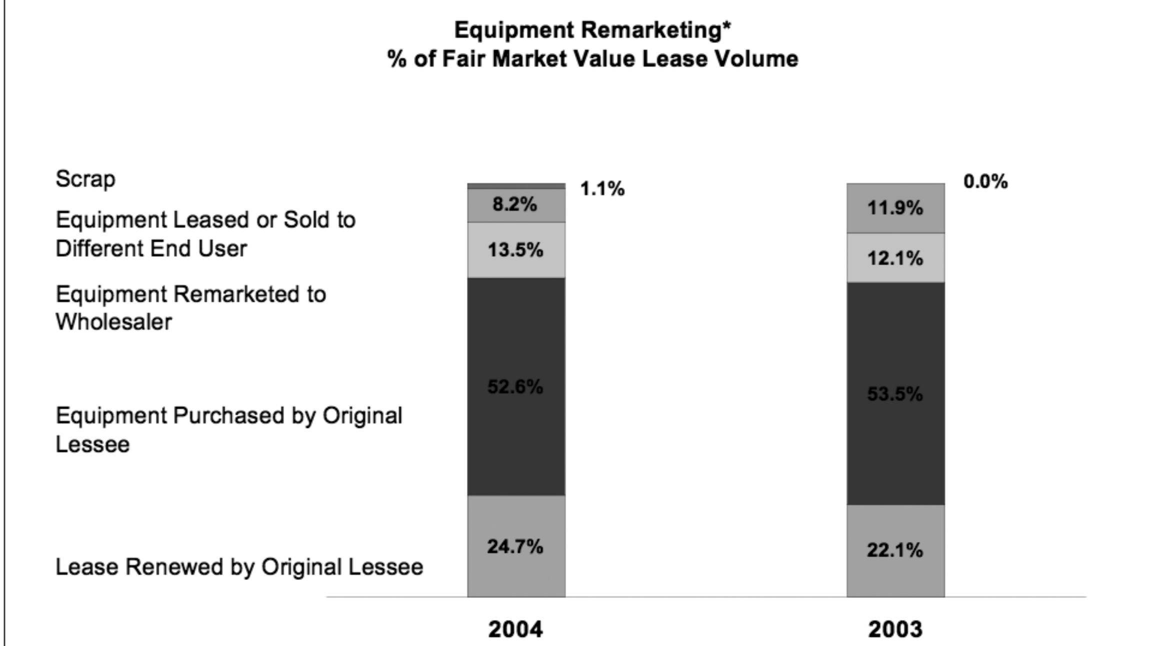
This year's respondents approved almost 72 percent of the applications submitted and over 75 percent of the dollars submitted (Figures 18 and 19). In general, larger lessors approved a higher percentage of both applications and dollars submitted. While the largest lessors, those with over $1 billion in annual volume, approved nearly 73 percent of applications

**Figure 19**




Source: 2005 ELA Survey of Industry Activity

**Figure 20**




* 2003 data is from the 2004 SIA and represents a different respondent set
Source: 2004 and 2005 ELA Survey of Industry Activity

submitted and 79 percent of dollars submitted, the smallest lessors (less than $50 million in volume) approved 61 percent of applications submitted and less than 50 percent of dollars submitted. These lower percentages reflect that smaller lessors are primarily involved in the micro- and small-ticket segments, where rejection rates are typically much higher versus the other market segments.

Overall, the industry lost[6] 16 percent of approved applications and over 27 percent of approved dollars (Figures 18 and 19). Lessors with over $1 billion in volume lost the fewest applications, but they lost the largest dollars, indicating that large lessors lost, or were unable to complete, a significant number of large-ticket transactions.

## Equipment Remarketing

Overall, respondents reported that the original lessee purchased nearly 53 percent of leased equipment (by fair market value [FMV] lease volume). An additional 24.7 percent was re-leased by the original lessee. As shown in Figure 20, this year's remarketing activity closely matched activity in 2003.[7]

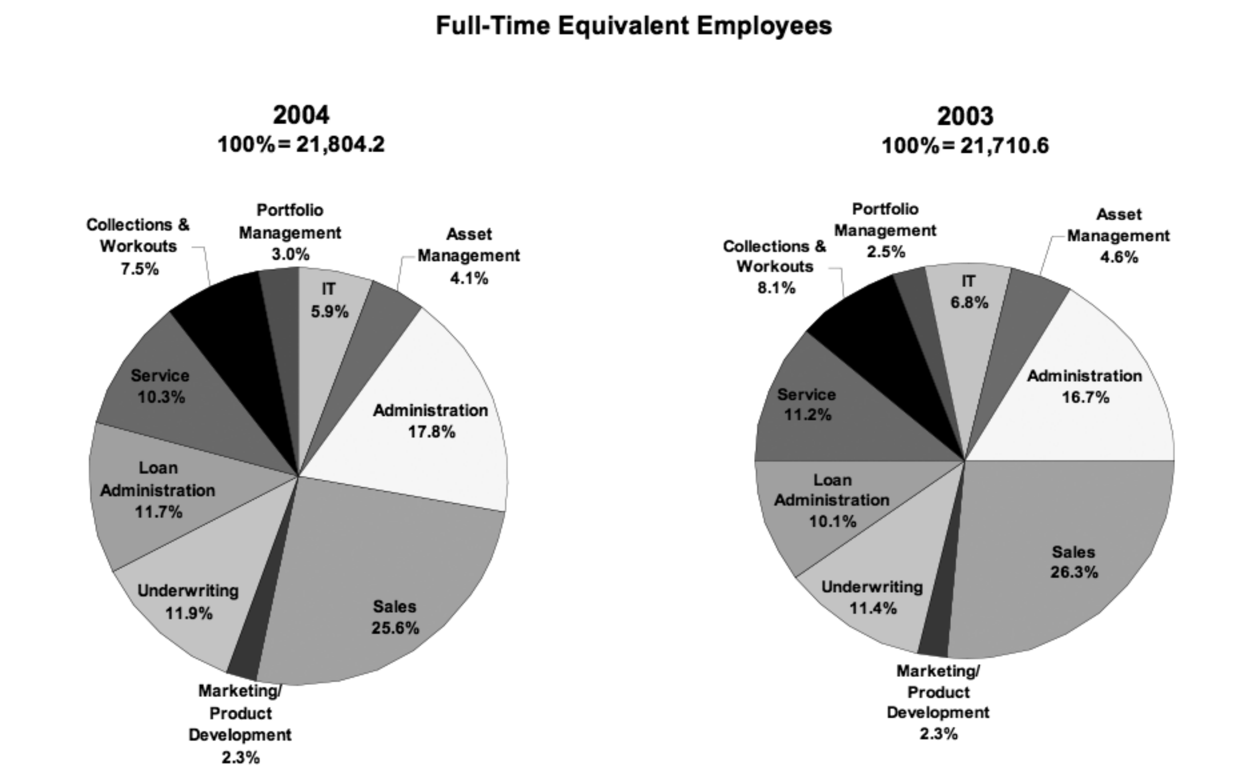
Not surprisingly, large-ticket lessees purchased over 90 percent of their leased equipment versus 57 percent for middle-ticket lessees and 43 percent for small-ticket lessees. Since large-ticket equipment typically has a long expected useful life, lessees can continue using the equipment far past the lease term.

## Employee Distribution

Despite an 11 percent increase in volume, this year's respondents reported operating with virtually the same number of employees as in the previous year. However, as Figure 21 shows, lessors reallocated employees, partly in response to improved economic conditions.

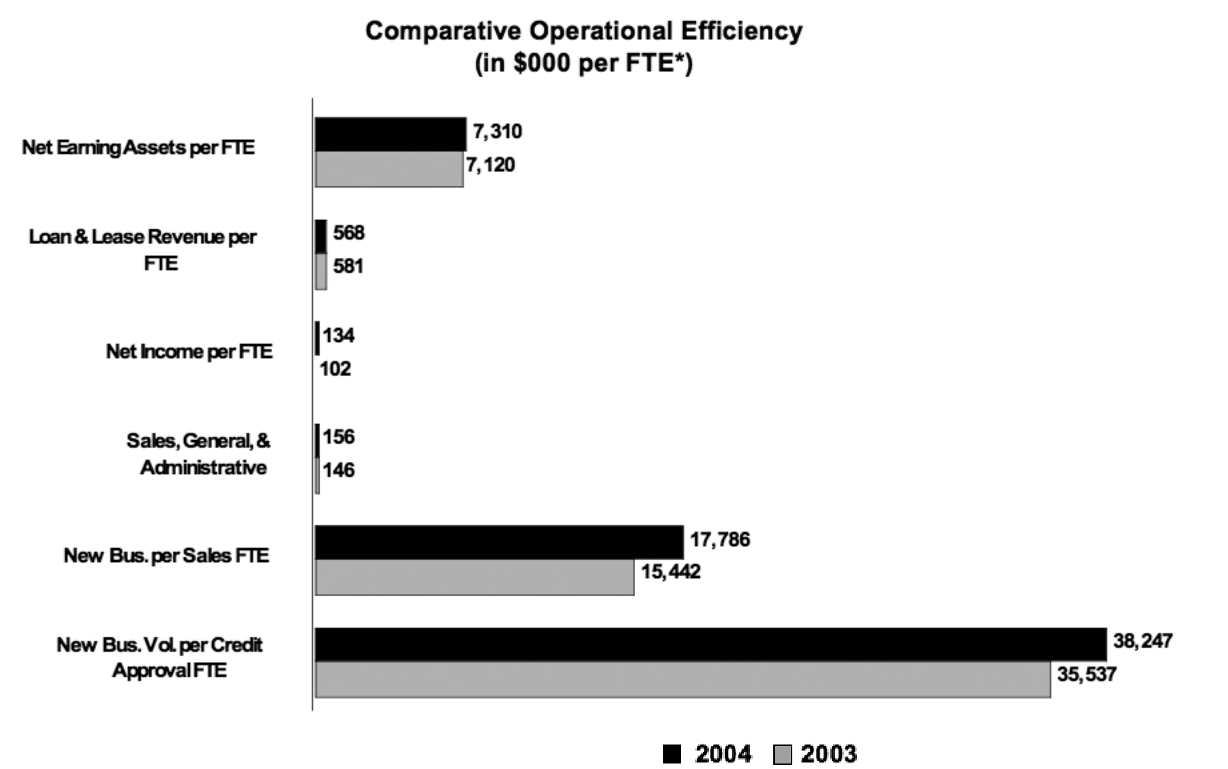
In 2004, respondents reported reducing collections and workout and asset management staff by 1.1 percent of total full-time equivalent employees (FTE), likely in response to improved portfolio quality and lower delinquencies. Lessors also reduced customer service and sales staff by 0.9 percent and 0.7 percent, respectively,

## Figure 21



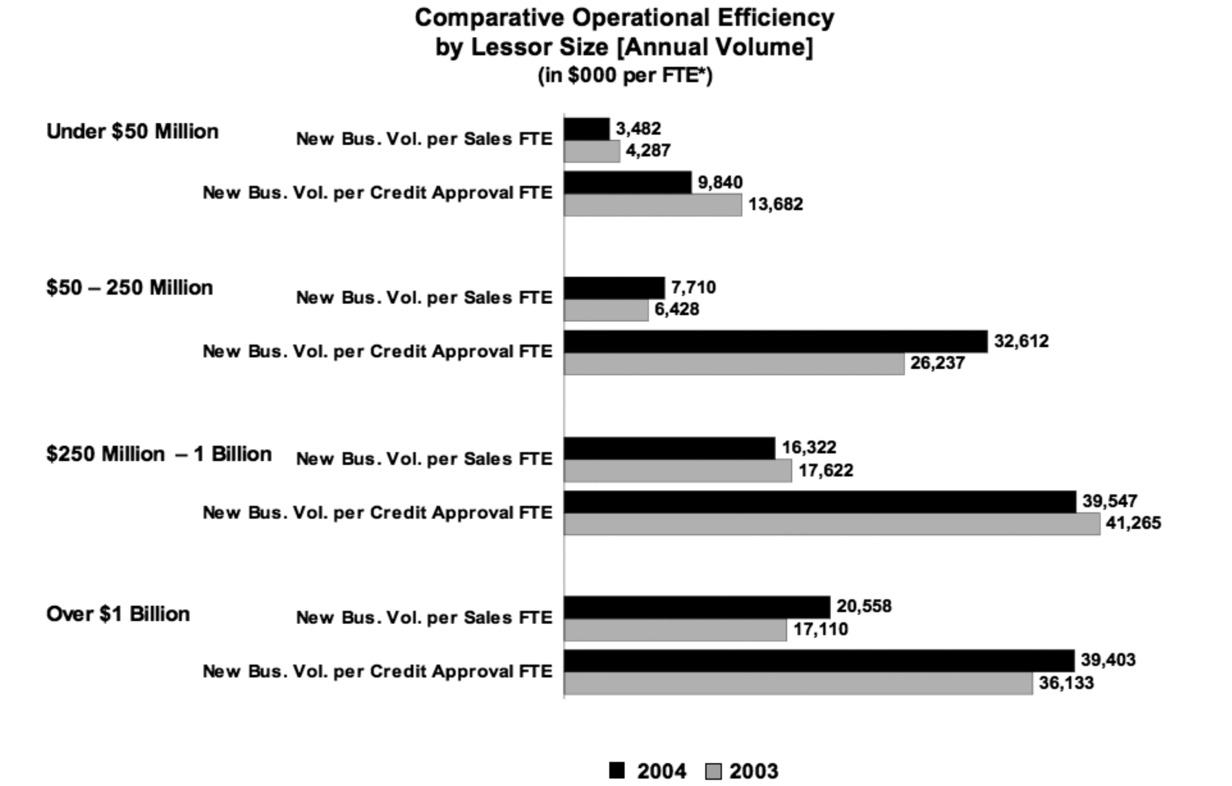

Source: 2005 ELA Survey of Industry Activity

## Figure 22




* FTE = Full-time equivalent
Source: 2005 ELA Survey of Industry Activity

**Figure 23**




* FTE = Full-time equivalent
Source: 2005 ELA Survey of Industry Activity

and increased administrative staff by 1.1 percent. Although no comparative 2003 data is available for respondents' outsourcing activity, the reduction in customer service staff may be the result of increased reliance on outsourced resources.

