2008

State of the Equipment Finance Industry

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

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FOUNDATION

Your Eye On The Future

The *premier* provider of industry research.

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

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

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

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EQUIPMENT LEASING & FINANCE FOUNDATION
Your Eye On The Future

State of the Equipment Finance Industry 2008

Prepared by:

FIC

Financial Institutions Consulting, Inc.

September 2008

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

October, 2008

Dear Equipment Lease Finance Professionals,

We are pleased to provide you with this copy of the Equipment Leasing & Finance Foundation's 2008 State of the Equipment Finance Industry report. We believe that in these uncertain times, you'll find this strategic planning tool more valuable than ever.

The Report is the product of an exhaustive review and analysis of equipment finance industry information sources, including ELFA's 2008 Survey of Equipment Finance Activity, government data, independent research and interviews with executives in all the major industry segments. The result is a comprehensive portrait of the leasing and finance industry in the near term.

The Report shows us an industry whose fundamentals remain solid, but one being buffeted by larger economic trends. Liquidity, so plentiful just a couple of years ago, has now all but dried up. Many firms currently enjoying a strong year may see things change quickly as it becomes more difficult to fund new business. Many banks and large independent institutions have lost their traditional advantage of lower cost of funds, and the competitive scene is reconfiguring as a result. Increased regulation is certain to further complicate the picture, and we'll likely see an industry in considerable flux for at least the next 12 – 18 months.

The "bumpy ride" that the report predicts makes the future-oriented research of the Equipment Leasing & Finance Foundation all the more valuable. All Foundation reports, along with the Journal of Equipment Lease Finance are designed to help you navigate through swirling economic currents and a shifting competitive landscape, to help you identify and arrive at your destination.

None of this would be possible if not for your generous support. The Foundation is funded entirely by individuals and companies within the equipment finance industry, those who—like you—understand that their donations are an investment in their industry, their businesses and their careers.

As you read and use this Report, please keep in mind that your contribution helped to create it, and that your continued generosity will help the Foundation provide you with a glimpse into the future, long into the future. Please visit the Foundation website at www.leasefoundation.org for more information on our products and mission.

Sincerely,

Lisa A. Levine

Lisa A. Levine
Executive Director

Table of Contents

Preface

Purpose of This Study

The Equipment Leasing & Finance Foundation (the Foundation) selected Financial Institutions Consulting, Inc. (FIC) to prepare its State of the Equipment Finance Industry. The mission of the Foundation centers on evaluating current trends, their potential impact on the equipment finance industry and to help provide focus for the future of the 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 and Finance Association's (ELFA) 2008 Survey of Equipment Finance Activity (SEFA). Using this and other information, we project and discuss future implications for the industry.

FIC, a management consulting firm that focuses on developing fact-based strategic and tactical solutions for its clients, centers its work on issues related to increasing growth and productivity. It possesses extensive experience with commercial finance and leasing clients as well as the middle market and small business segments.

The FIC methodology for this analysis incorporates statistical data, past client experience, and in-depth personal interviews. SEFA reflects fiscal year-end 2007 performance and, particularly in the current period, does not present a fully accurate picture of the industry today. In addition, given that many SEFA participants offer both lease and loan products, throughout this Report, the term *equipment finance* includes both product sets. Similarly, the terms *lessor* and *equipment financier* both refer to the providers of equipment finance.

Interviewees

Given the events impacting the financial services industry over the past 8-12 months, both FIC and the Foundation wanted to leverage the industry's valuable human capital in order to best understand how current conditions affect how equipment financiers do business both today and in the future. Therefore, in addition to presenting data from SEFA, this Report includes the insights and perspectives of industry executives, analysts, and observers. FIC conducted in-depth interviews with over 25 senior managers and industry experts, representing a cross-section of financier types, ticket sizes, and industry service providers.

These interviews focused on obtaining the experts qualitative assessment of current market conditions and the implications for the industry both today and going forward. In addition, we asked them to share their perspectives on the impact to the industry of Basel II and other regulatory and accounting changes as well as to identify any areas of potential opportunity. The insiders who shared their insights include:

James Ambrose - President, GE Healthcare Financial Services
Robert Anderson - President, Honeywell Global Finance
Laird Boulden – President & CEO, Tygris Asset Finance
John Callies - General Manager, IBM Global Financing
William Clark – Senior Vice President, Univest Capital, Inc.
Justin Cooper – President, CHP Consulting
Glenn Davis – Vice President, Norlease, Inc.
Jay DesMarteau – President, CIT Equipment Finance
Ed Foley – Executive Vice President, Caterpillar Financial Services Corporation
Paul Frisch – Executive Vice President, US Bank Equipment Finance
Tony Golobic – Chairman & CEO, GreatAmerica Leasing Corporation
Spence Hamrick – Managing Director-Originations, Wachovia Equipment Finance
Dan Henson, President & CEO, GE Capital Solutions
Harry Kaplun – President, Frost Leasing
Joseph Lane – Vice Chairman, Sinter Capital
Paul Larkins – President & CEO, KeyNational Finance
Richard Latour – President & CEO, Timepayment Corporation
Michael Leichtling – Partner, Troutman, Sanders, LLP, Chairman, Equipment Leasing & Finance Foundation
David Maurer - Senior Vice President, Equipment Leasing, City National Bank
Dennis McCafferty – Group CFO, De Lage Landen
James McGrane – President, Tygris Vendor Finance
John McQueen – President, Wells Fargo Equipment Finance
David Merrill – President, Fifth Third Leasing Company
Bob Mura – Editor, ABS Alert
Allen Qualey – President, 1st Source Bank Specialty Finance Group
Robert Rinek – Managing Director, Piper Jaffray & Co.
Walter Rabin – President, All Points Capital Corp.

Adam Warner – President, Key Equipment Finance
Frederick Wolfert – President, Tygris Commercial Finance Group

We thank these individuals for their generous commitment of time and candid insights into the intricacies, opportunities, and challenges of the leasing and finance industry. Given the particularly unsettled current operating environment, their insights were of critical importance to us. Throughout this monograph, we include direct quotations from these interviews; however, to preserve confidentiality, we present quotes on an anonymous basis.

Financier and Segment Types

As in prior years, the financier types analyzed in this report fall into three categories: Banks (either separately-operating subsidiary or integrated), Captives, and Independent Financial Services companies.

Definitions of these various financier types are as follows:

Banks - 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.

Captives - Operate as subsidiaries of dealers or manufacturing companies. At least 60 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 Companies - Usually finance companies offering leases directly to businesses and 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.

SEFA 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). SEFA also presents data by business model, based on each respondent's primary origination channel, defined as the channel through which the respondent generated at least 60 percent of its business. The four business models presented are: Direct, Vendor or Captive, Third-Party, and Mixed. Financiers operating with a Mixed business model generate volume through a variety of channels, no one of which represents greater than 60 percent of its total volume. Captives are excluded from the analyses by business model. This is the third year that SEFA has captured these data.

State of the Equipment Finance Industry: Primary Focus

We begin this report with an overview of the equipment finance industry, including an estimate of the size of the U.S. equipment finance market and an analysis of the dynamics impacting industry drivers and related implications. Given the current economic environment, we present an in-depth discussion related to the impact of the credit crunch, coupled with the uncertainty in the capital markets and other macroeconomic factors, on both funding for equipment financiers and the overall competitive environment.

Following the industry overview, we present an analysis of the ELFA 2008 Survey of Equipment Finance Activity (SEFA). 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 financier type, market segment, and business model. **Throughout our analysis, we refer to specific Tables within the Survey of Equipment Finance Activity. The SEFA is available from ELFA at http://www.elfaonline.org/pub/pubs/ProductDetail.cfm?product_code=RSEFA2008**

As strategy consultants to the leaders in the financial services industry, throughout this Report we provide our perspective on how the critical issues identified will impact the equipment finance industry. Where possible, we include insights into how best practice players are reacting and what providers of equipment finance can do to create opportunities in the market today.

Financial Institutions Consulting
Charles B. Wendel, President
Matthew L. Harvey, Senior Engagement Manager

Executive Summary

As detailed in this Report, the state of the equipment finance industry in 2007 was generally good. Results showed slight volume growth while providing mixed indications for future industry performance. For example, Return on Equity (ROE) and portfolio quality declined while Return on Assets (ROA) and operational efficiency increased.

However, since year end, the market disruptions indicated in 2007 have become much more pointed and suggest a difficult and highly unpredictable operating environment for 2008 and beyond. Industry analysts, interviewees, and FIC's clients agree that a confluence of macroeconomic issues, including the subprime mortgage meltdown, the collapse of the credit and default swap markets, the continuing decline in real estate values, and the volatility of energy and commodity prices, among other concerns, have significantly changed the game for the equipment finance industry.

The key themes that emerged from the interviews and analysis include:

• *Continued market disruption and declining confidence.* Most executives and analysts expect current market instability to continue for a significant period of time, up to another four-six quarters, as customer performance slides and lenders and the markets are forced to work through mounting losses in various areas. Nearly everyone interviewed expects "another shoe to drop," although the expected problem areas vary.

• *Funding as the critical area of focus.* As a result of losses in mortgage-related investments and the failure of key areas of the credit markets, liquidity for providers of equipment finance, including some units owned by banks, has significantly declined. As one executive stated, "Two years ago we were awash in liquidity. Today, it is a desert."

Those players with continuing access to reasonably priced funding have a distinct advantage and possess a clear opportunity to grow high quality market share. Those without must either curtail activities or find non-traditional sources of funding, including, for a few, Private Equity investments. One indication of the industry's funding focus: several bank-owned equipment lenders are beginning to leverage new technology, specifically Remote Deposit Capture, to gather deposits from customers outside their retail bank's footprint. Some larger independents, understanding the value of a deposit franchise, have either purchased or started banks.

Independent players lacking the track record and portfolio quality to obtain traditional bank credit may be forced to further deleverage their balance sheets, reducing their ability to drive either volume or returns. Unless funding opportunities improve, their long-term survival has to be in question.