## Operational Efficiency

Overall, lessors reported improved operational efficiency in 2004 versus 2003. As shown in Figure 22, respondents gained efficiency in most areas except for loan and lease revenue per FTE. The apparent decrease in efficiency in this area is likely due to the margin compression experienced by most players.

Two groups of lessors, those with volume less than $50 million and those with volume between $250 million and $1 billion, reported being less efficient in 2004 versus 2003. As shown in Figure 23, both new business volume per sales FTE and new business volume per credit approval FTE decreased for both groups. However, the reasons differ. The smallest lessors (less than $50 million in volume) reported increasing headcount by nearly 28 percent in 2004, far ahead of their increased volume. The larger lessors ($250 million to $1 billion in volume) reduced headcount by seven percent versus 2003, but also experienced a 1.1 percent decline in volume (Figure 6).

***Industry Perspective and Potential Implications***

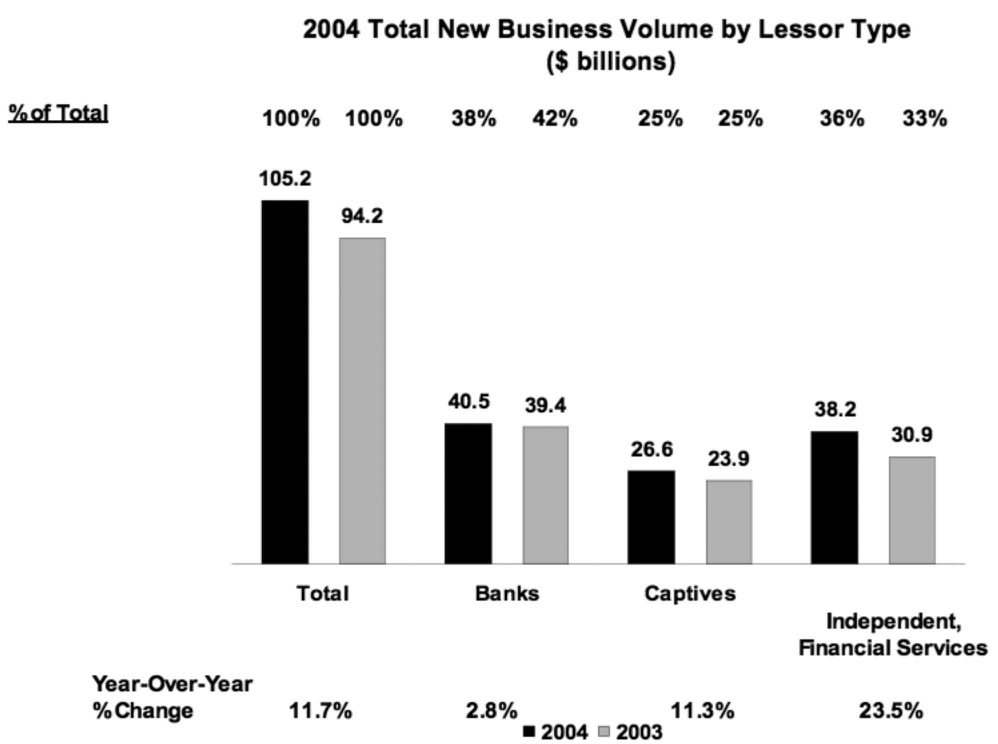
Overall, lessors' operational data points to sound credit decisions and improved efficiency. However, lessors may have more difficulty squeezing profits out of enhanced efficiency in the coming years. While most executives we interviewed and our clients believe they can obtain some additional cost savings from their organizations, few believe that they can continue to do so indefinitely. As we noted in last year's Report, one way to add new volume efficiently may be to stem the flow of "lost" deals. As discussed earlier, these lost deals represent significant dollars, and, while many of those dollars likely remain within the leasing industry (i.e., the deal was lost to another lessor), it is clear that many more dollars leave the industry entirely. In our view, each lessor, as well as the overall industry, should know where these lost deals went and the reason why. Another area where the industry may be able to generate operational efficiency requires increasing the use of technology. One service provider stated that, as an industry, lessors spend less on technology than nearly any other industry group. While many lessors may argue that, "the capital is better spent funding deals rather than purchasing technology," it maybe a shortsighted approach.

***Potential Implications***

➭ Lessors that perform honest post mortems on lost deals and then take action to improve their products, service, and operations should see a rapid return on their investment. Because of the cost of origination, saving a deal often becomes more valuable than finding a new one. While certainly not all deals can be saved, even saving a small percentage of them will have a meaningful impact on the bottom line

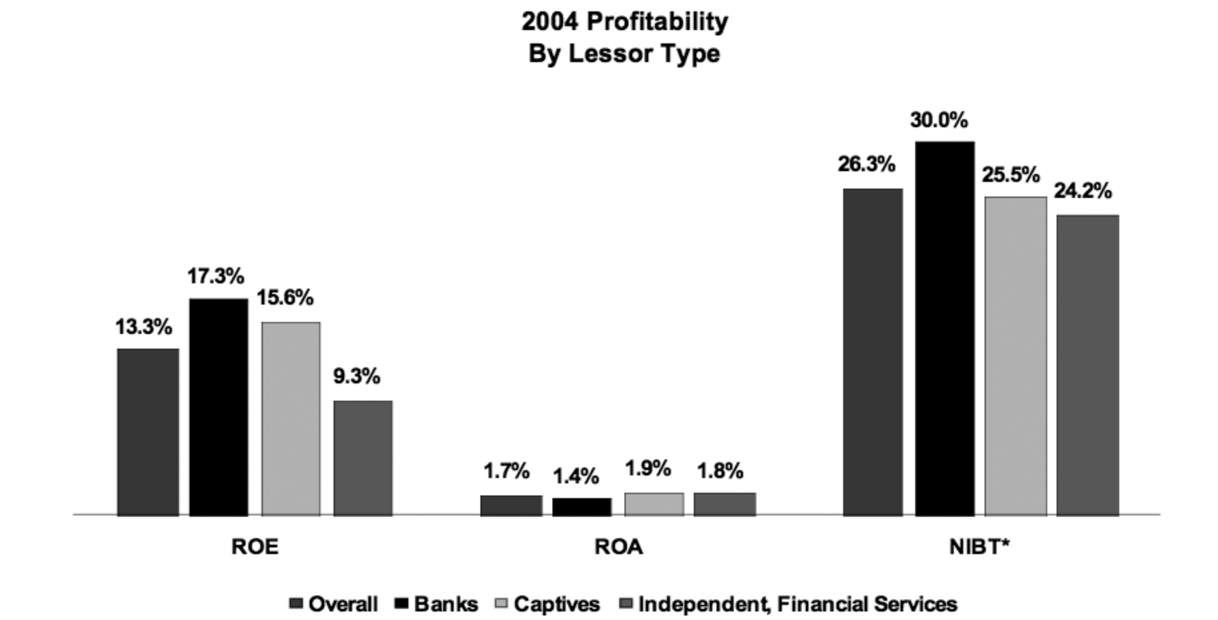
➭ The best players will continue to improve operational efficiency and will seek out innovative means to do so. Intelligent investments in technology, with well-conceived business plans and defined ROIs, will improve efficiency and service. While some lessors can use technology to facilitate the flow of new business, most will find that their most likely use of technology will involve streamlining operations and offering enhanced customer service at a reduced cost. Increasingly, customers require 24/7 access to their data and the ability to self-service at their convenience. Lessors that are not able to offer these basics can expect

**Figure 24**




Source: 2005 ELA Survey of Industry Activity

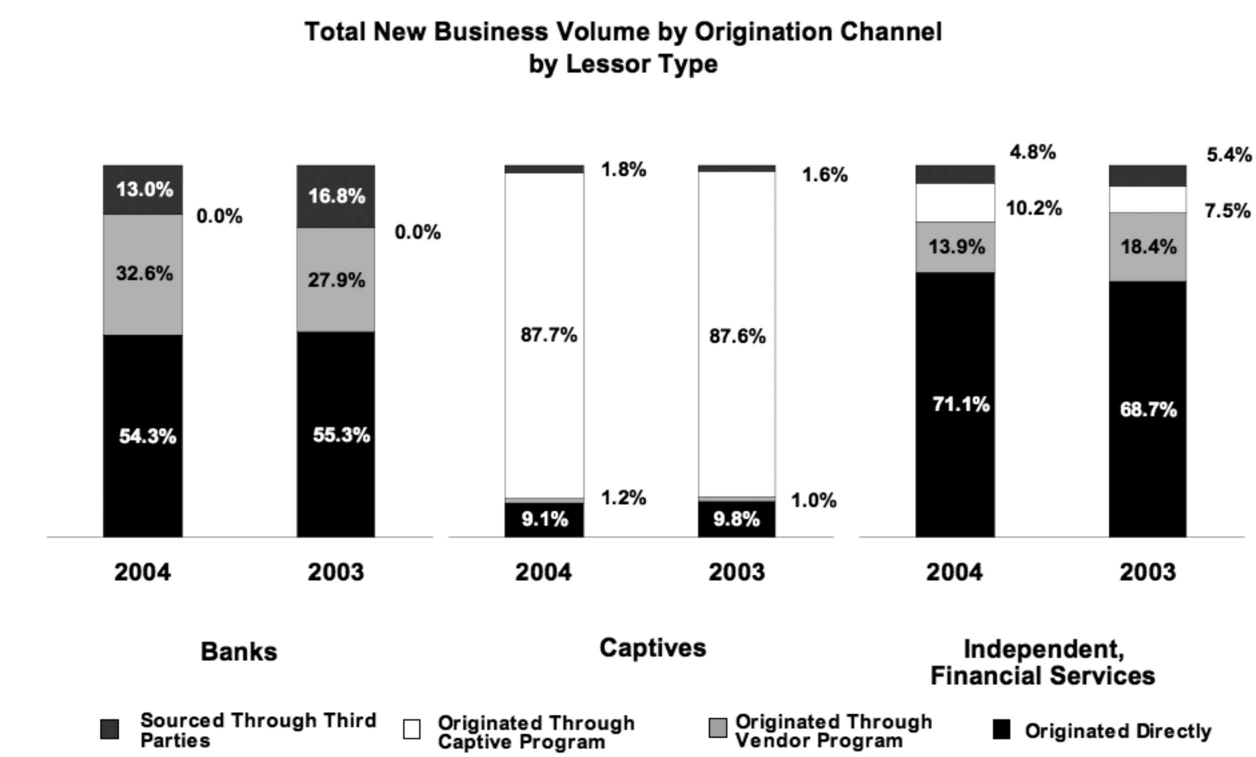
## Figure 25




* As a percentage of total revenue

Source: 2005 ELA Survey of Industry Activity

## Figure 26




Source: 2005 ELA Survey of Industry Activity

their business to decline

**Lessor Profitability**

In 2004, respondents reported a significant volume increase for Independent, Financial Services lessors. Market share, as a percentage of new business volume also increased for Independents. Banks experienced only a moderate increase in volume and lost market share to Independents. Market share for Captives remained unchanged from 2003 and new business volume grew with the market. Average pre-tax spread declined for each lessor type, a combination of declining yields and increasing cost of funds. Among the three lessor types, Banks reported the highest net income and Return on Equity.

***Banks***

Banks suffered from the decline in large-ticket volume. Figure 24 shows that new business volume increased by just 2.8 percent, and market share declined from 42 percent in 2003 to 38 percent in 2004.