• *Seismic change in the competitive environment.* In past economic downturns, smaller Independents suffered as bank credit became more expensive and terms and covenants more onerous; the smallest and weakest sometimes failed or were acquired. Big banks, with access to low-cost deposits as a funding source, increased market share.

In this cycle, the largest financial institutions, collectively having lost hundreds of billions of dollars, have experienced major funding challenges themselves; both large bank and non bank players have pulled back or dropped out of segments of the equipment finance market. Large Independents, once with access to the Commercial Paper and debt markets for relatively inexpensive capital, are now experiencing a significant increase in their cost of funds linked to a lack of market liquidity.

As a result, the overall competitive picture has changed significantly: previously aggressive players have become more selective; some large players have exited the industry; new types of competitors, particularly those backed by Private Equity, are beginning to enter and at the early stage of becoming a force within the market. At the end of this cycle, there will likely be fewer players with smaller players being most adversely affected.

• *A "return to sanity."* Virtually all interviewee stated that they are seeing a swift return to pricing and structuring sanity in the market. Over the first half of 2008, pricing and spreads have increased and deal structures have tightened. Executives note that, for the first time in years, the risk/return relationship is where it should be. An additional positive factor is that many end customers appear more interested in working with a reliable financing source rather than issuing price-oriented RFPs. They want deals that preserve cash and are willing to accept higher margins to do so.

• *Increased regulation will likely have a significant impact.* Most insiders agree that, as a result of the current financial crisis, increased regulatory oversight is inevitable. While few expressed significant concerns related to the implementation of Basel II or the shift to international accounting standards, most believe that regulators will expand their authority to include all types of lenders, including those currently subject to little if any scrutiny. Executives express concern that requirements for increased provisions, lower leverage, and consumer-like protection for all borrowers may result in reduced profitability and less competition.

• *2008 will show strong performance … for some.* Based on both anecdotal evidence and statistics compiled by the ELFA and PayNet[1], new business volume has increased over 2007, spreads have improved, and losses, while ticking up, are well below 2003 levels, the last significant problem year.

Industry analysts attribute the apparent increase in volume to two factors: first, an increased demand for equipment financing as companies work to preserve cash and, second, fewer players in the market. Virtually every executive interviewed expects delinquencies and losses to increase beyond current levels. However, in order to minimize potential losses, most indicate that they have tightened their collection efforts in addition to evaluating risk management practices and increasing credit requirements for new deals.

• *Scale over smarts?* In previous Reports, FIC has often featured case studies of niche players that have managed to succeed because of their ability to segment and differentiate themselves versus larger players. While "smarts" will remain important, given funding and capital requirements, going forward it may no longer be sufficient for success. "Brawn", discussed in the next section, will also be increasingly important going forward.

The state of the industry in 2008 appears to be more volatile and complex than in many years. The handful of very strong players will exploit their funding depth and competitive gaps to grow. Many others, hamstrung by capital and funding issues, will narrow their level and scope of activity. Some, unable to find sufficient amounts of either, may discontinue operations or shrink to a point of insignificance.

Analysts agree that the industry will experience continued volatility and uncertainty over the next 12-18 months and that, ultimately, it will look very different than it does today, both with fewer total players and, in all likelihood, fewer small players. In our view, the 1950 Betty Davis movie *All About Eve* concisely captures our likely near-term operating environment: "Fasten your seat belts, it's going to be a bumpy night!"

[1]PayNet provides predictive credit and risk management tools to improve the process of originating loans to small businesses. *www.paynetonline.com*

Overview of the Equipment Leasing and Finance Industry

The comments to the right, made by very senior and well respected executives in the equipment financing industry, typify the sentiments of industry leaders today who frequently cite volatility and lack of clarity about the future economic path for the equipment finance industry. Their comments synch with FIC's experience in writing this report seven times over the past nine years. The current environment presents more difficult and perilous challenges than we have previously seen with many players reevaluating their interest and ability to compete in this market. When market turbulence and competitive reassessment subside, as we will discuss below, we expect the competitive landscape to be profoundly changed.

> *"I have never seen anything like this in 25 years in the business."*
>
> *"This is the choppiest market I have seen since I started my career in 1979."*
>
> *"We are only one-third of the way through this economic cycle. We have another 12-18 months to go."*

Market Size and Growth

Growth of the equipment leasing and finance market is largely related to growth in public and private investment in equipment and software. The propensity of business and government to use financing versus cash to acquire equipment, which varies significantly by equipment type, also directly impacts the size and growth of the industry.

Industry analysts observe that in times of economic uncertainty, companies' reliance on financing, particularly leasing, increases as they try to preserve cash and enhance cash flow by minimizing payments. Our interviews with industry executives substantiate this observation with many stating that, despite a slowdown in equipment sales, overall demand for financing has increased through August 2008.

While forecasting growth in an unsettled market is more an art than science, Global Insight, a leader in economic forecasting, estimates that in 2008, the total investment in equipment and software will exceed $1.15 trillion, a 2.3 percent increase over 2007 (Figure 1). They further estimate, based upon their proprietary model, that in 2008, end-users will finance approximately 57 percent of their equipment investment, or about $652 billion, a 1.6 percent increase over 2007.

In 2009, Global Insight projects that end-users will finance approximately $672 billion of their nearly $1.19 trillion of equipment and software investment. The firm expects end-users to finance the same percentage of their equipment investment in 2009 as in 2008, resulting in a year-over-year increase in both equipment investment and finance volume of 3.1 percent.

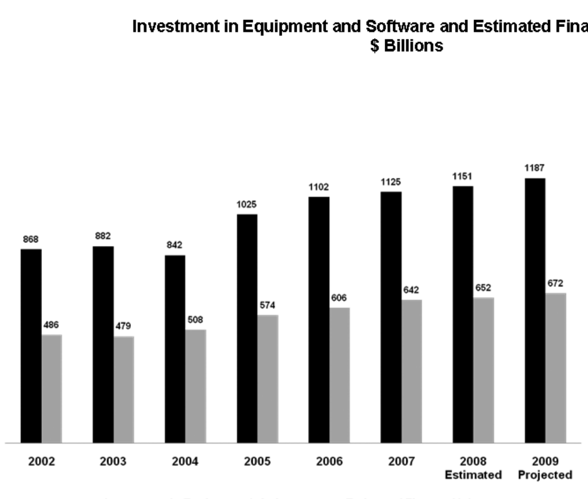
Based on our interviews with senior equipment finance executives, analyst assessments, and market forecasts, equipment categories/markets expected to outperform the industry through 2009 include:

• *Energy/Alternative Energy* – Interest in this sector is largely driven by recent significant increases in oil-based energy costs. Continuing tax credits for the sector are critical for growth of this category

• *Corporate Aircraft* – The General Aviation Manufacturers Association reports that, based on current orders and backlog, annual deliveries of business jets will double over the next ten years

Given the continuing weakness in the residential housing market, analysts expect softness in construction equipment associated with residential and commercial real estate to continue through 2009. In addition, continued high diesel prices as well as an overall economic slowdown will negatively impact the truck and trailer category over the next 18 months.

Figure 1



Year over Year Growth

	Equipment & Software Investment	Finance Volume
2005-2006	7.5%	5.6%
2006-2007	2.1%	5.9%
2007-2008*	2.3%	1.6%
2008-2009*	3.1%	3.1%

* Forecast

Source: Global Insights

Market Drivers

Five key themes emerge from FIC's analysis of industry trends and its interviews with some of the top minds in the business:

- Market dislocation will continue
- Funding remains a long-term issue for the industry
- The competitive landscape will differ significantly
- Regulations will negatively impact marginal players
- The future is uncertain but, in all likelihood, quite different from today

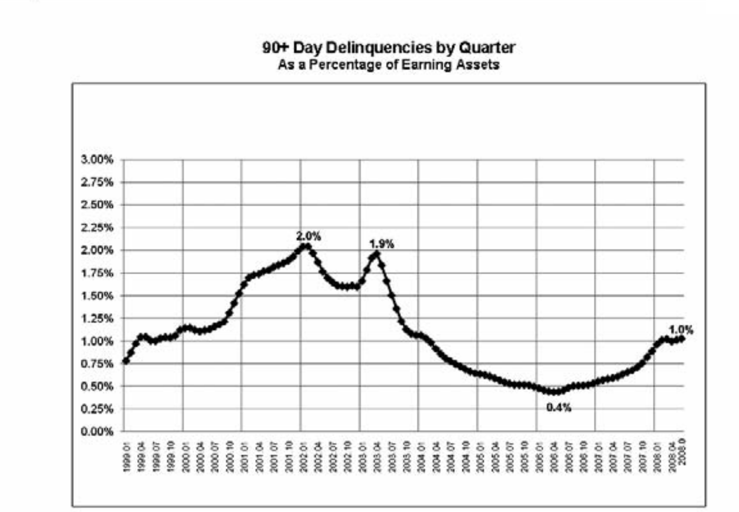
Continued market dislocation

Dislocation in the market means that the relationship between the end customer and the lender continues to undergo significant change, resulting from at least seven factors:

1. *The industry is experiencing declines in portfolio performance.*
   2007 results point to at least some credit deterioration in multiple areas:
   - Construction, primarily real estate-related
   - Transportation, particularly trucks and trailers
   - Office equipment
   - Fleet vehicles

Based upon FIC's interviews and analysis, credit quality has continued to deteriorate in 2008. However, credit problems appear to be under control. PayNet shows average delinquency numbers increasing to approximately 1.0 percent from .5 percent at year end, well below the high of about 2.0 percent that occurred during the 2002-2003 economic downturn (Figure 2).

Figure 2



Source: PayNet, Inc.

Interviewees point to selected problem areas but no one indicates that a wide spread credit problem exists. One banking head stated that, other than in the construction and transportation sectors, the overall portfolio quality was in line with 2007. Even in the industries he cited, the bank was experiencing "slight declines, nothing ominous." Different from most previous downturns, individual segments cannot be painted negatively with a broad brush. For example, the construction concerns expressed by the above lender are not shared by another player who focuses on infrastructure-related construction equipment.

<u>Bottom line perspective</u>: Portfolios are deteriorating slightly but not precipitously, so far.

2. *Virtually all interviewees expect more problems to surface.*

Exacerbating lender concerns over equipment finance's limited credit deterioration is the expectation that another shoe will drop, whether tied to commercial real estate, home equity lending or credit cards (three areas frequently mentioned), or other areas such as revolvers for leveraged deals or retailers.

Even though these areas may not involve a leasing or equipment finance activity, they impact the industry in several ways. First, bank risk managers tend to tighten lending terms for all loans not just those performing poorly. (One comment: "If our credit people had their way, we wouldn't be doing any deals.") Second, losses resulting from areas such as subprime mortgages may impact the available capital, even if the equipment finance business is performing well. (Comment: "Banks have become very conservative, cutting back on capital commitments to the commercial sector.") Third, as we will discuss more in the section on competition, lenders use an unsettled period to rethink the strategic fit of various businesses and clients within those businesses. (Example: "We looked at our segments and determined who our priority customers were.") The net result is a narrowing of competitive focus.

<u>Bottom line perspective</u>: No matter the unit's performance, with few exceptions, bank funding is being limited for equipment financing activities. Outside of banking, investor nervousness is negatively impacting some independents.

3. More managers are focusing on quality and downplaying growth.

"My growth this year is about 2 percent. We could easily be in the double digits if I had the funding." Another national lender suggests they will generate "tepid" growth in 2008 while a third mentioned that his "salesmen are whining" due to the number of deals being turned down this year. These comments summarize what we have heard from many of the industry's leaders, particularly those from bank-owned and smaller independent entities.The opportunity for growth exists, but internal funding constraints cap that growth.

Even among those players with access to adequate funding, profitability and credit quality has taken priority over growth. Executives assert that they will walk away from deals they would have done even three months ago because the return is too low, or they are not comfortable with the borrower.

The emphasis on quality over growth is another factor in customer dislocation, with many lenders declining a higher number of applications than in previous years. Further, "a damper has been put on innovation," as lenders narrow their deal comfort zone and reduce their interest in story credits.

Bottom line perspective: Growth is taking a back seat in 2008 to quality credit and stabilizing the portfolio.

4. Players are increasingly emphasizing relationships over transactions.

Relationship banking is hardly a new concept, but it is one that has been largely ignored by transaction oriented lenders. No more. More bank lenders are providing equipment financing to current clients only, using it as a cross-sell tool to build wallet share. ("Banks are shifting liquidity to grow their client business.") In other cases, bank-owned lenders are requiring a fuller relationship with their borrowers. One commented that while historically "we have been transactional in nature," he expects to pursue deposit relationships with clients, including the value of those deposits in their pricing matrix. The advent of Remote Deposit Capture (RDC) technology allows bank lenders to capture deposits from borrowers no matter where they are headquartered, increasing the equipment lenders' focus on the liability side of the balance sheet.

This relationship emphasis extends well beyond bank-owned companies. One independent spoke about "firing" his vendor finance partners because of the performance of their portfolios and the efficiency of working with them. In their case, they intend to go "deeper with fewer clients"

Bottom line perspective: Bank management intolerance for transactional lending may result in some fundamental shifts in approaches to client management. Increasingly, all lenders will focus on relationship-building activities.

5. Some lenders (including banks) are capital and funding constrained.

"Banks were always assumed to have funding. However, today, do not expect the banks and the biggest independents to be there."

It comes as no news that many major financial services players are capital and funding constrained. While FIC believes that size may be critically important going forward, certainly in itself it is not sufficient for success. The list of large players that are exiting the equipment finance market or limiting their involvement in it seems to be increasing weekly. CitiCapital and Merrill Lynch Capital are two recent exits from the marketplace, but many more companies, including major banks and insurance companies as well as two of the largest independents, have narrowed their market focus and increased their selectivity at least in part due to capital and funding issues.

2008 is seeing the deleveraging of the industry. One independent said that while they once operated at seven-nine times leverage, they were now at two-three times. Others quoted a similar leverage pullback.

Bottom line perspective: Deleveraging may mean lower returns for the industry. Given funding constraints, independents will be hard pressed to generate the returns required for investors, including private equity players.

6. Uncertainty viewed as continuing.

"No one knows if we have hit bottom…we don't know what the new normal will be."

Interviewees have been uniformly humble about predicting the future. While some think we are at or near bottom, many others hesitate to offer a guess. In general, however, the perspective is that the next four-six quarters, taking us through mid to end of year 2009, will be very unsettled.

Bottom line perspective: Uncertain results in hesitancy and indecision on the part of credit personnel and investors. Those companies that cannot self-fund or access ready funding sources may continue to struggle, limiting their growth, perhaps ultimately resulting in another round of industry consolidation.

7. However, exceptions exist.

It is important to note that some players are having banner years, despite the overall market difficulty:

- One company owned by a top-20 bank expects to generate 20 percent organic growth this year.
- Several players that act as third-party funders for deals that others originate see 2008 as a great year: "Banks are pushing more deals through because they do not have the capital to fund them. They want to be responsive to customers…so, where we usually had to beg for volume, we are now seeing a flood."
- One recent start-up sees 2008 and beyond as providing tremendous growth opportunities due to the pullback in competition.
- An independent sees its volumes up 50 percent in light of fewer competitors who "either have left or do not have funding."

<u>Bottom line perspective</u>: Some new and other long-established companies are taking advantage of the opening provided by the current environment to exploit the weaknesses of their competitors.

Funding as a long-term issue for the industry

"The industry is funding challenged."

The first section mentioned funding, but it merits much greater emphasis because it represents the number one issue facing the industry today and over the next 12-18 months.

While some banks have already exited the market and others will do so, most will continue to operate with a funding advantage, given their access to low-cost demand deposits, certificate of deposits, and medium term notes.

Many interviewees cite medium and small independents as the group facing the greatest funding hurdles. Major funding options for them include bank lines, asset-based transactions, private equity, and sovereign wealth funds. The current availability of each of these funding avenues highlights challenges for the industry in general and independents in particular.

Bank lines - Most independents that depend on bank lines are finding some bank funding (assuming their performance is strong) but, in most cases, are paying increased fees and interest rates at more restrictive terms. However, in what could signal a disturbing change, one large bank has decided to reduce its exposure to independents: "We have cut back significantly both the lines of credit and warehouse lines that we offer to independent equipment financing companies. We want out of that market."

Banks funding independents will be smaller in number and more demanding in terms and conditions. In addition, one bank executive stated that, "In recent weeks, regulators have become increasingly critical of loans to the equipment finance industry. They feel that there are less risky ways for banks to deploy capital."

Asset-backed market - In the words of one commentator, "The market will come back, but not this year and maybe not next year." Many independents can no longer rely on this arena as a secure funding source for, as one analyst commented, "Only the biggest and the best will have access to securitization." And, when the securitization market does return, most analysts expect that the requirements for placement will become increasingly strict, driving up the cost of this funding method.

Commercial Paper Market - While the Commercial Paper market continues to operate, the cost of funding through this vehicle has increased as investors demand higher returns. In addition, the market's reduced liquidity can impact a lender's ability to match-fund specific periods. While analysts agree that this market is returning to normal, the cost to issue will likely remain prohibitively high for all but the strongest companies.

Private Equity (PE) - PE firms may offer funding to some players, but they will be highly selective in whom they work with and demand high returns for whatever funding or investments they provide. Also, given the mixed results of many of the PE's initial financial services results, they appear to be slowing down and are taking longer to analyze opportunities. As one commentator said, "Those Private Equity firms that have been aggressive have been rewarded in a rude way." Another added, "Private Equity firms are looking at distressed portfolios and companies under pressure. However, they are still waiting."

In addition, as several observers noted and our experience confirms, while PEs may see the equipment finance industry as attractive and a generator of a huge level of assets, many PEs tend to thrive on high leverage and, therefore, need to be able to raise debt. Increasingly, they are facing the same constraints and rate issues that the equipment finance industry itself faces.

While PE firms appear to be a permanent part of the equipment finance landscape, the extent and nature of their involvement is still evolving. Given the interest both of investors and industry leaders, we expect more PE-funded ventures like Tygris will surface. But, as one analyst stated, "Private equity firms will want belt and suspenders credit protection," limiting their focus to a relative handful of equipment finance companies.

Private Placements. Private deal placement appears to be one of the few funding vehicles to remain available to selected smaller independents. However, many of the large banks and insurance companies that typically purchase deals from smaller players are themselves capital constrained as a result of losses in the mortgage market. As a result, those investors with sufficient capital are able to cherry pick the best quality deals, command better returns, and negotiate stronger guarantees, effectively driving up the cost of funding through these markets.

Sovereign Wealth Funds. These foreign-owned investment funds have been in the news as they make investments in some of the largest U.S. financial services players. However, their interest is limited only to the biggest names. Within equipment finance, we estimate that this includes no more than ten companies, hardly providing a panacea for the industry.

Buying/building a depository. Several players, CIT and CapitalSource among them, operate or are considering purchasing/starting up a bank to allow them to gather deposits while taking advantage of the FDIC's insurance to attract money. As with Private Equity and Sovereign Wealth Funds, opportunities to form banks will likely remain limited to the largest and most sophisticated players. In addition, the length of time required to obtain a banking license and then generate a significant deposit base makes this source of funding an impractical remedy for near-term needs.

Based on funding constraints, many interviewees believe that smaller independents will find it increasingly difficult to survive:

- "Minnows will have a tough time. Those that used structured finance or securitization are shut down."
- "No one [investors] cares about the small players."
- "Small players need capital and funding, but, they are not attractive to investors"
- "I can't come up with an equation that funds independents."

Of course, similar "doom and gloom" scenarios have been painted in other down years, but this time problems are more severe and, probably, longer lasting. Nonetheless, at least in the near term, funding issues will limit growth for many players, whether banks, independents, or captives. Smaller independents will find themselves extremely challenged to generate deal funding and, in some cases, may need to change their operating model to reflect the more difficult funding environment.