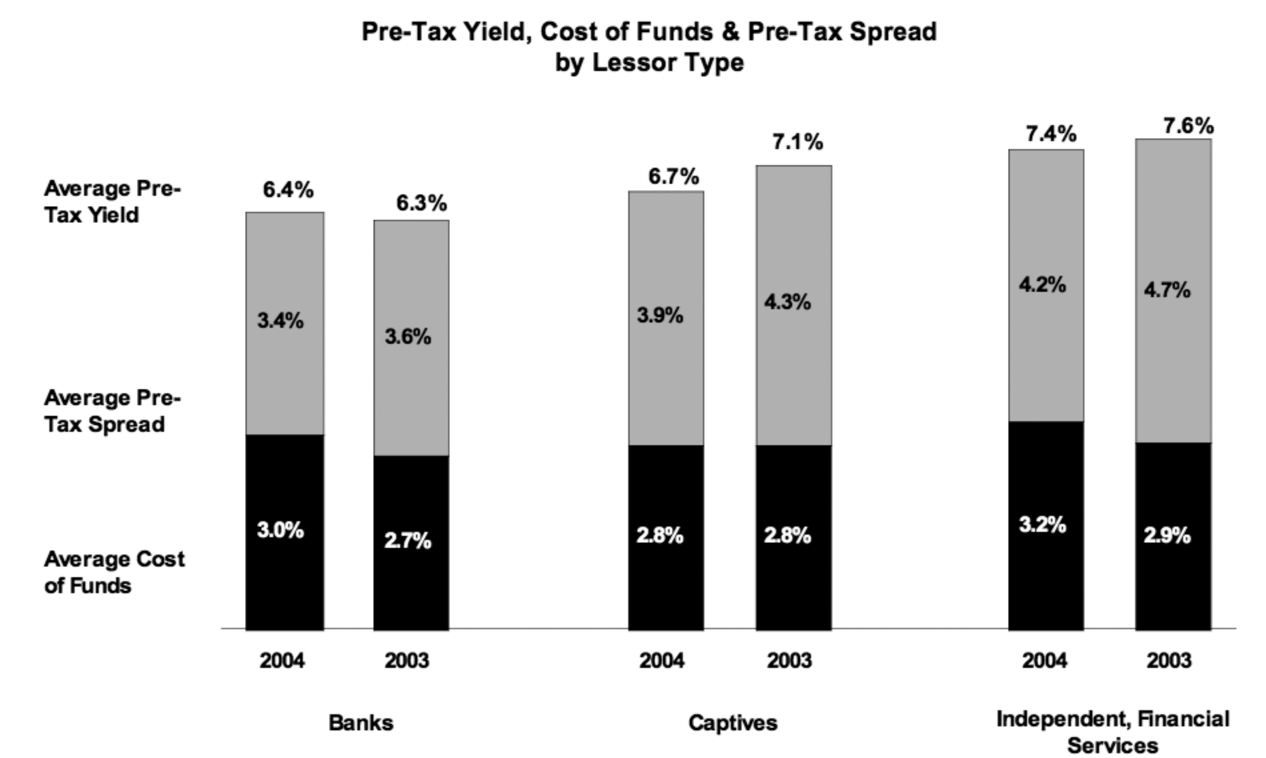
However, Bank lessors remained very profitable, as Figure 25 shows. Banks generated significantly higher than average net income and ROE. Overall, they remain the most profitable lessor type.

Banks generate over 50 percent of their volume directly (Figure 26). A number of large Banks are heavily involved in the vendor business, accounting for over 30 percent of total Bank volume. In 2004, Banks reduced their reliance on third parties for volume.

This year the Banks' cost of funds is not the lowest among competitive groups (Figure 27). Banks' cost of funds increased from 2.7 percent in 2003 to 3.0 percent in 2004. Captives, however, reported their cost of funds at just 2.8 percent in 2004.

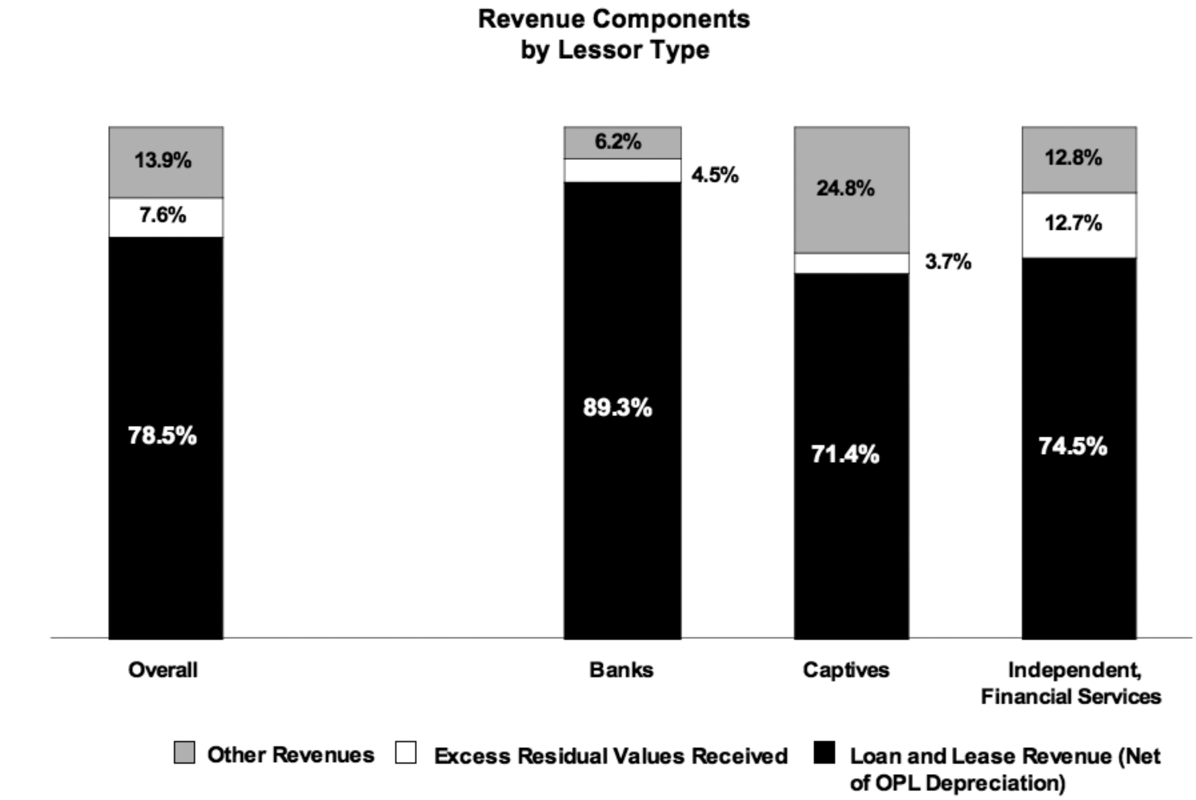
Why this change? As the bank parents begin implementing Basel II, they have increased the internal cost of capital charged to the various business units. Although average pricing increased by one-tenth of one percent, pre-tax spread declined from 2003. Banks report the

**Figure 27**



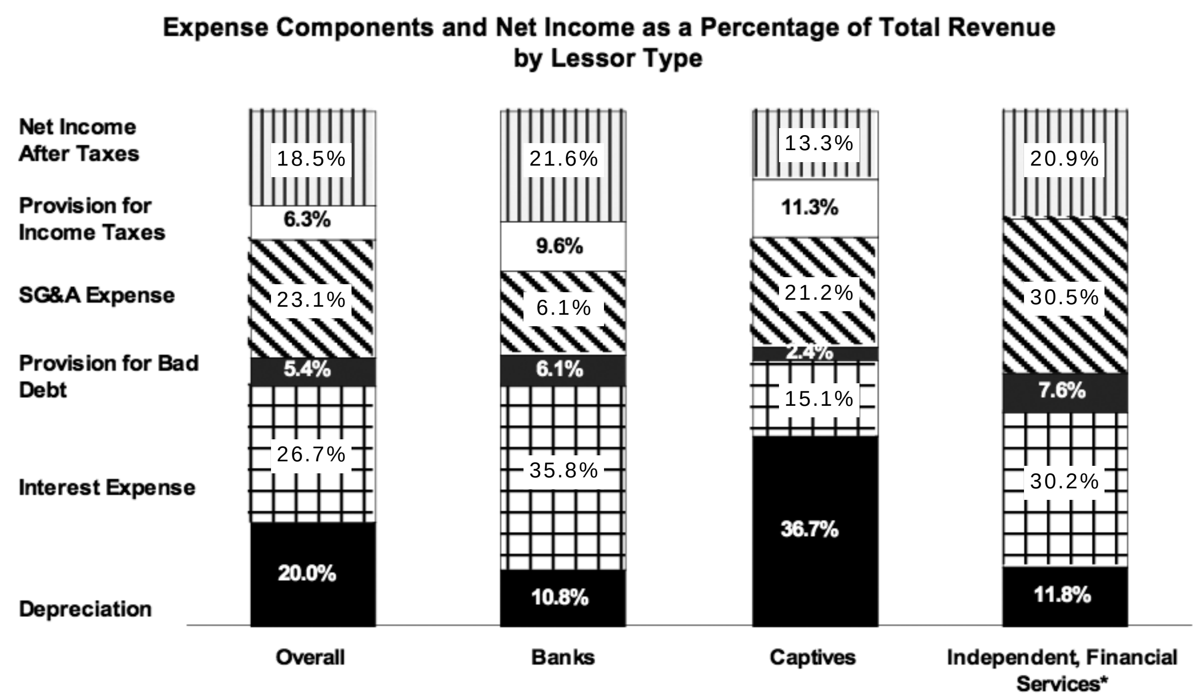

Source: 2005 ELA Survey of Industry Activity

## Figure 28




Source: 2005 ELA Survey of Industry Activity

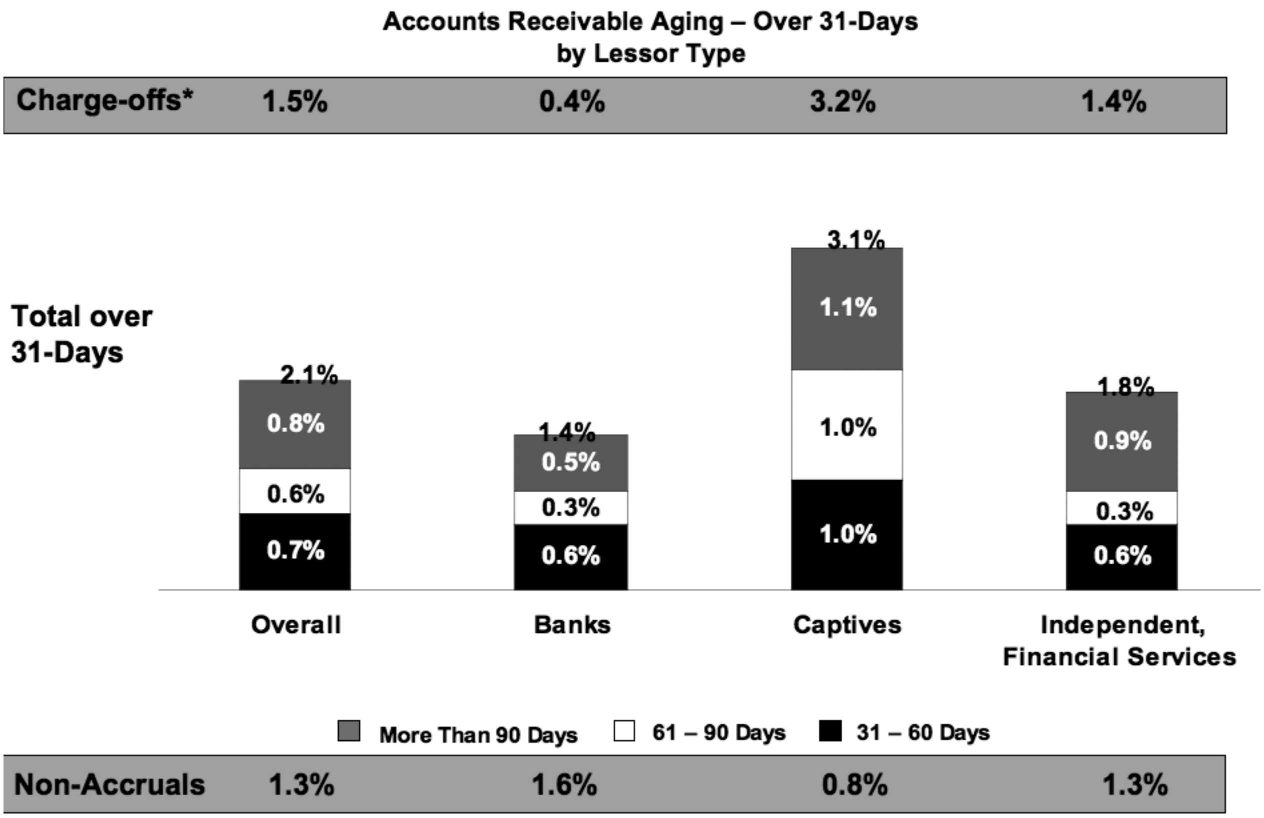
## Figure 29




* Provision for Income Taxes = -1.0% of Total Revenue

Source: 2005 ELA Survey of Industry Activity

**Figure 30**




*Full year loss as a percentage of full year average net lease receivables balance.
Source: 2005 ELA Survey of Industry Activity

lowest spread of the three lessor types.