Changing competitive environment

Market dislocations and funding challenges will result in significant differences in the competitive environment over the next two years. Changes may include:

- Many (four-five) of the top ten bank players will exit the business.
- Many of the top 50 bank players will operate with low growth goals for equipment finance.
- Other bank players will restrict themselves to current client or relationship business only, with an increased emphasis on the liability side of the balance sheet based upon the use of RDC and other emerging technology.
- A significant number of independents will close, consolidate, or change their business models.
- Other independents will be forced to deleverage themselves, significantly reducing both origination volume and profitability, potentially leading to another round of consolidation.
- A number of captives will close as their parents redeploy capital to support core competencies. Potentially, this change provides an opening for players to work with the parents of captives to wring out as much value as possible from their captives.
- Those remaining captives will continue to focus on their supporting their owner's sales, narrowing their focus outside that area.
- Private equity funded start-ups will occur, but they will be larger entities as opposed to "mom and pops".

All of the above points to less supply for the end customer as each type of industry player pulls back or limits its activities. Resulting from these types of changes, the good news is that deal structures will continue to strengthen, and margins will continue to grow. As one commentator noted, "Sanity has returned to the market, with pricing and spreads up."

While not all players have experienced significant margin improvements, a strong positive trend surfaces from our interviews. Margin improvements from one year ago of 100 basis points or more are increasingly common. And, while lenders may not yet be able to dictate terms to borrowers, they have found themselves increasingly placed in the driver's seat in this regard. As one manager commented, "Eighteen months ago, customers were able to get a 15-year term on an energy management system. A month ago, we did a similar deal at seven years. By the end of the year, we will be able to write that deal at five-years, which is what it should be."

Regulations will impact weaker players

Initially, FIC's assessment of the impact of regulatory and accounting changes on the equipment finance industry focused primarily on the implementation of Basel II and on the apparently imminent implementation of International Financial Reporting Standards (IFRS). Overall, executives expect limited impact from either:

- "We have been working with Basel II for five or six years now; we don't expect anything to change once it is officially implemented."
- "We would like to think that Basel II will allow us to reduce the amount of capital allocated to each deal, but that isn't something that will change how we do business."
- "The only impact I see from the adoption of IFRS is that banks will have to re-write the debt ratio section of all of their loan covenants when borrowers start bring liabilities on balance sheet. But, that does not really impact our business."
- "When they are determining how to finance equipment, customers don't think about tax and accounting implications, they think about cash flow, pricing, and down payments. I don't think that changing to IFRS will affect us at all."

However, a number of industry insiders we spoke with, particularly those associated with banks, expressed concern that significantly increased regulatory oversight is imminent. While bank oversight typically increases during periods of financial turmoil, interviewees believe that in this cycle, that oversight will extend beyond banks and other traditionally regulated lenders to include all organizations involved commercial or consumer finance. Despite their recent refusal to rescue Lehman Brothers, insiders point to the recent Fed-orchestrated takeovers of Bear, Stearns and Fannie Mae and Freddie Mac as well as the recent unprecedented rescue of AIG as evidence that regulators, in their efforts to contain an economic maelstrom, are very willing to step far beyond their traditional boundaries.

Among the immediate likely implications for currently unregulated players are:

- A significant increase in overhead costs related to compliance, including systems and staff.
- A likely increase in loss reserves and a requirement to revalue assets (probably lower) to reflect their true value.
- An increase in charge-offs and non-performing assets as regulators standardize treatment of delinquencies and non-accruals.
- Reduced origination capacity resulting from requirements to maintain specific capital reserves.
- Increased legal liability as regulations extend many of the consumer credit protections to commercial borrowers.

While banks note that this additional oversight will "level the playing field", they also recognize that captives and smaller independents will be unwilling and/or unable to absorb the costs associated with compliance. As a result, the industry will likely see a further reduction in the number of captives as their manufacturing parents outsource the financing operation to a third-party vendor. In addition, the cost of compliance as well as the capital requirements will push an even greater number of independents out of the industry.

In our view, the Fed and others have demonstrated an extraordinary willingness to step outside the box in order to minimize the impact of today's financial crisis on the overall economy. It is now conceivable that, if significant problems develop, they could place the entire commercial finance industry under regulatory oversight. In order to reduce that possibility, the industry needs both to increase its self regulation significantly and continue to emphasize and demonstrate that it is fundamentally sound.

The future? Uncertain yes but, potentially, quite different from today

What does the future hold and how should various players position themselves for it? While FIC's crystal ball is as murky as everyone else's, some future events seem relatively easy to predict, others much less so.

- *Volatility and uncertainty continue.* No crystal ball is required for this statement. While some interviewees suggest we may be at or near the bottom, none suggest that there will be a quick economic rebound from current levels. The best guess on the timing for an improved business environment seems to be the second half of 2009. As discussed below, before the upturn occurs, fewer active bank and independent players will remain.

- *Greater bank discipline in approaching equipment finance.* Certainly, there will be fewer bank players operating in this space over the next 12 months. In addition, many banks that continue to offer equipment finance will do so differently, demanding a relationship focus from their sales staffs.

Years ago, FIC interviewed one head of a bank-owned leasing company who proudly discussed how he avoided working with his company's bankers and generated all of his group's business independently. That type of approach is disappearing as more equipment finance heads appreciate the value of working with their bank colleagues and as the banks demand a relationship sales approach. A relationship focus means that the one-off sale of a lease or financing product will either be discouraged or disallowed. Instead, a disciplined cross-sell effort will be mandated (initially), ultimately becoming part of the sales culture. Importantly, the sales discipline will also include deposit generation, supported by remote deposit capture technology.

- *Independents increasingly stressed.* Every time a downturn occurs, industry prognosticators say that many small to mid-sized independents will disappear. The difference this time is that the funding availability appears to be at or close to crisis level for this segment of the industry. Certainly, no one expects all independents to disappear, but FIC and virtually all its interviewees (other than small to mid-sized independents) believe substantial consolidation will occur within this segment.

- *Size counts*. Given funding disruption and investor concerns, size is increasingly important to survival and success. Small companies, even with well developed niche strategies, operate with a distinct disadvantage in the current environment versus a less capable player that possesses capital strength and funding access. That was not always the case, but it is the situation today and for the foreseeable future.

- *New competitive entrants will be limited.* As discussed above, Private Equity (PE) firms may be increasingly hesitant to invest given their rocky experience so far in financial services. PE investments will occur but neither we nor other observers expect them to provide a panacea for the capital and funding needs of the industry. PEs will invest in big opportunities whether existing or de novo. Small start-ups will be few in number, given funding constraints.

How should various players respond to the expected operating environment for equipment finance?

Banks should determine if providing equipment finance is a core capability. Those that do should view this period as one in which they can gain share and differentiate themselves with their client base. Banks that decide not to commit to this business should consider sourcing these opportunities for a third-party lender while maintaining control over the client relationship. However, in many instances players should not show total commitment or abandon the market; rather they should select key segments (based on industries, loan types, client relationship, or other criteria) in which to participate. Increased segmentation and selectivity is an appropriate approach for most banks.

Captives' parents should determine if providing financing to its customers is the best use of increasingly scarce capital. Those that choose to exit the industry should partner with a third-party provider that is familiar with their industry and that can continue to support the manufacturer's dealers and end-users. Captives remaining in the equipment finance space should increasingly limit their activity to financing the parent's products and, potentially, other manufacturers' products purchased as part of a solution package.

Given the declining dependence of the global economy on the U.S. for growth, captives whose parents have a global presence should focus on developing their own international capabilities in order to reduce the impact of regional economic slowdowns. In addition, as a number of players have noted, leveraging the high demand for equipment in Asia and South America has enabled some to generate significant profits from remarketing equipment originally sold, then repossessed, in the U.S. and Europe.

Independents need to be discussed as two groups, based upon their size and access to funding. Large independents, no more than five to ten in number, appear for the most part to have succeeded in developing the funding access necessary for continued growth.

The story appears to be very different for smaller independents. A substantial number will find access to funding increasingly expensive and available only with more restrictive covenants. They will need to continue to look for traditional and nontraditional funding sources while introducing increased selectivity about the deals they do. Growth has to take second place to generating improved returns and eliminating losses.

Private Equity firms have multiple investment opportunities. However, they need to take a very cautious approach prior to doing a deal and go well beyond numbers to assess the attractiveness of various investment alternatives. Based on the evidence so far, for every successful PE firm in this industry there will be several failures.

By the time the 2009 State of the Equipment Finance Industry is written, FIC hopes that greater stability and predictability will have returned to the equipment finance market. In the meantime, players need to excel at broken field running, avoiding the landmines that exist while taking advantage of the higher margins and increased returns that market discontinuities offer successful competitors.

Analysis of ELFA's 2008 Survey of Equipment Finance Activity (SEFA)

This year's SEFA includes 154 responses from 146 companies. As in prior years, three companies submitted separate responses for each business unit.

Each year respondents provide current and prior year data. Unless otherwise indicated, data charts comparing two years' data include only those respondents providing information for both years. Since the respondent set varies each year, it is not possible to compare absolute numbers between different years' SEFA results. 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 financier type or percentage of new business originated through a certain channel) is statistically accurate. Therefore, some of our analysis of SEFA relies on relative, not absolute, data.

As discussed previously, SEFA reflects data for the 2007 fiscal year and is likely not indicative of today's activity. Many of the industry executives with whom we spoke stated that the third quarter of 2007 marked the beginning of the paradigm-shifting changes that the industry has experienced. Therefore, elements of it may not fully reflect the realities of today's market.

FIC has organized its analysis of this year's SEFA into the following major components:

- The Overall Industry
- Financier Profitability
- Market Segment Profitability
- Business Model Profitability

As noted in the Preface, throughout this section of the Report, FIC references specific TABLES from the Survey of Equipment Finance Activity(SEFA). SEFA TABLES are <u>not</u> included in this report. The SEFA can be downloaded at www.elfaonline.org.