As in previous years, Banks rely primarily on loan and lease revenue (Figure 28). The percentage of total revenue generated from "other revenue" lags the other lessor types. Other revenue results from fees, typically late payment and other "nuisance" fees. Given that Banks typically target the highest credit grade customers, the lack of fee income should not be surprising.

As Figure 29 shows, Banks have the lowest depreciation expense (as a percentage of total revenue), indicating that they are more likely to structure deals as loans or finance leases rather than maintain ownership of the equipment. Sales, general, and administrative (SG&A) expense is also lower compared with the other two lessor types, likely the result of Banks' ability to leverage the parent franchise to generate volume.

Again, given that Banks typically target the highest credit grade customers, it is not surprising that they have the lowest delinquency and charge-off rate (Figure 30). However, the amount of non-accruing assets Banks reported versus the other lessor types indicates that a combination of regulatory oversight and their inherent caution may cause Banks to be more conservative than other lessors.

Banks' operational efficiency, as shown in Figure 31, falls between that of Captives and Independents. Although they outperform in Net Earning Assets per FTE and Net Income per FTE, they lag Captives in key sales areas, such as New Business Volume per FTE.

As discussed elsewhere, Banks will continue to be active in the leasing market. Those that relied heavily on the large-ticket segment will refocus their efforts, likely on the middle-ticket segment. The most successful will continue to mine existing bank relationships and exploit their relationship advantage. Those Banks that have not yet determined how to work with their commercial bankers must make that a priority.

### *Captives*

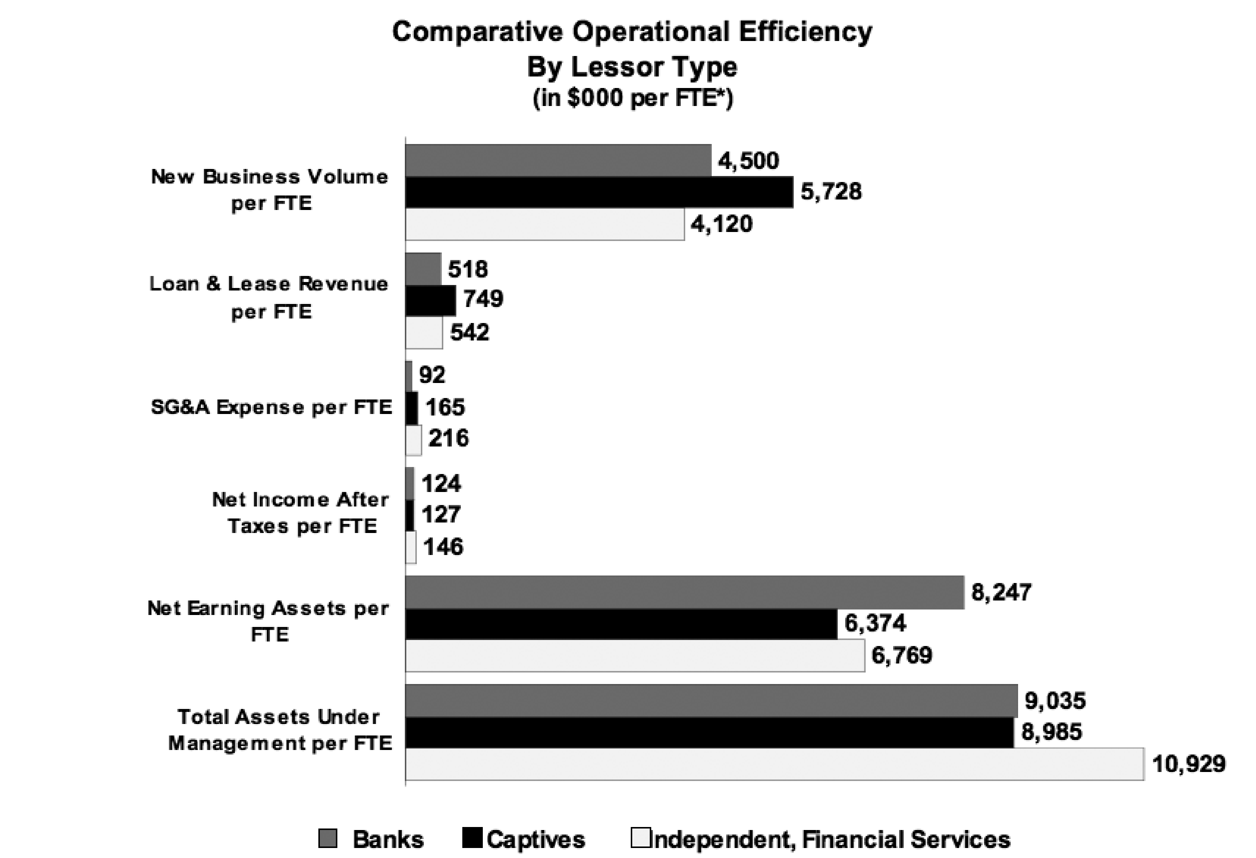
Captive lessors reported that their volume increased by over 11 percent in 2004 (Figure 24). Their share of the market remained unchanged at 25 percent. As Figure 25 shows, Captives generated net income of 25.5 percent of total revenue, ROE of 15.6 percent, and ROA of 1.9%. Overall, Captives continued to grow profitably.

In 2004, Captives generated nearly 98 percent of their new business volume either directly to end-customers or through dealers and manufacturer representatives (Figure 26). Volume described as sourced through third parties may represent deals originated by independent dealers or it may represent deals purchased for growth or diversity by Captives engaged in financing equipment other than their parents.

Traditionally, Captives have the highest cost of funds of the three lessor types. However, as Figure 27 shows, this year's respondents reported the lowest cost of funds, 2.8 percent, unchanged from the previous year. The relatively low cost of funds may result from the parents of several large Captives funding the leasing unit from excess cash instead of from capital raised in the market, essentially equivalent to a bank funding its leasing unit from deposits. Despite their low cost of funds, Captives' average pre-tax spread shrank from 4.3 percent in 2003 to 3.9 percent in 2004, due to a corresponding decline in pricing.

As in past years, Captives derive most of their revenue from loan and lease revenue and from other revenue, typically fees. As Figure 28 shows, nearly 25 percent of Captives' revenue results from fees. The Survey reports that in

**Figure 31**




* FTE = Full-time equivalent
Source: 2005 ELA Survey of Industry Activity

2003, fee income for Captives also represented nearly 25 percent of total revenue. While some types of fee revenue are tied to volume (e.g., application fees), other fees are less predictable (e.g., late fees). Lessors generating a significant amount of revenue from fees should understand the origin of the fee revenue and whether it is likely to continue.

Captives typically generate less of their revenue (as a percentage of total revenue) from excess residuals versus other lessor types. This points to the Captives' expertise in their equipment area and to the continued stability of their earnings and profits. By being sufficiently familiar with the equipment, Captives are able to accurately estimate residual values at end-of-lease. As a result, Captives revenue stream is based largely on stable lease payments and is not dependent on excess residuals, which can be negatively impacted by multiple factors.

As shown in Figure 29, Captives reported the highest depreciation expense (as a percentage of total revenue) of the three lessor types, indicating that they are much more likely to retain ownership of the equipment. One area of potential concern may be the Captives' provision for bad debt. Despite full-year charge offs of 3.2 percent (Figure 30) and delinquencies topping 3 percent (both the highest of the three lessor types), Captives' provision for bad debt totaled 2.4 percent of revenue, the lowest provision of the three lessor types. This may result in some Captives reporting unexpected charges for credit losses in upcoming financial statements.

On a per FTE basis, Captives generated more new business volume and more loan and lease revenue versus the other two lessor types (Figure 31). However, on average, Captives appear to operate with more FTEs than both Banks and Independents. This year's Survey reports that Captives operate with an average of 188 FTEs, versus 163 for Banks and 178 for Independents. The Survey also reports that Captives deploy the fewest sales/origination FTEs, just 17.4 percent of all FTEs. At Bank lessors, 22.6 percent of FTEs are engaged in sales/origination and at Independents, 32 percent of FTEs are sales related. Those Captives that have integrated the finance process with the equipment sales process have been able to significantly reduce their origination cost. While it is not obvious from Captives' sales, general, and administrative expenses, some Captive parents may allocate some of the costs of the equipment sale back to the leasing unit, reflecting the lessor's integration with the equipment sales channel.

Captives' point-of-sale advantage and equipment knowledge make them strong competitors. They will continue to work to integrate themselves into the sales process and the best will be in a position to capture virtually all the financing needs of their parents' customers.

### *Independent, Financial Services*

New business volume grew sharply for Independents, creating an increase in market share. However, both net income and ROE lagged the other lessor types. Executives of Independent lessors indicated that 2004 remained a year of transition for their businesses. Several discussed some fundamental strategic changes that they implemented in either late 2004 or early 2005. In our view, if they are able to execute on their plans, these Independents will show very strong results in next year's Survey.

In 2004, Independents' new business volume increased 23.5 percent (Figure 24). However, even with this volume increase, Independents reported ROE of just 9.3 percent, far below the average (Figure 25). Net income was also below average, 24.2 percent of total revenue versus 30.0 percent for Banks and 25.5 percent for Captives.

In general, Independents directly originate over 70 percent of new business volume. As shown in Figure 26, they generate an additional 26 percent of their new business through vendor and captive programs. The captive program volume shown, approximately 10 percent of Independent's total volume, likely represents the activities of two firms: one that finances equipment produced by its parent and one that operates a captive business through a joint-venture with a manufacturer.

As shown in Figure 27, Independents operate with the highest pricing, the highest cost of funds, and the highest pre-tax spread. Margin compression between 2003 and 2004 resulted through a combination of increased cost of funds (300bp increase), and a decline in pricing (200 bps decline). The Independents' high pricing results from their willingness to do business with lower credit grade customers. Moreover, as shown in Figure 30, they appear to be doing an adequate job managing the risk.

There are two items to note related to Independents' expense components (Figure 29). First, sales, general, and administrative expense is typically significantly higher versus other lessor types. While the other lessor types have a ready supply of "captive" customers (Banks have the existing banking customers and Captives have the equipment purchaser), Independents must originate each customer through its external sales force. Independents have struggled to find an alternative origination model, such as operating vendor programs.

The second item to note involves the interest expense reported by Independents. As Figure 29 shows, Independents report interest expense of over 30 percent of revenue. Analysis of Independents' balance sheets, however, shows that two-thirds of reported debt is classified as inter-company loans. That would indicate that approximately two-thirds of the reported interest expense may be transfer payments to a parent or affiliate.

Because of their need for a strong sales organization, Independents will remain less efficient, on an FTE level, than both Banks and Captives. However, from our discussion with industry executives, two trends have emerged. Independents are increasingly operating vendor programs, an occurrence we discussed as a probability last year. We have seen several instances in which Independent lessors have gained traction operating vendor programs. While there is certainly a need for a sales organization to successfully find and maintain vendor deals, the sales role becomes more relationship-focused and less transaction-focused. And, one vendor relationship, managed by one account executive, can yield hundreds or thousands of transactions annually.

The second trend that emerged is an increasing focus on identifying a niche and developing expertise in that niche market. A number of Independent lessors discussed their ability to set rather than accept pricing and noted that both their volume and margins have increased notably.

These trends will continue and others will emerge as smaller Independents innovate new ways to compete in the industry. We believe that these innovations are less likely to be product-related. This is a mature and increasingly regulated industry; success is more likely to result from execution or specialization rather than significant innovations.

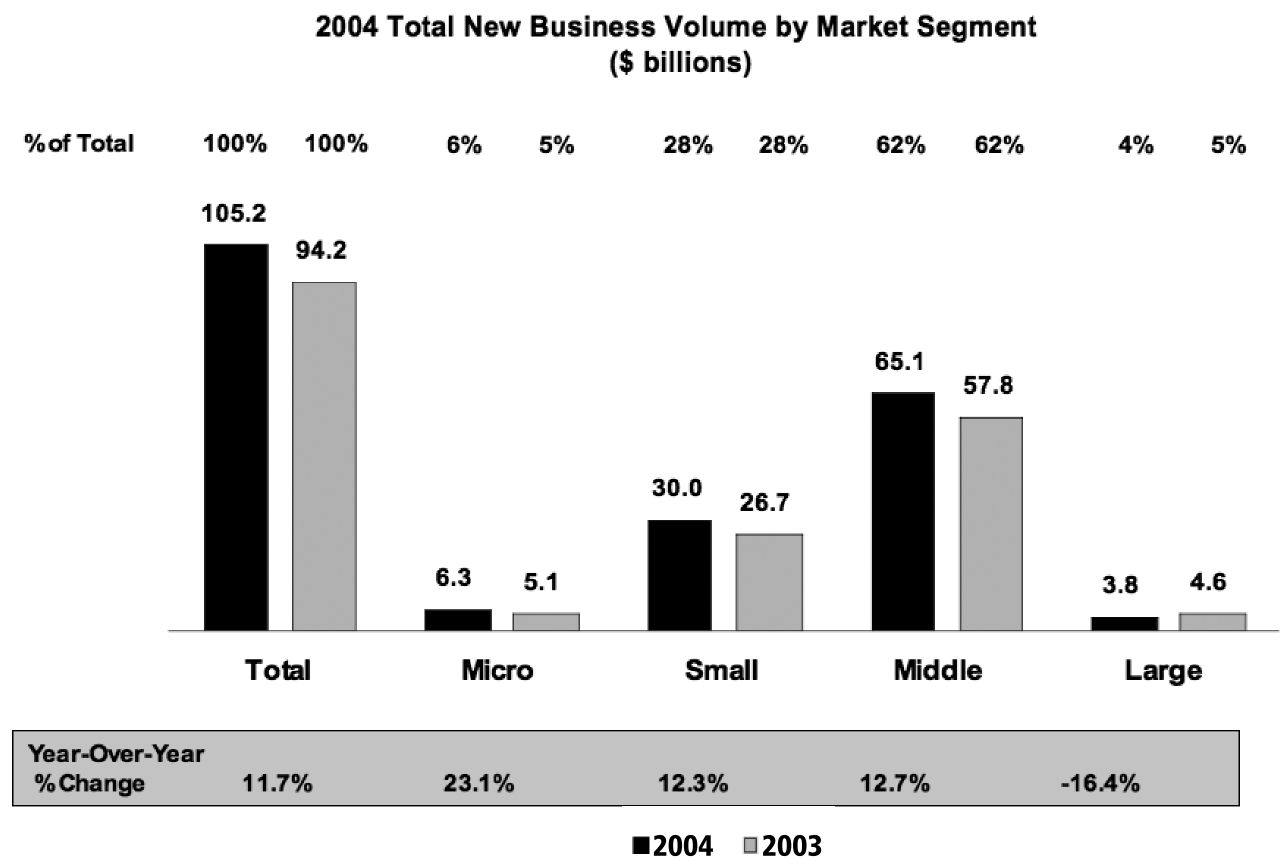
**Market Segment Profitability**

This year's analysis of the leasing industry by market segment assesses each segment to identify some of its key characteristics and uncover drivers of profitability. Lessor type remains 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, sophisticated portfolio management, and superior asset management skills.
- **Small-Ticket** - As with the micro-ticket segment, key definers include: vendor/captive origination, high spreads,

**Figure 32**




Source: 2005 ELA Survey of Industry Activity

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, sophisticated portfolio management, and superior asset management skills.

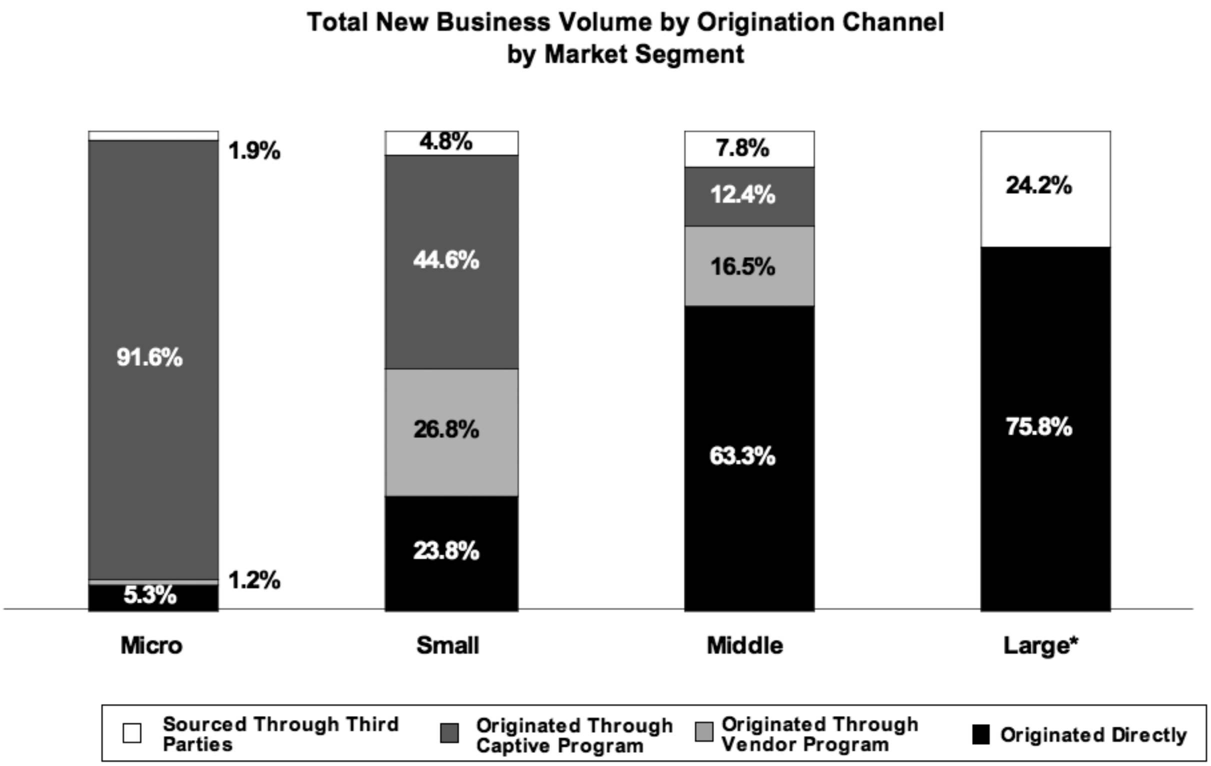
➩ **Middle-Ticket** - Narrow spreads and heavy competition define this transaction segment. As large-ticket players move down into this space, competition and pricing pressure will increase. While operational efficiencies such as low-cost origination, low cost of funds, and tight cost controls are critical in this segment, the key to success or even survival involves strategic differentiation. Players must find ways to differentiate themselves from the competition and deliver some unique value that the customer is willing to pay for.

➩ **Large-Ticket** - As we have discussed elsewhere, the rules for this segment have fundamentally changed for, in some lessors' view, at least the next ten years. Keys to success will likely no longer be sophisticated structuring capabilities and cross-border expertise. Keys to success will be access to customers, access to funding, and equipment expertise.

***Micro-Ticket***

The micro-ticket segment experienced a sharp increase in volume from 2003, albeit from a low base. As expected, this segment generates higher yields and spreads than the other market segments; it also has the highest cost of funds. However, micro-ticket yields declined from the previous year, compressing spreads. Yet, despite its high charge-off rate, this segment produced the most attractive returns for its investors. However, the characteristics of the type of lessor that is active in this market drives profitability,

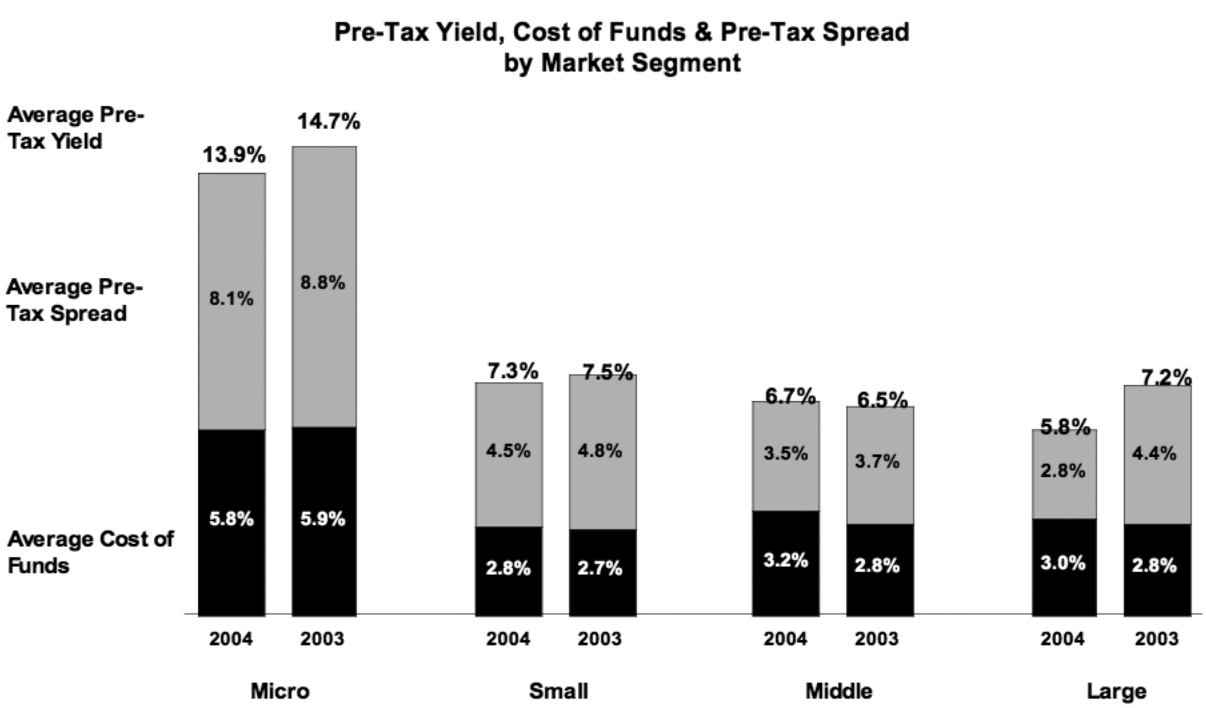
## Figure 33




•Originated no new volume through captive or vendor program.

Source: 2005 ELA Survey of Industry Activity

## Figure 34




Source: 2005 ELA Survey of Industry Activity

rather than the attributes of the market segment.

As Figure 32 shows, micro-ticket volume grew over 23 percent to $6.3 billion. However, despite its strong growth, micro-ticket volume represents only six percent of total new business volume. According to the Survey, the micro-ticket segment generates over 91 percent of its volume from personal computer, servers, and related hardware. The segment derives an additional five percent of its volume from office equipment. This concentration in the computer sector mirrors last year's data. However, the primary type of lessor involved is this segment mitigates this concentration risk to some degree.

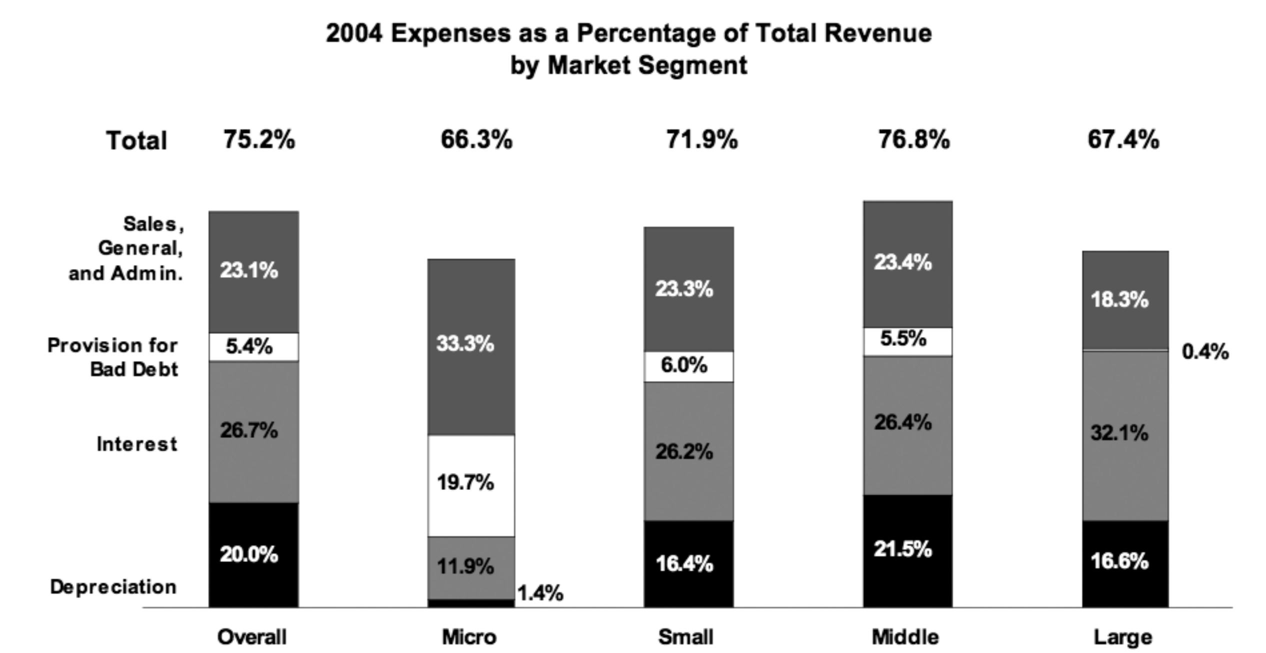
As shown in Figure 33, captive programs generate nearly 92 percent of micro-ticket volume, a strong indication that Captives are the primary lessor type involved in the market. As we discussed earlier, Captives' equipment knowledge and asset management capabilities can help mitigate default risk. Concentration risk becomes largely a moot issue, particularly if the Captive's parent manufactures primarily one product, in this case, computers.