The Overall Industry

Overall, respondents reported a two percent increase in new business volume in 2007 versus the prior year. Average pre-tax yields slipped as pricing declined from 2006 while the average cost of funds increased. The dollar-weighted Return on Equity (ROE) declined sharply over the prior year and Return on Assets (ROA) rose to its highest level in five years. Portfolio quality declined slightly over 2006 as both charge-offs and delinquencies increased. However, both remained close to their five-year lows. Operational efficiency also improved over 2006 as the industry grew new business volume without increasing headcount. Both net earning assets and new business volume per FTE increased over the previous year.

FIC's analysis of the overall industry focuses on the following areas:

- New Business Volume
- Yield and Funding
- Financial Statement Information
- Portfolio Performance
- Business Processes

New Business Volume

This year's SEFA reported a moderate two percent increase in new business volume with a decline in originations through captive programs offset by increased origination through third-parties. Respondents reported an increase in volume for only one of the top five end-user industries and a significant volume decline in the largest equipment category. The percentage of new business volume transacted in loan-like products increased, largely at the expense of direct finance leases.

Respondents reported originating $136.8 billion in new business in 2007, a two percent increase over 2006. As Table 1c illustrates, the largest providers, those with over $1 billion in new volume annually, generated 84 percent of total new business volume, a slight decline over 2006. Year over year growth for the largest providers was flat at 0.1 percent. Second tier providers, companies with $250 million to $1 billion of annual volume, reported new business volume growth of nearly 17 percent over 2006. Second tier companies generated 11 percent of all new business volume, an increase from 9 percent in 2006.

New business originated through captive programs declined by over $4 billion over the prior year, a significant 10.8 percent decline (Table 2a). However, a $4.5 billion (38.1 percent) increase in new business sourced through third parties offset the decline through captive programs. New business originated directly and through vendor programs increased modestly over the prior year.

In 2007, the top five end-user industries comprised 49.2 percent of total new business volume versus 52.2 percent in 2006 (Figure 3). Of the top five end-user industries, only

Figure 3

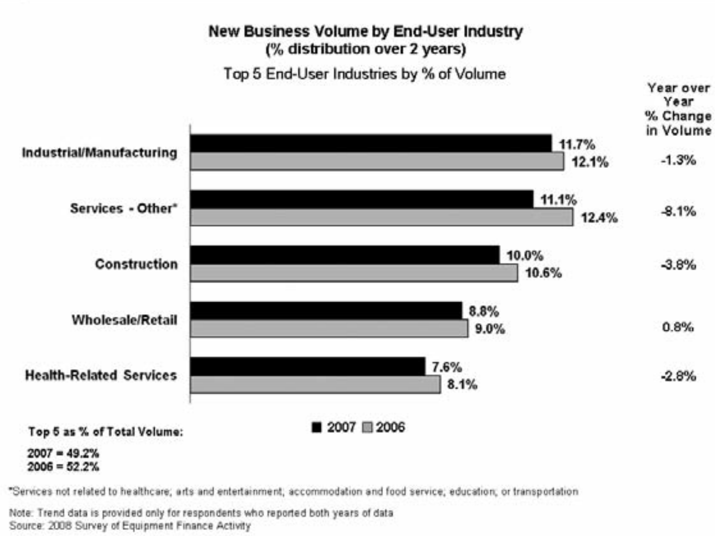
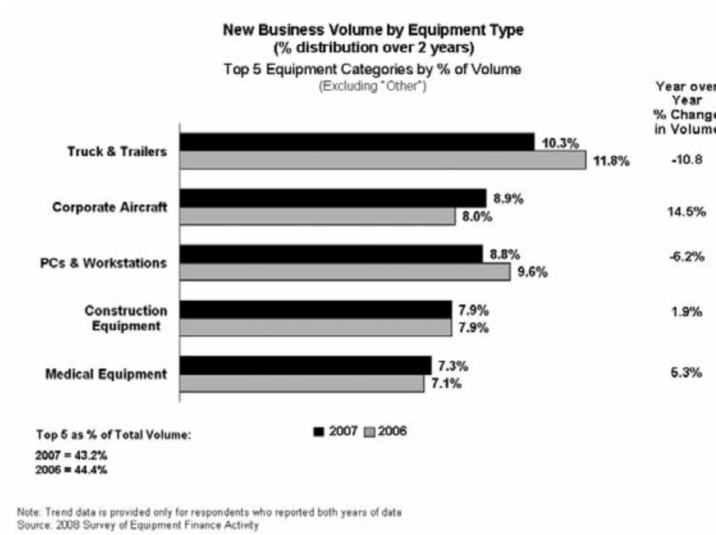


Figure 4



the wholesale/retail sector experienced year-over-year new business volume growth, a modest 0.8 percent increase. The services sector (services not related to healthcare, arts and entertainment, accommodation and food services, education, and transportation) experienced the sharpest year-over-year decline in new business volume.

As illustrated in Table 4b, sectors with the largest year-over-year increases in new business volume include:

- Utilities - $1.98 billion (31.3 percent)
- State and Local Governments - $1.42 billion (44.3 percent)
- Telecommunications - $0.94 billion (98.9 percent)

These increases likely reflect increased investment in alternative energy, the shift to voice-over-IP technology, and an increased need by governments to finance capital expenditures due to falling tax revenues.

As a percentage of new business volume, the top five equipment categories fell slightly from 44.4 percent of total volume in 2006 to 43.2 percent of total volume in 2007 (Figure 4). The largest category (as a percentage of total volume), trucks and trailers, experienced a 10.8 percent year-over-year decline in volume. The decline reflects a decline in 2007 sales of class 8 trucks related to tightened emissions standards as well as pressure on the transportation industry from a slowing economy and rising fuel prices.

The second largest equipment category, corporate aircraft, experienced a 14.5 percent year-over-year increase in new business volume, reflecting the continuing strong demand for business and personal aircraft. Despite a downturn in the U.S. economy, the industry expects deliveries of business aircraft over the next ten years to double versus the previous decade, resulting in an increased opportunity for the equipment finance industry.

This year's respondents reported that conditional sales agreements and term loans comprised 55.6 percent of total new business volume versus 53.9 percent in 2006 (Table 6a). New business volume transacted through direct finance leases declined by 18.2 percent over the prior year, likely in anticipation of upcoming changes in accounting standards. Tax-exempt leases comprised 5.0 percent of total volume in 2007, an increase of 25 percent over the prior year. In addition, new business volume in alternative products, such as equipment-secured revolving debt, increased by 81.1 percent over 2006, reflecting industry efforts to expand its product offer in response to customer demand.

Industry Perspective and Potential Implications

While economic conditions drive overall growth in new business volume, additional factors, such as technological, political, and regulatory changes can impact specific end-user industries or equipment categories differently. For example, the inefficiencies in air travel that resulted from tightened airport security created a sustained increase in demand for corporate aircraft. Similarly, public perception, as well as an anticipated change in accounting standards, caused a shift in recent years away from off-balance sheet products to more transparent and less complex vehicles. However, in 2008, industry leaders see a return to more traditional leasing products as customers try to preserve cash and lower monthly payments in light of economic uncertainty.

Potential Implications

➢ While segmentation, either by industry or equipment category, is an effective competitive tool, financiers must be aware of trends and changes that could impact a segment in which they play. Top players will also continually monitor related or similar segments in order to identify and act on potential opportunities before competitors. For example, those players that identified opportunities in the corporate aircraft market five years ago have a competitive advantage over the numerous players entering that market today.

➢ In today's uncertain economic environment, customers that must purchase capital equipment are looking to do so in a way that both preserves cash and reduces monthly payments. Players possessing traditional leasing expertise, such as residual valuation and deal structuring, may have an advantage over competitors offering primarily loan-like finance products.

Yield and Funding

For the industry, dollar-weighted average pricing and spreads declined while cost of funds increased. Pricing, cost of funds, and spreads varied widely based on organization size. For respondents involved in funding through asset securitization, securitization volume changed little between 2006 and 2007. Private placement and Commercial Paper conduits comprised most of the volume in both years. However, the dollar volume of transactions sold to others increased significantly in 2007 with banks and other financial institutions purchasing most of the volume. 2007 saw private investors, such as private equity funds, significantly increase their purchase of equipment finance transactions.

For all respondents, SEFA reports that the dollar-weighted average yield declined 11bps to 8.19 percent in 2007 (Table 8a). This decline in pricing, combined with an increase in the dollar-weighted average cost of funds, resulted in a 13bps decline in the dollar weighted average pre-tax spread to its five-year low. However, as shown in Table 8b of SEFA, median pre-tax yields and spreads both improved over 2006 while the median cost of funds declined.

In 2007, larger financiers (those with annual volume exceeding $50 million) drove much of the industry's margin compression, primarily through decreased pricing (Table 8e). Over the same period, equipment finance providers with annual volume less than $50 million enjoyed a modest increase in pricing and a decline in their cost of funds, resulting in a 14bps spread improvement.

A similar percentage of SEFA respondents reported being involved in funding through securitization of assets in both 2006 and 2007 (Table 9a). The dollar volume of assets securitized declined by a modest 2 percent from $17.4 billion in 2006 to $16.9 billion in 2007. Over 80 percent of securitization volume was placed privately or through Commercial Paper conduits (Table 9e).

The percentage of respondents that sold transactions to other organizations and investors increased significantly in 2007. As shown in Table 10a, in 2006, slightly fewer than half of respondents sold transactions. In 2007, nearly 60 percent reported selling transactions. As a result, the dollar volume of transactions sold increased by nearly 58 percent in 2007 to $19.5 billion. Whether this number will increase in 2008 remains unclear. Certainly, an increased number of lenders wish to outsource some or all of their funding requirements. However, investors appear increasingly selective and some are suffering from the ill effect of earlier purchases.

As shown in Table 11a, banks and other financial institutions purchased nearly 80 percent of the transactions sold by equipment financiers. Independent, Financial Services companies purchased an additional 14.3 percent with the remainder purchased by Captives (1.5 percent), insurance companies (1.8 percent), individual investors such as private equity funds (2.3 percent) and other investors (0.6 percent). Activity by private equity funds and other individual investors increased tenfold in 2007 versus 2006, the only significant change in activity across investor types.

SEFA respondents selling transactions reported a variety of reasons for doing so. As shown in Table 12a, 61 percent reported that portfolio management was their primary reason for selling transactions. Other reasons reported for selling include fee income (21 percent), funding (11 percent), and yield enhancement (6.8 percent). Large organizations (those with annual volume exceeding $250 million) were most likely to employ transaction sales as portfolio management tool (Table 12c). Financiers with annual volume less than $50 million were less likely than all but the largest companies (volume exceeding $1 billion) to use transaction sales as a funding source.

Industry Perspective and Potential Implications

Through 2007, smaller equipment financiers appeared better able to leverage their service and segment knowledge to command higher pricing. Large finance providers, while claiming to differentiate themselves from competitors in a variety of ways, competed largely on price. As discussed above, today, those dynamics have changed. While smaller players may still possess the service levels and knowledge base to command premium pricing, they lack the scale required to compete for scarce capital. Large players are also feeling the funding squeeze and are employing their capital more strategically. As one executive stated, “Deals that we would have done even a month ago we will walk away from today because the price is too low.”

The significant increase in transaction sales is likely the result of the seizure of the securitization and Commercial Paper markets in mid-2007 as well as the decreased availability of credit to fund transactions. Finance providers that were cut off from their normal funding sources were required to sell transactions in order to fund future business. Those banks that remained well-capitalized after the subprime meltdown leveraged their capital to achieve low-cost growth by purchasing equipment finance transactions from distressed providers. Similarly, well-funded investors, like private equity funds, took advantage of the funding crisis to enter the equipment finance market in a low-risk manner while acquiring high-quality and high-yield assets.

Potential Implications

➢ Today, expertise and strong service may no longer be enough to ensure success in the equipment finance industry. Players lacking the track record and scale to attract reasonably priced funding will be forced to reduce their new business volume to that which can be internally funded

➢ As investors and creditors demand greater protection, most players relying on external funding sources will be forced to deleverage in order to maintain their access to capital. As a result, the ability to generate new business volume as well as earnings and returns will decline. Players able to fund through bank deposits will have a significant competitive advantage. As discussed early, a number of non-bank players have purchased bank licenses and have developed strategies to build deposits into a sustainable and reasonably priced source of funding

➢ The increase in the volume of transaction sales may also impede the recovery of the secondary securitization markets. As one industry executive noted, “Why would anyone buy on the secondary market when there are such great deals to be had in the primary market. Besides, in the primary market you have first-hand knowledge of what you are buying, something you don’t have after Wall Street has had its hand in.”

Financial Statement Information

SEFA respondents reported over $286 billion in assets under management (Table 13a) at the end of 2007, an increase of 6.1 percent over the prior year. Off balance sheet assets, including securitized managed assets, syndicated managed assets, and other off balance sheet items, totaled $25.8 billion, or nine percent of total assets under management. In 2007, off balance sheet assets as a percentage of total managed assets declined by 1.5 percent versus the prior year, likely the result of the collapse of the securitization market in August 2007.

As represented in Table 13c, organization size appears to be an indicator of degree to which an equipment financier utilizes off balance sheet accounting. Because of their desire for balance sheet growth and their lack of access to the securitization and syndication market, the smallest companies (less than $50 million in annual volume) report the fewest off balance sheet assets, just 1.8 percent of total assets under management. Organizations generating $50-250 million in annual volume reported nine percent of total assets under management as off balance sheet, comprised primarily of syndicated managed assets as few organizations of this size had access to the securitization market. Second tier companies ($250 million to $1 billion in annual volume) reported off balance sheet assets at 17.3 percent of total assets under management, a significant increase over the prior year. Providers of this size were active in both the securitization and syndication markets and the degree to which they utilized both indicates their reliance on these markets for funding ongoing business. The largest equipment financiers (over $1 billion in annual volume) reduced securitized managed assets from 8.3 percent of total assets under management in 2006 to 4.5 percent in 2007. This decline was likely the result of the collapse of the market as well as the need by some lenders to remove these assets from their balance sheets and to raise capital.

In 2007, respondents reduced their reserve for losses from 0.9 to 0.8 percent of net earnings and operating lease assets (Table 13a). As a percentage of revenue, provision for bad debt was essentially unchanged from the prior year (Table 14a). The smallest equipment finance providers reported the smallest reserve for losses at 0.4 percent of net earnings and operating lease assets. This group also reported the highest provision for losses at 9.9 percent of total revenue (Tables 13c and 14c, respectively).

For all respondents, income before taxes declined from 31.8 percent of total revenue in 2006 to 29.3 percent in 200, reflecting increases in both interest and sales, general, and administrative expenses. Net income after taxes declined slightly in 2007 to 21.2 percent of revenue, largely due to a decrease in the provision for income taxes (Table 14a).

Despite the highest leverage ratio reported in over five years (7.9:1), on a dollar-weighted average basis, Return on Equity declined to 12 percent in 2007, its lowest level since 2003 (Table 15a). However, Return on Assets improved from 1.6 percent in 2006 to 1.9 percent in 2007.

At the median, respondents reported 2007 Return on Equity of 11.7 percent levered at only 6.1:1 (Table 15b). This suggests that in 2007, large equipment financiers were a drag on total industry profitability.

Industry Perspective and Potential Implications

The lackluster returns generated by the some of the largest equipment financiers indicate the degree to which falling margins were not offset by reducing costs or increasing leverage. At least through 2007, smaller players, differentiating on service and expertise, were able to generate better returns than large players competing on price.

While portfolio quality remained strong throughout 2007, beginning in the third quarter, macroeconomic conditions indicated that a significant deterioration in credit quality would likely occur in 2008. However, respondents' continued to reduce reserves, apparently in order to increase income. In 2008, however, industry leaders indicate that they are proactively increasing reserves in anticipation of losses in specific industries.

Potential Implications

➢ While margins appear to be improving in 2008, requirements by regulators, lenders, and investors to reduce leverage will significantly impact Return on Equity. Players must immediately begin restructuring their balance sheets to reduce debt loads. In addition, given the market's perception of off balance sheet items as well as the nearly total disruption of the securitization market, players restructuring their balance sheets in order to attract funding will likely find it necessary to bring many of these assets back on balance sheet, in some cases at a significantly reduced value

➢ Despite indications that credit quality held through the end of the second quarter 2008, top players are anticipating sustained softness in the commercial sector and, accordingly, are increasing their loan loss reserves. Those players continuing to use loss provisions to manipulate earnings may find themselves under increased scrutiny from regulators, lenders, and investors

Portfolio Performance

For all respondents, portfolio performance remained strong in 2007. Non-performing assets declined slightly from 2006, however charge-offs increased nominally. In 2007, average delinquencies also improved slightly over the prior year.

In 2007, SEFA respondents reported that the weighted average of receivables aged 31-days or greater declined to 2.2 percent from 2.3 percent in 2006 (Table 16a). Over the same period, non-accrual assets, as a percentage of receivables and non-accrual assets, declined by 10bps to 0.9 percent, their lowest level in over ten years.

Overall, delinquencies (defined as receivables aged greater than 31-days) were significantly lower among the largest financiers (annual volume greater than $1 billion) versus smaller organizations (Table 16e). This likely reflects the larger organizations' ability to devote more resources to the collections process, including dedicated staff and sophisticated technology.

Respondents reported that 2007 weighted-average charge-offs increased by 20bps over the prior year to 0.8 percent of full-year average receivables (Table 17a). Median charge-offs increased by 10bps over 2006 to 0.4 percent of receivables. The largest equipment financiers (annual volume greater than $1 billion) reported charge-offs of 0.2 percent of receivables, one-third the level of smaller companies (Table 17e). Again, this is likely reflective of large companies ability to invest in more effective collections and recovery processes.

Industry Perspective and Potential Implications

As discussed above, portfolio performance has remained strong through the first half of 2008. While managers see softness in certain sectors, such as housing and transportation, most state that delinquencies and charge-offs remain the same as the end of last year. However, most also recognize that as the economy slows and corporate defaults increase, it is inevitable that delinquencies and losses will increase. Most have stated that they are increasing their reserve for losses. A number of executives report that they have increased their underwriting requirements and/or reduced their exposure in certain industries. Many, particularly those in the small-ticket space are increasing their focus on collections.

Potential Implications

➢ As discussed earlier, those players with funding that are able to manage losses will not only survive but emerge from this downturn in a strong competitive position. In our view, players that are unable to manage portfolio performance will see lenders and investors move quickly to pull funding. In order to minimize potential issues, financiers should review and tighten their collections processes, evaluate their portfolios and sell potentially troublesome transactions, reduce their activity in weak sectors, and strengthen underwriting standards and collateral requirements

Business Processes

This year's SEFA focused on a number of areas related to business processes and efficiency, including:

- Application processing
- Credit decision turnaround time
- Residual valuation
- Asset disposition/equipment remarketing
- FTE distribution
- Operational efficiency

Application Processing

In terms of both applications submitted and the dollar value of applications submitted, overall, in 2007, respondents approved fewer deals versus the prior year (Table 18a). The decline, however, was driven by the largest players (annual volume greater than $1 billion) as smaller financiers reported an increase in their approval rates (Table 18c).

As illustrated in Table 18a, the percentage of deals approved but not funded increased in 2007 over the prior year. These are deals that could have been lost to a competitor within the industry or lost to an alternative source of financing from outside the equipment leasing and finance industry. Understanding this trend and taking steps to reduce its impact represents a significant opportunity for players.

Credit Decision Turnaround Time

For transactions under $250,000, respondents reported that the median credit decision turnaround time decreased from eight hours in 2006 to six hours in 2007 (Tables 19a-i and 19a-ii). This likely reflects an increased usage of credit scoring and auto-decisioning technology for smaller transactions. The median turnaround time for middle-ticket ($250,000 - $5 million) and large-ticket (over $5 million) transactions remained the same at three- and five-days, respectively.