Figure 34 shows that the micro-segment commanded higher than average pricing, but that competitive pressures reduced its average yield by 80 bps versus 2003. Surprisingly, respondents in this segment reported a slight decrease (10 bps) in average cost of fund, although at 5.8 percent, it remained the highest of all market segments. As a result of the decline in average yield, the segment's average spread also declined, offset only marginally by the reduction in cost of funds.

Typically, Captives operate with the lowest sales and origination expense of any lessor type. As discussed earlier, they employ, on average, the smallest sales force of the three lessor types. However, as Figure 36 indicates, SG&A expense for the micro-ticket segment, one that strongly appears to be dominated by captives, is higher than for any other segment. Possible explanations include respondents allocating costs for equipment sales (assuming that equipment sales and financing are bundled) or respondents allocating the cost of establishing and running the captive program through a third party.

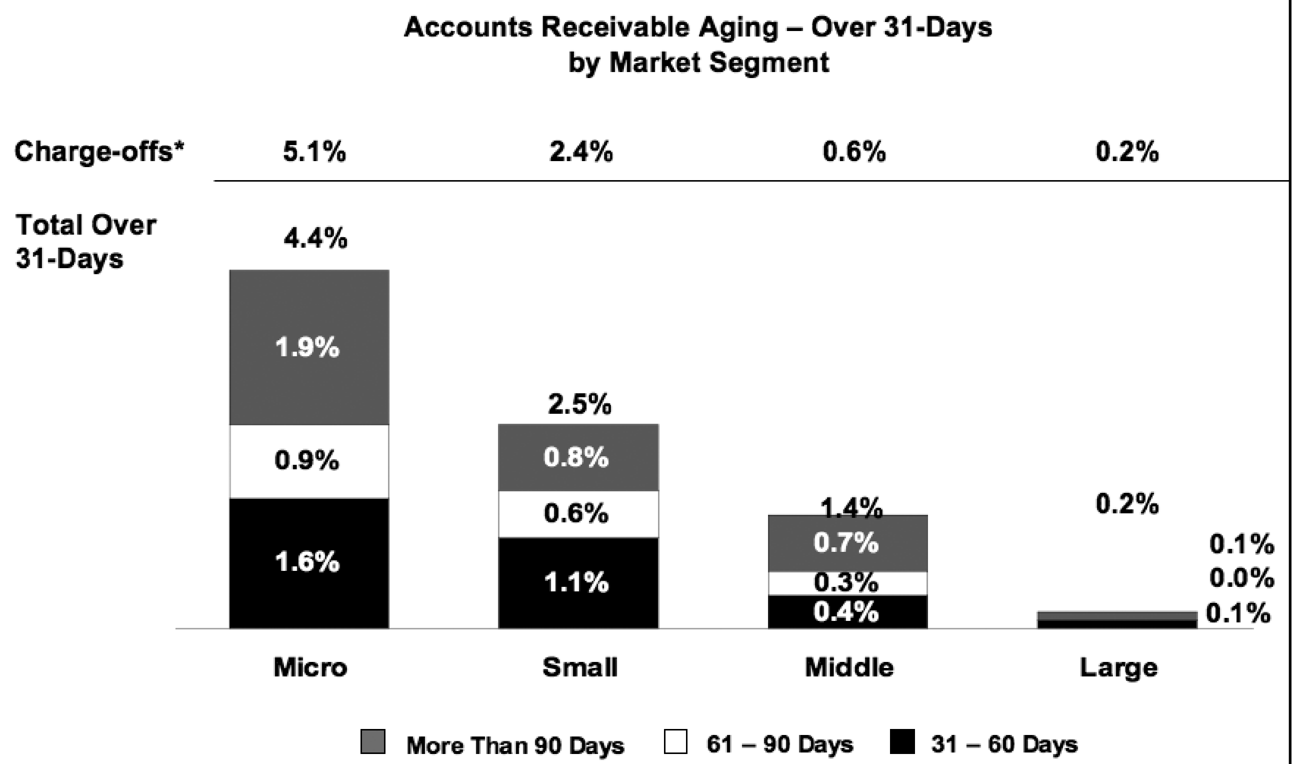
Further analysis of the segment's expenses reveal that depreciation expense is very low, just

**Figure 35**




Source: 2005 ELA Survey of Industry Activity, FIC Analysis

**Figure 36**




*Full year loss as a percentage of full year average net lease receivables balance.
Source: 2005 ELA Survey of Industry Activity

over one percent, indicating that most of this segment's volume involves loans and/or finance leases. Provision for bad debt is significantly higher than for other market segments, reflecting the risk associated with this segment. Figure 36 shows that both the charge-off and the delinquency rate are significantly higher than for other segments.

Given the nature of micro-ticket transactions (high volume and low value), it is too expensive for lessors to underwrite each transaction manually. Most micro- and small-ticket transactions are credit scored and some are auto-decisioned. Therefore, the underwriting is only as good as the scoring tool; however, during the recent economic downturn, most banks scored portfolios outperformed their underwritten ones.

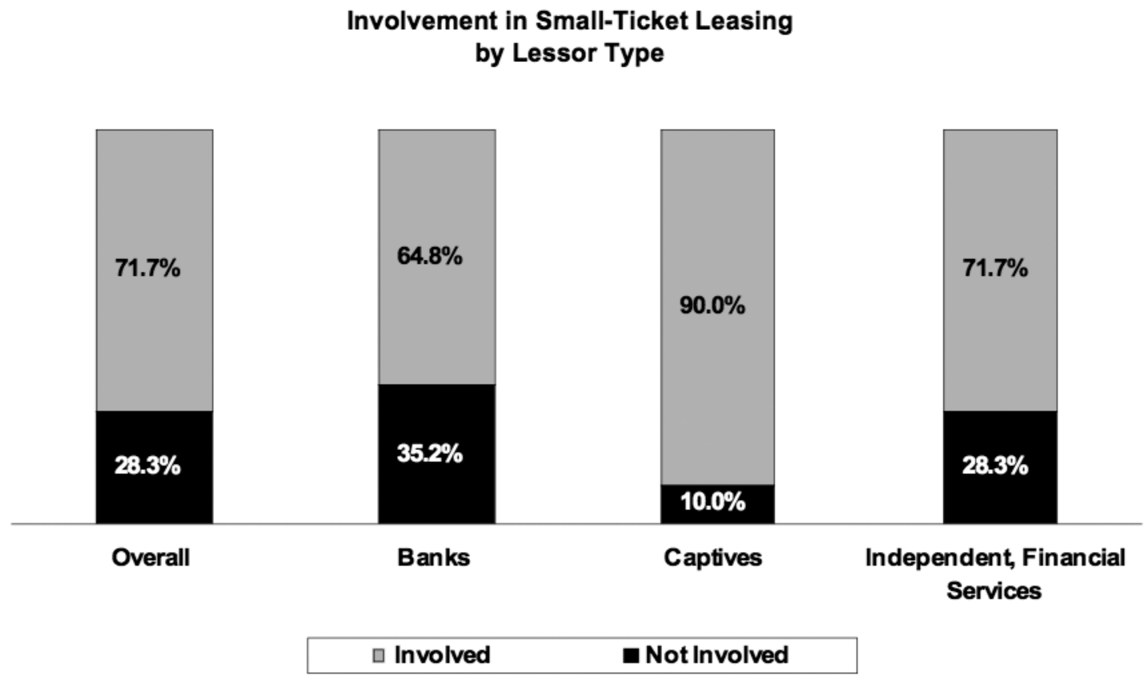
In order to mitigate risk, micro-ticket lessors must possess sophisticated asset management skills and superior asset management capabilities. They must be able to detect a problem early, reclaim the equipment, and then dispose of it quickly and efficiently.

***Small-Ticket***

As in previous years, this year's Survey includes a separate analysis of the small-ticket segment. As shown in Figure 37, over 70 percent of Survey respondents are active in the small-ticket segment. Banks show the least involvement in the segment, with just 65 percent of Bank respondents reporting activity. Ninety percent of Captives report being active in small-ticket as do nearly 72 percent of Independents. A number of Bank respondents outsource small-ticket deals to third parties. They are primarily middle-ticket players, understand the fundamental difference in approach required for small-ticket, and have chosen to concentrate in their area of expertise.

As we noted earlier, the small- and micro-ticket segments share many of the same characteristics. As Figure 33 shows, a higher percentage of small-ticket transactions are

**Figure 37**




Source: 2005 ELA Survey of Industry Activity

originated directly; however, captive and vendor programs remain the primary channels. Pricing declined slightly for the small-ticket segment (Figure 34) and, as a result of decreased yields and increased cost of funds, average spreads also declined.

Small-ticket lessors retain ownership of more equipment than do micro-ticket lessors, as indicated by the depreciation expense shown in Figure 35. In addition, both credit quality and portfolio performance are significantly better for small-ticket versus micro-ticket. Provision for bad debt (Figure 35) is significantly lower as are charge-offs and delinquencies (Figure 36).

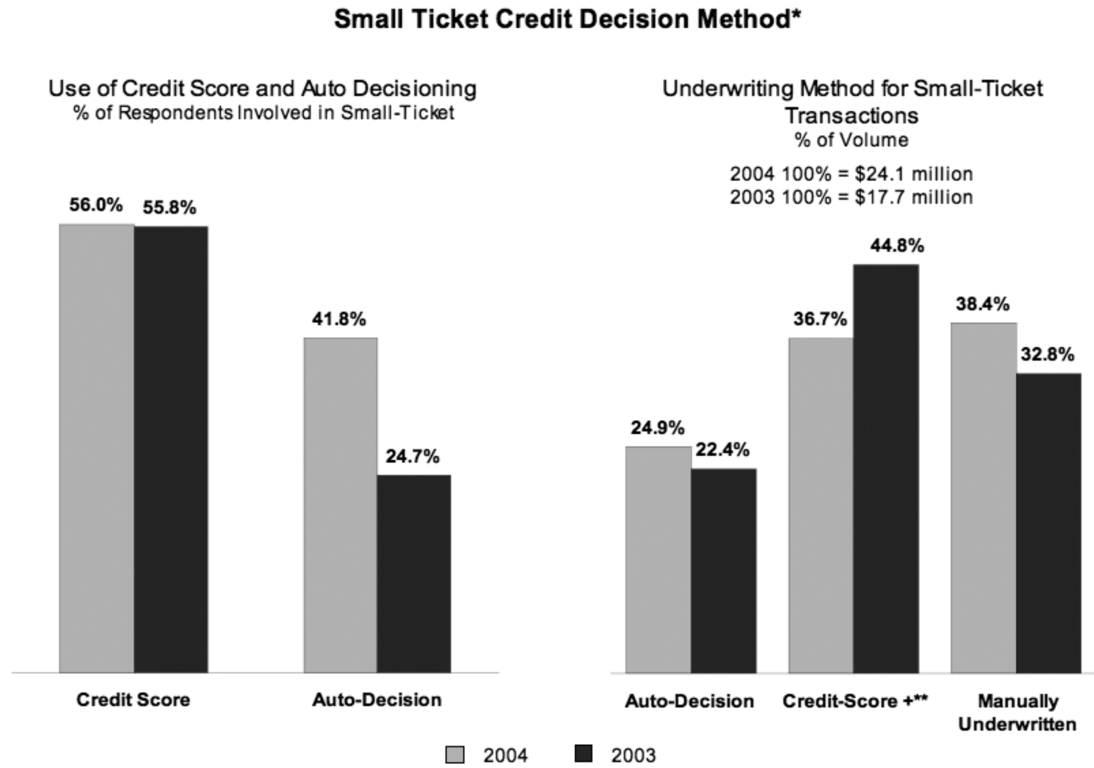
As shown in Figure 38, the percentage of small-ticket lessors that used some type of credit scoring in their underwriting process remained relatively unchanged between 2003 and 2004. From our perspective and client experience, it is difficult to understand how the nearly 45 percent of small-ticket lessors not using credit scoring remain profitable. In a segment that is defined by its high volume of low value transactions, reducing the cost to process each transaction is one of the keys to survival.

Figure 38 also shows that almost 42 percent of small-ticket lessors use auto-decisioning tools, a significant increase over the previous year. However, when we analyze the underwriting methods for small-ticket transactions, only about 25 percent of small business volume is auto-decisioned, a slight increase over the previous year. What is most surprising is that the percentage of small-ticket volume that is manually underwritten increased by nearly six percent over 2003. Survey respondents report that they manually underwrite almost 40 percent of small-ticket volume. Figure 39 shows that Independents, almost certainly very small Independents, are the most likely to manually underwrite small-ticket transactions. While the cost of purchasing and implementing credit-scoring tools may seem prohibitive for small players, it is, in our view, a required cost to participate in this segment.