Residual Valuation

SEFA respondents appeared to be less aggressive in valuating residuals in 2007 versus the prior year. For those transactions with residuals, respondents overall residual position declined from 22.3 percent of volume in 2006 to 19.9 percent of volume (Table 20a). As illustrated in Table 20c, the largest financiers (annual volume greater than $1 billion) took the most aggressive residual positions while the smallest companies (annual volume less than $50 million) took the least aggressive positions.

Some within the industry have speculated that problems experienced by FMCC and GMAC related to residual valuations in their leased auto portfolios would result in an industry-wide reduction in the importance of residuals. However, most of the executives and analysts that we interviewed agreed that the problems experienced in the auto leasing sector were largely the result of an unsustainable business model designed to move autos off the showroom floor. In fact, they believe there is an increasing emphasis on the use of residual positions as borrowers leverage deal structure to reduce payments and conserve cash. Strong knowledge of the underlying equipment and the industry in which it is used as well as the ability to remarket the equipment are critical capabilities in this area.

Asset Disposition and Equipment Remarketing

Overall, asset disposition and equipment remarketing activity is little changed from 2006. For 2007, respondents reported that just fewer than 60 percent (by fair market value) of leases reached maturity (Table 22a). Of the remaining leases, nearly 30 percent were bought out prior to maturity and nine percent were rolled over due to equipment upgrades.

Of those leases reaching maturity, 25.2 percent (by fair market value) were renewed by the original lessee and nearly 50 percent (by FMV) were purchased by the original lessee (Table 23a).

FTE Distribution

In 2007, respondents' headcount remained virtually unchanged from the prior year (Table 25b). Respondents appeared to increase their emphasis on sales and origination (25 percent of FTEs in 2007 versus 24.2 percent in 2006), and credit approval activities (10.7 percent of FTEs versus 10 percent in 2006). Areas of decreased focus include booking activities (12.8 percent of FTEs in 2007 versus 13.7 percent the prior year) and servicing (22.4 percent in 2007 versus 22.8 percent in 2006). Additionally, FTEs employed in collections and workouts declined from 7.9 percent of headcount in 2006 to 7.8 percent in 2007.

Areas with the most outsourcing activity in 2007 include legal and compliance with 17 percent of headcount outsourced, information systems (9.9 percent of headcount outsourced), and human resources (5.6 percent of headcount outsourced) (Table 26a). Areas that are outsourced overseas include collections (one percent of headcount), customer service (1.2 percent of headcount), and information systems (one percent of headcount). In 2007, respondents reported a decrease in reliance on overseas outsourcing, specifically in the collections and workout area.

Operational Efficiency

This year's respondents reported an increase in operational efficiency in multiple areas versus the prior year. New business volume per FTE grew by four percent over 2006 and net income per FTE increased by over 11 percent over the same period (Table 27b).

Industry Perspective and Potential Implications

In the face of falling margins, the industry has focused over the past five to seven years on improving productivity and efficiency. In 2007, through increased productivity and the use of technology, respondents generated $2.7 billion more volume than in 2006 while adding just 32.5 FTEs industry wide.

Application processing provides a significant area of focus for increased efficiency. SEFA respondents report a substantial number of deals that are submitted but not approved. In addition, they continually report that a significant number of deals are approved but never booked or funded, indicating that the customer took business elsewhere. While FIC expects the number of deals declined may increase as lenders tighten standards, management should assess whether deals that should have been screened are going through the underwriting process. Similarly, they should evaluate the reason that deals are being lost after they have been approved.

Going forward, players will likely need to increase their staffing levels in the collections and workout areas. However, unless funding constraints imposes capacity restrictions, financiers should avoid doing so at the expense of sales and originations. As noted above, the change in the competitive environment provides capital-rich players with a significant opportunity to grow market share.

Potential Implications

➢ As discussed throughout this Report, 2008 is likely to be a very different year from 2007. Gains in efficiency and productivity become largely irrelevant without the funding required to originate new business. However, those players with sufficient capital have an opportunity to leverage increasing margins along with current efficiency to generate significant profits. In addition, as competitors retract or exit the industry, opportunities exist to add highly experienced sales and administrative staff in order to position oneself for stronger future growth

Comparative Profitability

As part of this year's Report, FIC assessed relative profitability by financier type, market segment, and business model and evaluated the performance of each across a variety of metrics and identified their key opportunities and challenges. While the quantitative analysis is based on 2007 data presented in the SEFA, it incorporates the findings from interviews with industry leaders to highlight how performance is changing in the current environment.

Profitability by Financier Type

In 2007, by virtually all measures, Captives were the most profitable type of equipment finance provider. Despite operating with over double the leverage of Captives, Banks ranked as the least profitable, largely due to pricing and debt service. However, in 2007, Banks generated 45 percent of new business volume and were they only financier type to increase volume over 2006.

As illustrated in Figure 5, Captives generated a median Return on Equity of 12.1 percent, 100bps higher than Bank and 20bps higher than Independents. Similarly, median Return on Assets and Net Income as a Percentage of Revenue were also significantly higher for Captives versus

Figure 5

Yield and Profitability Comparison By Financier Type 2007

	Banks	Captives	Independent Financial Services
Net Income (% of revenue)	16.3%	25.2%	22.7%
Median ROE	11.1%	12.1%	11.9%
Median ROA	1.0%	2.6%	1.5%
Median Leverage	8.8 : 1	4.1 : 1	5.3 : 1
Median Charge-offs	0.2%	0.4%	0.7%
Median Pre-Tax Yield	7.92%	8.62%	11.07%
Median Cost of Funds	5.07%	5.08%	5.70%
Median Pre-Tax Spread	2.78%	3.49%	4.23%
Percentage of New Business Volume	45%	24%	31%
Percent Change in New Business Volume (2006-2007)	7.2%	-2.4%	-1.3%

Source: 2008 Survey of Equipment Finance Activity

other financier types. A number of factors drive Captives' profitability:

• *Low cost of funds* – Median cost of funds for Captives averaged 5.08 percent, just 10 bps higher than Banks, which due to their access to low-cost deposits, traditionally have the lowest funding cost

• *Premium pricing* – While Captives do not generate the highest median yields, they are able to command, on average, 70bps more than Banks. The combination of premium pricing and low cost of funds generates a median pre-tax spread of 3.49 percent

• *Low debt service* – As shown in Table 14a of the SEFA, Captives' aggregate interest expense totaled 41.9 percent of revenue. While higher than Independents (35.0 percent) Captives' debt service is significantly lower than Banks (55.2 percent)

• *Low-cost origination* – Table 14a of the SEFA also shows that aggregate Sales, General, and Administrative (SG&A) expense for Captives totals 19.3 percent of revenue, driven by the low cost of origination associated with the Captives' point-of-sale model. In comparison, SG&A expense for Independents totaled 34.4 percent of revenue and 15.6 percent for Banks, which also enjoy relatively low origination costs

Banks generated the least profits among equipment finance providers with aggregate net income totaling just 16.3 percent of revenue and median Return on Equity of 11.1 percent. Banks' traditional competitive advantage, low-cost funding, appears to have eroded, likely due to more sophisticated treasury management practices by the bank parent. However, two factors primarily drive Banks' poor performance:

• *Commodity pricing* – Banks' median pre-tax yield falls significantly below both Captives and Independents. While relationship pricing may drive down yields to some degree, a more likely explanation is that, lacking any distinct market differentiation, Banks competed largely on price. However, in 2008, with significantly less capital to deploy, executives state that they are now operating with a strong emphasis on yields

• *High interest expense* – Leveraged at 8.8:1 (versus 4.1:1 and 5.3:1 for Captives and Independents, respectively) Banks carry significantly more debt versus other financier types. As noted above, Banks' aggregate interest expense exceeds 55 percent of revenue. Given the significant increase in the cost of debt in 2008, Banks' leverage may be an increasing drag on earning

As Figure 6 shows, Banks' advantages include their access to existing bank customers, their ability to leverage the trust of the bank franchise, and their access to deposit-driven funding. Factors that could impede Bank performance include internal competition for scarce capital and the cost of debt service. The outlook for Banks over the next 12-18 months is flat. Those Bank players not capital constrained by mortgage and other losses should be in a position to thrive.

Figure 6

Opportunities and Challenges By Financier Type

	Banks	Captives	Independent Financial Services
Pros/Opportunities	• Existing bank customers • Trust • Deposit-driven funding	• Point-of-sale origination • Equipment expertise • Strong re-marketing capabilities • Potential for global diversification	• Equipment expertise • Deal structure capabilities • Regulatory oversight
Cons/Challenges	• High degree of regulation • Internal competition for shelf space • Internal competition for capital • High debt load	• Limited funding sources • Volume tied to parent sales	• Limited funding sources • Expensive origination
2008-2009 Outlook	↔ Mixed • Cost of funding increasing • Capital/funding constraints at some • Smaller banks have plenty of capital	↑ Positive • Captives with global parent in best position	↓ Negative • Lack of funding causing many to fail

The outlook for Captives is generally good, particularly for players whose parents operate globally. Not only are these players able to offset regional declines in manufacturing, but they are able to leverage their global reach to remarket equipment, often at a substantial premium over what it would have received by remarketing locally. Of course, funding costs and availability will be an issue for Captives, particularly those lacking a strong parent.

Independents will face significant funding challenges over the next 12-18 months. Those able to obtain funds will likely do so at a greatly increased cost and with the requirement that they deleverage. Many smaller Independents will likely be unable to secure funding at any cost and will be forced to consolidate.

Profitability by Market Segment

By most metrics, in 2007, the Micro-Ticket segment outperformed all other market segments. This segment generated significantly higher returns as measured by Net Income as a Percentage of Revenue, Return on Equity, Return on Assets, and Pre-Tax Spread. The one area in which Micro-Ticket lagged was credit losses. By contrast, the Middle-Ticket segment generally underperformed, producing the lowest Return on Equity despite being highly leveraged.

Micro-Ticket comprised six percent of 2007 new business volume, a decline of nearly seven percent from the prior year. As Figure 7 shows, Net Income as a Percentage of Revenue totaled 37 percent for the segment versus 27.3 percent for Large-Ticket, the next highest segment in this area.