***Middle-Ticket***

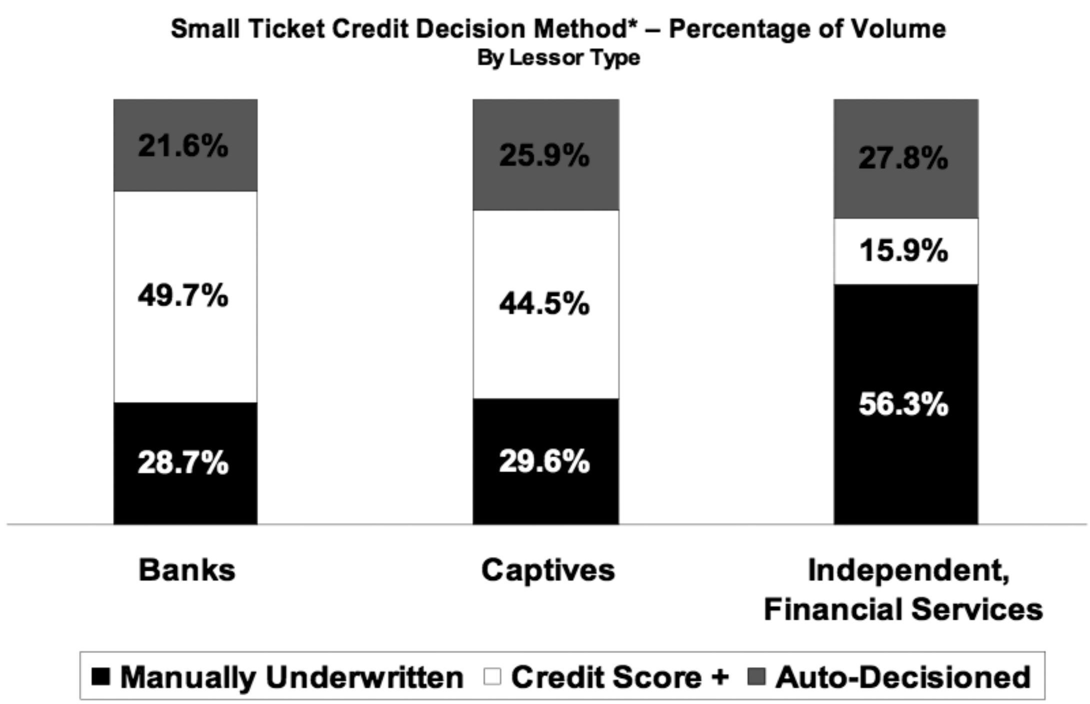
Middle-ticket transactions represent 62 per-

**Figure 38**




* Among lessors involved in the small-ticket segment
**Credit scored and manually reviewed
Source: 2005 and 2004 ELA Survey of Industry Activity

**Figure 39**




* Among lessors involved in the small-ticket segment
**Credit scored and manually reviewed
Source: 2005 ELA Survey of Industry Activity

cent of total new business volume. As Figure 32 shows, this segment grew by nearly 13 percent over the previous year to $65.1 billion. As discussed elsewhere in this Report, lessors in this segment, though it is by far the largest, face a number of challenges resulting from changes in the market and in the competitive landscape. The sidebar, The Middle-Ticket Squeeze, looks at some of the challenges facing lessors in this space and some potential opportunities.

Over 63 percent of middle-ticket transactions are originated directly (Figure 33) and an additional 29 percent are generated through captive or vendor channels. Middle-ticket respondents report generating nearly eight percent of their new business volume through third parties, through either brokers or syndication deals.

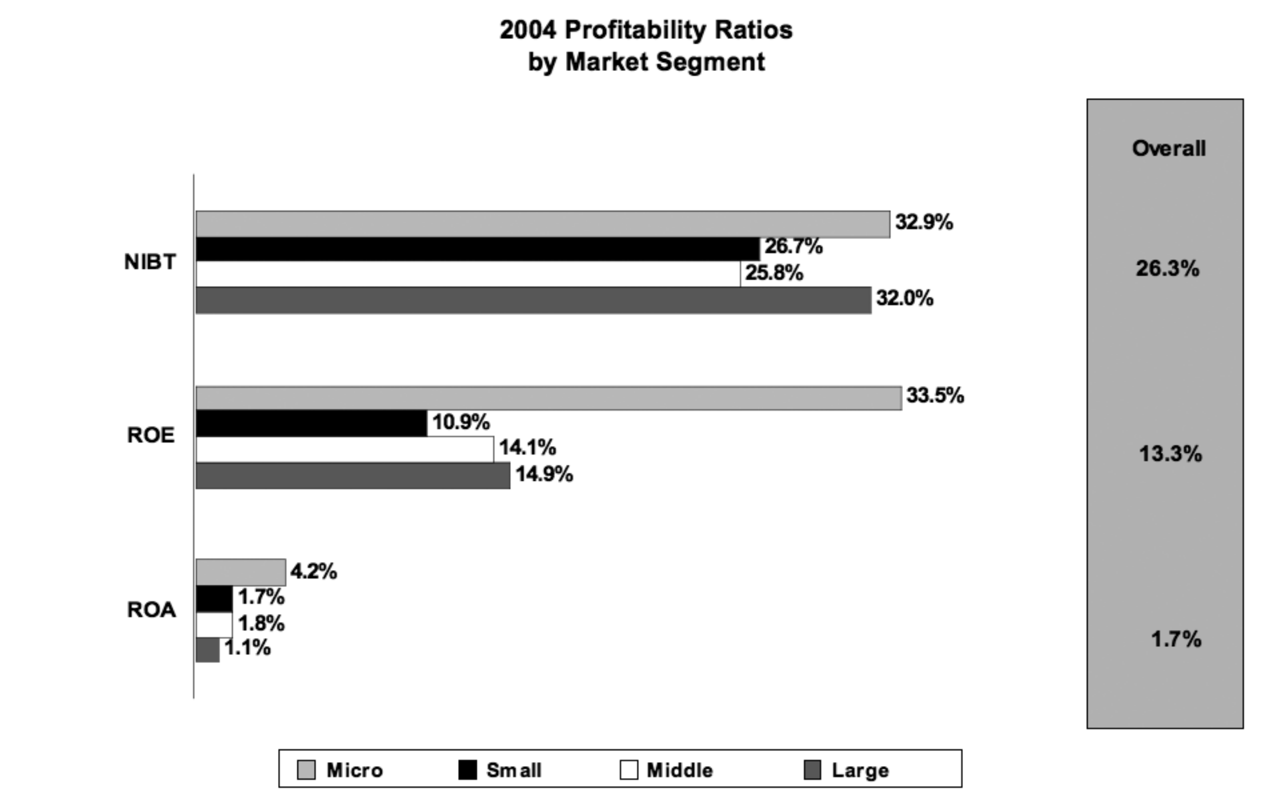
While many executives discussed the pricing and margin pressures on the middle-ticket segment, Survey respondents reported the segment's pricing increased, average yields improved 20 bps over 2003, the only segment reporting an increase in yield (Figure 34). However, a 40 bps increase in the cost of funds caused spreads to shrink by 20 bps. Overall, in terms of yields and spreads, the middle-ticket outperformed the other market segments.

As shown in Figure 35, the middle-ticket segment has a relatively high cost structure. However, analysis of middle-ticket lessors' balance sheet shows that 75 percent of lessors' interest-bearing debt involves inter-company borrowings. It is likely, therefore, that transfer payments to a parent or affiliate comprise most of the middle-ticket's reported interest expense.

The delinquency rate for the middle-ticket was 1.4 percent (Figure 36), with less than one percent over 91 days. Charge-offs for the segment were also less than one percent.

As we discuss in detail in the middle-ticket related sidebar, there are significant opportunities in the middle-ticket for lessors that are able to establish niches, develop targeted expertise, and hunt off the beaten track.

**Figure 40**




Source: 2005 ELA Survey of Industry Activity

### *Large-Ticket*

The large-ticket segment has undergone some fundamental changes over the past two years. The sidebar titled, "How Can Large-Ticket Lessors Adapt to the New Environment" explores the factors responsible for those changes, how players should react, and what, if any, opportunities remain in the large-ticket segment.

As Figure 32 shows, large-ticket volume declined sharply from $4.6 billion in 2003 to $3.8 billion in 2004. Over 75 percent of new business volume was originated directly (Figure 33). Third parties generated the remaining 25 percent, from either brokers or syndication. Neither captives nor vendor programs generated large-ticket volume.

The large-ticket segment suffered the most from spread compression. As Figure 34 shows, average yields for the segment declined by 140 bps while funding costs increased by 20bps. The net impact on average spreads was a 160 bps decline.

Due to the large-ticket segment's relatively low cost structure (Figure 35) and the sterling quality of its portfolio (Figure 36), the large-ticket segment generated admirable returns, despite its problems. As shown in Figure 40, both net income and ROE outperformed the average, coming in second only to micro-ticket.

As we discussed, there will remain a demand for large-ticket equipment and a need for financing. Players that will remain successful in this market segment will be banks that can effectively mine their parents' customer base to uncover opportunities and large independents that will continue to leverage their relationships with the airline industry and other large-ticket

[6]We define lost deals as the difference between applications approved and applications booked and funded or sold

[7]2003 data comes from the 2004 SIA and represents a different respondent set

# Going Global 101

This year, a number of interviewees discussed the need to expand outside the U.S. and follow the global economy. One expert stated, “Within the next five years, lessors will have to begin developing international capabilities.”

Developing international capabilities does not necessarily mean establishing a brick and mortar presence in a foreign country. The following case examples demonstrate that lessors can expand globally while limiting both their risk and investment.

***Case Example: Generating International Business Without an Overseas Presence***

One small, bank-owned player has built international volume with no offshore presence. In order to generate higher yields in its aircraft finance unit, this lessor began to finance business and personal use aircraft for non-U.S. individuals and companies. Through relationships with manufacturers, they have successfully completed deals in Mexico, Central and South America, Canada, the E.U., and other countries.

According to this lessor, beyond country risk (including the legal and regulatory environment), attributes that contribute to an attractive offshore deal include the individual or company's ties to the U.S. and the amount of down payment. They look for deals in which the borrower either has assets or business operations in the U.S. and in which the borrower has substantial equity in the aircraft. In the words of one executive, “Most wealthy individuals, particularly in Latin America and the Middle East, have sizable assets in the U.S. We make sure that we have a claim on those assets, as well as the aircraft.”

When doing offshore deals, this player makes it a practice to use in-country attorneys to prepare and review financing documents, security agreements, etc. Their in-house counsel works with the foreign attorney to ensure the lessor is protected. They also require clients to use a specific international aviation services company to maintain the financed aircraft. Therefore, they know that the aircraft is being properly maintained (the bank receives reports from the aviation company) and the aviation services company will, with virtually a moment's notice, fly the plane out of country, either to the U.S. or a safe harbor country. Although the bank has never had a delinquency with its overseas accounts, it regards this service as necessary method to protect its assets.

By leveraging manufacturer relationships and selectively choosing deals, this player has developed a substantial, higher yielding, international business, without any investment in an offshore presence.

***Case Example: Minimizing the Investment in Overseas Infrastructure***

One Captive lessor needed to expand overseas to support its parent's operations. While its parent does business in virtually every country in the world, this lessor wanted to expand slowly and limit its infrastructure investment. Following a model it employs domestically, it co-located sales officers with its parent's sales representatives. The company contracts with local financial services companies to provide back-office support on a fee-per-transaction basis.

As one senior manager stated, “We are here to support our parent's business and help to sell product. Transaction processing, billing, and collections are not our expertise, and we do not want to invest in building those capabilities.”

However, since this lessor keeps the asset, it has had some difficulty finding banks willing to participate as a servicing agent only. “Most banks are trying to grow their assets and want us to source deals that they can fund and put on their books. But, that means that our customers are subject to the bank's underwriting standards. There are many times when we want to do a deal for strategic reasons that would never pass a bank's credit requirements. So, we feel we are better off funding and holding our own deals.”

To support its business, they often use both banks and commercial finance companies to provide back-office support. As the company expands overseas, it contracts back-office support on a regional basis rather than for each individual country in which it does business. In this lessor's view, this model allows it to expand overseas to meet its parent's requirements without making a significant investment in “non-core” operations.

### *Industry Implications*

Implications for the industry include:

- Given the highly competitive nature of the equipment finance market today, lessors trying to grow volume and increase margins, should consider selected offshore opportunities
- Best practices players are finding ways to do business overseas while limiting both their risk and their need for significant investment, including:
  - Sourcing business through relationships with domestic manufacturers that sell their equipment to overseas customers
  - “Following their customers overseas” by developing relationships with foreign subsidiaries of existing customers
  - Establishing an overseas sales presence and contracting local infrastructure
  - Leveraging the Import Export Bank to mitigate credit risk

### *Concluding Thoughts*

In the U.S., business investment in equipment, the key determinant to the size of the leasing market, is expected to grow by less than seven percent annually through 2006. Many lessors have growth goals that are significantly higher than the growth rate of the total industry. As one lessor stated, “No lessor ever said they planned negative or even zero growth. In fact, planning growth at anything less than double-digits will likely get him fired.” In order to meet growth and profitability goals, lessors may have to look overseas. The best players are already beginning to do so.

## The Middle-Ticket Squeeze

The decline in the large-ticket segment has forced many large-ticket players (typically banks) looking for volume growth into the middle-ticket arena. At the other end of the size spectrum, small-ticket players are gradually redefining small-ticket upwards to include larger companies. While the ELA defines the upper range of small-ticket at $250,000, many small-ticket lessors consider $500,000 to be a small-ticket transaction.

Typically, middle-ticket executives are unconcerned about small-ticket players entering their market. However, they express concerned about the impact of large-ticket players moving into the middle-ticket space. As one lessor stated, "It has already happened, they are already here and have been for over a year. The trouble is that some of them are so hungry for deals, and have so much capital to deploy, they are offering prices below anything I can even consider looking at."

As we discussed in our analysis of the middle-ticket segment, yields increased in 2004 (See Figure 36), although an increase in the cost of funds caused a 20bps decline in spreads. However, competition has intensified further throughout 2005. Many middle-ticket executives agree that competing on price is likely to be self-destructive, but they feel limited in their competitive options. Unless they compete on price, some believe that they will be squeezed out of the market completely.

Lessors must develop a value proposition that differentiates them in the market. Some of the more innovative lessors have developed expertise in one or more of several areas, including:

• *Equipment category:* Some lessors have differentiated themselves through equipment expertise, particularly in the technology field. Since many of the price competitors entering the middle-ticket segment are banks, successful players need to focus on equipment categories that banks typically avoid, such as trucks and trailers or gaming equipment.

In addition to hiring experienced sales people, other tactics to build equipment expertise include developing underwriting skills and asset management capabilities that support the equipment focus.

• *Industry segment:* Building an industry expertise allows a company to provide insights to its customers and build a marketing advantage by becoming known to the key buyers within a segment.

One of our clients has created a niche in the "environmental industry" (trash haulers). They regularly attend industry events, advertise in industry publications, and participate in events important to the industry. As a result, this client is a first choice when a trash hauler needs a new truck, and they are able to command pricing 25-50bps over the competition. This client entered this market by hiring a salesperson known to the industry. He brought clients with him and convinced other salespeople to join the team.

• *Credit grade:* A number of lessors have created a niche focusing on customers of a risk grade with which some banks are uncomfortable. For example, one company focuses on start-ups funded with venture capital. They view these customers as ideal because the companies are less price sensitive and are leasing mission-critical equipment. As one executive noted, “They would sooner go hungry than miss a payment and risk having us take the equipment back.” (This lessor retains ownership of nearly all of its equipment.) In fact, in the past five years the executive could only remember one time a customer was late, by two days.

This lessor views asset management capability as the primary skill required for focusing on lower grade credits. As the executive noted, “Our underwriting typically consists of credit checks on the principals, otherwise, what else is there to underwrite? Besides, those venture firms are going to do a far more thorough job vetting this company than we ever could. All we need to be able to do is go in, get our equipment, and turn around and sell it without losing money.”

Another lessor targets mid-size, non-investment grade customers. These companies are typically not of interest to banks, and they expect to pay higher rates for capital. In addition, this lessor limits its focus to two or three types of equipment. This allows them to leverage their underwriting expertise as well as their asset management capabilities.

Strong underwriting skills are most critical to this lessor. “We check everything,' the lessor stated, 'we look at their suppliers, their customers, their competitors. We are very thorough, and it has paid off.”

The second way this company mitigates its risk is through its asset management expertise. By focusing on a limited set of assets, the company believes that it is able to determine the equipment's value curve when it structures a deal, ensuring it is never “under water” during the life of the transaction. It also relies on its ability to remarket the equipment and recoup its investment in the event of default.

**Concluding Thoughts**

In the competitive environment of the middle-ticket segment, lessors must differentiate themselves either by exploiting existing internal capabilities or by buying/building expertise to satisfy a need in the market. Lessors that do not differentiate themselves and try to compete on the cost of money will find it increasingly difficult to generate profitable growth in this segment.

# How Can Large Ticket Lessors Adapt to the New Environment?

In recent years, large-ticket transactions have suffered a dramatic decline. In 2002, the large-ticket segment generated 37 percent of new business volume. This year's Survey of Industry Activity reports that the large-ticket segment generated just four percent of new business volume. In just two years, large-ticket's contribution to new business volume declined from 37 to four percent, a drop of more than 89 percent.

What happened to large-ticket leasing? How can lessors adapt to the new environment?

***Background***

Aside from the continued weakness in a number of key large-ticket equipment segments, such as commercial aircraft and marine equipment, we trace the disappearance of large-ticket volume to two events: Enron and Basel II.

Some industry observers have commented that until the collapse of Enron no one in Congress had even heard of a “Special Purpose Entity.” However, in its aftermath, as revelations about how these structures had been used to “cook the books,” a series of accounting and regulatory reforms were enacted to ensure that these entities could never again be used fraudulently.

In fact, it was not so much the regulatory or accounting restrictions that slowed the use of these vehicles in legitimate lease structures. Rather, it was management concern about perception and the reticence of lessees to use them. As one leasing executive said, “Customers turn white as a ghost if you even say the words 'Special Purpose Entity,' they start edging toward the door in fear.”

Another event impacting the large-ticket segment occurred when Senator Chuck Grassley (IA), Chair of the Senate Finance Committee, decided that it was time to reign in “all the abuses in the leasing industry.” He was referring to transactions in which U.S. lessors receive tax benefits from assets bought from and re-leased to a foreign tax-exempt entity and transactions in which a U.S. lessor receive tax benefits from assets bought from and re-leased to a U.S. tax-exempt entity. He stated that lessors should not receive tax deductions for shipping American money overseas nor receive tax benefits from transactions with tax-disinterested parties.

Grassley included provisions into the American Jobs Creation Act of 2004 that would close those “loopholes” retroactively. A significant piece of large-ticket volume ceased.

While the 2004 tax legislation was mainly aimed at so-called “SILO” transactions, recent FASB rulings regarding how lessors report the tax benefits resulting from any leveraged transaction will likely further limit volume for these type of leases.

The impact of Basel II may be even more long lasting. As one bank-owned large-ticket lessor stated, “Basel II really killed my business.” He went on to explain that Basel II requires the inclusion of three elements when calculating the amount of risk-adjusted capital the bank must hold: the lessee's credit rating, the probability the lessee will default, and the loss given default.

Loss given default, the element that Basel II adds to the equation, requires the lessor to determine the value of the underlying asset and, therefore, the actual loss the lessor would suffer in the event the lessee defaults. "However', as the executive noted, 'large-ticket lessees tend to be Fortune 500 companies that strongly influence the value of the revenue-producing asset. Therefore, if that lessee fails, chances are very good that the underlying asset will be worth little. For example, if a major railroad were to fail and liquidate, the value of locomotives and railcars would plunge. That means that, because these are leveraged deals and the debt-holder is paid first, our loss given default would likely be total. The inclusion of loss given default reduces a deal's Risk Adjusted Return on Capital from 18 percent (pre-Basel II) to 6-7 percent, well below our required internal rate of return."

The combined impact of Enron and Basel II has resulted in new business volume dropping to zero for some large ticket lessors. These players have to pursue new business models in order to survive.

***Success in the Large-Ticket Space: A Case Example***

One Bank lessor continues to do well in the large-ticket space by emphasizing "out of favor" industries and individual companies

Although never involved in the leveraged lease or cross-border markets, it has still felt some impact from their demise as lessors focus on recovering volume. One executive commented, "We are seeing those Banks that lost their cross-border volume scrambling for volume. There is a lot of capital chasing too few deals and, particularly in investment grade deals, it is pushing pricing through the floor…"

"There are a number of ways to react to the kind of margin compression we are seeing today. Lessors can try to generate enough additional volume to stay ahead or they can hold the line on pricing and give up some volume. They can also be creative about generating fees to boost the return on deals, for example, through syndication."

This player's strategy in this segment centers on holding the line on pricing, adding new volume when appropriate, and adding fee income when it can.

It maintains its pricing largely because of its strategy of focusing on B or BB non-investment grade credits: "We focus on large companies with good long-term prospects that may have stubbed their toe along the way. These companies may have three or four years of losses and may be in an industry that is in the downside of its cycle. They are companies that banks are typically not going to look at."

One executive explained further, "There are two ways to make money in this industry, either from credit risk or equipment risk. We make money from well-mitigated credit risk." The company mitigates its risk through strong and thorough underwriting as well as through structuring.

"Every deal we do has a 20-30 page credit write-up. We look at the company's current and past performance, its dependence on raw materials, the price fluctuation of its products, etc. Our analysis includes, for example, how much the price of plastic resin must increase before the company's products are no longer generating the cash flow required to service its debt."

Executives explained that part of their underwriting process includes an analysis of how the equipment will be used and how critical it will be in the lessee's business. "For example, we look at whether the equipment will be used to produce gas-guzzling SUVs, which may not sell well with gasoline priced at $3 per gallon, or to produce hybrid vehicles for which there is a nine-month waiting list of buys." He went on to say, "We want to finance equipment that the borrower will affirm in a bankruptcy procedure."

Deal structuring is also important: "We use the standard structuring tool, down payments, letters of credit, guaranties, etc. But, we make sure that structure fits both the type and intended use of the equipment as well as the risk profile of the company."

While it does generate some business from internal referrals from its private banking unit and its corporate and investment banking group, this lessor largely relies on its outside sales force to originate new business volume. Management cited a number of reasons why it does not rely more heavily on referrals from its parent's other business units. "Although we may be doing $50 or $100 million deals, that is largely below the radar of the investment bank. Another issue is that the corporate and investment bank's clients are typically investment grade companies with plenty of access to capital. They are not our target market; we could never get the pricing from them that we need."

***Implications for the Industry***

Implications for the leasing industry from the regulatory, legislative, and accounting changes impacting the large-ticket segment include:

- Given the current environment, large-ticket leasing may never return to "the way it was"
- Many large-ticket players have already moved down market and will increase the intensity of their focus in the middle-ticket arena
- With limited exceptions, large-ticket volume will be comprised primarily of single-investor, structured transactions
- Going forward, competitive advantages in this segment include:
  - Origination ability/access to customers
  - Strong underwriting and structuring capabilities
  - Equipment expertise
- Other potential competitive advantages may include a captive relationship (Boeing Capital) or a close relationship with a manufacturer (GE Capital/GECAS)

***Conclusion***

While certain large-ticket activity has been limited by legislative or accounting changes, there remains a need for capital to finance large ticket deals. Success in this segment requires players to:

• *Determine their market focus* - The Bank lessor profiled above focuses its efforts in a specific market niche. While most Banks may not have the appetite to work with non-investment grade credits, they may decide to focus on a specific industry sector or equipment type.

• *Create a value proposition* - Given the liquidity in the market and the number of competitors, players that are chasing investment-grade deals must be able to offer the customer value beyond just capital. For example, First Union Rail (a subsidiary of Wachovia) built an expertise in railcars and locomotives, creating a value proposition that includes not only equipment financing, but also a wide range of fleet management services

• *Execute, execute, execute* - One of the reasons that the lessor in the above case example has been successful in its market segment is its ability to execute well against the most critical pillar of its strategy - underwriting. As one executive stated, "If a company cannot execute on the credit side in this market, they will quickly disappear."

# CONCLUDING THOUGHTS

The leasing industry has undergone significant changes over the past two years, including shifts in the competitive environment, fundamental changes to a major market segment, an increasingly vigilant regulatory environment, and wholesale changes to the lease accounting structure, among other changes.

However, the leasing executives we spoke with were, with few exceptions, uniformly positive about the future of both the industry and their companies. They talked about their plans to meet the industry's challenges through an understanding of their own company's competitive advantages and a strategic plan to exploit those advantages.

There is a best selling book by Spencer Johnson titled, *"Who Moved My Cheese?"* In the story, four mice live in a maze and feast daily on a large mound of cheese that appeared seemingly from nowhere. One day, the mound of cheese disappears. Two of the mice return every day to the place where the cheese used to be, expecting, that, somehow, it would reappear. The other two mice spent their days searching the maze for another source of cheese. In the end, the two mice that went in search of different cheese found it and prospered. The mice that stood waiting for "their" cheese to come back met an early demise.

When the market changes, those that change with it will survive and prosper, those that wait for it to come back the way it was, will not.

## 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.

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