Figure 7

Yield and Profitability Comparison
By Market Segment
2007

	Micro-Ticket	Small-Ticket	Middle-Ticket	Large-Ticket
Net Income (% of revenue)	37.0%	14.3%	22.9%	27.3%
Median ROE	12.9%	12.5%	8.7%	11.9%
Median ROA	3.3%	1.2%	1.1%	1.7%
Median Leverage	3.0 : 1	6.6 : 1	7.4 : 1	2.9 : 1
Median Charge-offs	2.0%	0.6%	0.2%	0%
Median Pre-Tax Yield	12.96%	9.85%	7.68%	7.00%
Median Cost of Funds	6.10%	5.61%	5.08%	4.83%
Median Pre-Tax Spread	6.95%	4.20%	2.64%	2.31%
Percentage of New Business Volume	6%	26%	49%	19%
Percent Change in New Business Volume (2006-2007)	-6.8%	-0.7%	1.5%	10.9%

Micro-Ticket operates with less than half the leverage of both the Small- and Middle-Ticket segments. At 3.0:1, its leverage is comparable to that of the Large-Ticket segment (2.9:1). Despite its leverage ratio, the Micro segment generated median Return on Equity of 12.9 percent versus 12.5 percent and 8.7 percent for Small- and Middle-Ticket, respectively. The segment generated median Return on Assets of 3.3 percent, three times that of the Middle-Ticket segment. Attributes of the Micro segment include:

- *Premium pricing* – Due to both the transactional nature of the segment and the higher risk associated with it, the Micro segment commands the industry's highest pricing. As Figure 7 illustrates, median Pre-Tax Yields average 311bps higher than for Small-Ticket
- *High losses* – Median charge-offs in the Micro-Ticket segment averaged 2.0 percent, significantly higher than for Small- (0.6 percent), Middle- (0.2 percent), and Large-Ticket (no losses). The segment's high loss rate is a key reason for its pricing
- *High volume, low touch* – More than any other segment, Micro-Ticket is a scale business requiring a highly automated, factory-like approach. The most significant barrier to entry in this space is the required investment in an end-to-end technology platform that allows the player to transact a large number of transaction with little human intervention without compromising portfolio quality
- *Point-of-sale origination* – The transaction volume required for success renders direct sales ineffective. Players in this space typically operate with a vendor, captive, or, in some cases, third-party/broker origination model. The technology required to deliver an effective vendor interface constitutes an additional barrier to entry to the segment

Despite generating almost half of all new business volume, the Middle-Ticket segment appears to be the least profitable. As shown in Figure 7, the segment delivered a median Return on Equity of just 8.7 percent on a leverage ratio of 7.4:1. While losses are very low, median Pre-Tax Yield averages just 2.64 percent, 156bps less than Small-Ticket. According to industry insiders, intense competition in the segment was the primary reason for the low returns. However, as discussed above, virtually all the executives interviewed stated that pricing and spreads for Middle-Ticket transactions have increased over the past six-months. Characteristics of the segment include:

- *Few barriers to entry* – Except for the critical element of funding and hiring experienced salespeople, there are few barriers to entry to the Middle-Ticket segment. Little investment is required in technology and, until mid-2007, players had ready access to funding through multiple channels; of course, that is no longer the case
- *Commodity pricing and low yields* – As a result of the low entry barriers as well as the large volume of available new business, the Middle-Ticket segment attracts many competitors. Given most players inability to differentiate themselves, price becomes the competitive weapon, driving

Figure 8

Opportunities and Challenges
By Market Segment

	Micro-Ticket	Small-Ticket	Middle-Ticket	Large-Ticket
Pros/ Opportunities	• Premium pricing • High profitability • Low origination cost	• High pricing/margins • Better than average profitability • Point-of-sale origination • Lower losses	• Large and growing volume • Fewer competitors likely • Low losses	• Growing volume • Fewer competitors likely • Relationship versus transaction focused • High barriers to entry
Cons/ Challenges	• High losses • Large technology investment • High volume requirements • Cash is primary competitor	• Large technology investment • High volume requirements	• Low entry barriers • High leverage/interest expense • Relatively high origination costs • Commodity pricing/low margins	• High cost to originate • Very capital intense • Requires high degree of equipment and structuring expertise • Commodity pricing/low margins
2008-2009 Outlook	↑ Good • Pricing/margins will continue to increase • Desire to conserve cash increases demand for financing • However, managing losses is critical	↑ Good • Pricing/margins will continue to increase • Desire to conserve cash increases demand for financing • However, losses will likely increase	↔ Mixed • Fewer competitors and increasing pricing/ margins • Current environment requires deleveraging • Volume likely to decline overall, but increase for players with capital	↔ Mixed • Fewer competitors and increasing pricing/ margins • Increasing appreciation and reward for deal structuring • Volume likely to decline overall, but increase for players with capital

down both yields and spreads

• *Highly leveraged* – As noted above, the segment is highly leveraged at 7.4:1, resulting in interest expense totaling over 51 percent of adjusted revenue versus less than 37 percent for both Large- and Small-Ticket and less than 20 percent for Micro-Ticket (Table 14b of the SEFA). If interest rates continue to increase, segment profitability will continue to be eroded

• *Asset intensive* – Depreciation for Operating Leases for the Middle-Ticket segment totals nearly 34 percent of total adjusted revenue, triple that of both Large- and Small-Ticket and ten times that of the Micro segment (Table 14b of the SEFA). The high level of depreciation indicates that equipment finance providers operating in this segment retain ownership of more lease assets, requiring greater expertise in both residual valuation and asset management

Over the next 12-18 months, the outlook for both the Micro- and Small-Ticket segments is optimistic as companies work to conserve cash. Pricing and margins should continue to increase, outpacing losses. Players in these segments will need to tighten their collections and portfolio management efforts and more aggressively price for risk in order to continue to succeed.

The 12-18 month outlook for the Middle- and Large-Ticket segments is mixed. We see pricing and spreads increasing as competition decreases due to funding constraints. Overall, new business volume for the two segments will likely decline. However, because there are fewer competitors and a greater demand for financing, those players with access to capital will see increasing volume.

Profitability by Business Model

As Figure 9 illustrates, overall, the Vendor model outperformed other business models across a range of metrics, including median Return on Assets, median Pre-Tax Yield and Spread, and median Return on Equity when adjusted for leverage. In 2007, players operating with a Vendor model generated 12.7 percent of total new business volume, a decline of over eight percent from the prior year (Figure 9). One issue for players operating with this business model appears to be the extremely high cost of building and maintaining vendor relationships. As Table 14d of the SEFA shows, Sales, General, and Administrative expense totaled over 56 percent of total adjusted revenue, nearly triple that of the other business models.

Figure 9

Yield and Profitability Comparison
By Business Model*
2007

	Direct	Vendor	Third-Party	Mixed
Net Income (% of revenue)	25.0%	9.6%	23.2%	20.3%
Median ROE	9.6%	14.0%	14.9%	11.7%
Median ROA	1.1%	1.8%	1.4%	1.1%
Median Leverage	5.9 : 1	5.3 : 1	8.2 : 1	8.8 : 1
Median Charge-offs	0.1%	1.0%	1.9%	0.8%
Median Pre-Tax Yield	8.24%	10.08%	9.72%	8.31%
Median Cost of Funds	5.19%	5.82%	6.10%	5.18%
Median Pre-Tax Spread	2.76%	4.54%	3.04%	3.22%
Percentage of New Business Volume	45.1%	12.7%	3.9%	38.3%
Percent Change in New Business Volume (2006-2007)	10.0%	-8.1%	54.6%	-2.4%

*Does not include Captives

Source: 2008 Survey of Equipment Finance Activity

In 2007, the Direct model was the least profitable based on median Returns on Equity and Assets as well as in terms of median Pre-Tax Yield and Spread. However, players operating with this business model generated the highest Net Income as a Percent of Revenue and also experienced the fewest losses, potentially an indication of the value of face-to-face customer contact. Players operating with the Direct model generated over 45 percent of all new business volume, an increase of ten percent over 2006.

While comprising only 3.9 percent of new business volume, equipment finance providers operating with a Third-Party origination model experienced a nearly 55 percent increase in volume versus 2006. The significant increase in volume was likely the result of an increased availability of quality transactions at favorable pricing from distressed players selling in order to raise capital. This business model

Figure 10

Opportunities and Challenges By Business Model*

	Direct	Vendor	Third-Party	Mixed
Pros/ Opportunities	• Low loss rate • Large and increasing volume • Lower SG&A expense • Lower cost of funds	• Premium pricing • High margins • High profitability • Low leverage	• High yields • High profitability • Low origination cost • Increasing availability of deals for sale	• Low cost of funds • Relatively low losses • Diversified origination
Cons/ Challenges	• Commodity pricing • Low margins • Low profitability	• Relatively high loss rate • Very high SG&A expense	• High cost of funds • High loss rate • High leverage leading to increased debt service	• Mediocre profitability • High leverage leading to increased debt service • Appears to capture the "worst of each model"
2008-2009 Outlook	↔ Mixed • Increasing pricing and margins • Decreasing competition • Increasing losses, but remaining lower than other models • Declining total volume, but increased volume for players with capital	↑ Good • Increasing pricing and margins • Greater demand for financing, despite lower overall volume • Declining credit quality and increasing losses • Increasing pressure from vendors to increase approval rates	↑ Good • Increasing availability of quality deals to purchase • Increased pricing power for players with capital • Increased ability to demand protection from losses on purchased deals	↔ Mixed • Continued low cost of funds • Continued low loss rate • Continued mediocre performance as players fail to capture the "best" of each model

*Not including Captives

generated the highest median Return on Equity, the result of operating with an 8.2:1 leverage ratio (Figure 9). As expected, players operating with this business model experienced the highest loss rate with median charge-offs at 1.9 percent.

Players operating with a Mixed origination model appear to highlight many of the least attractive attributes of each model. As Figure 9 indicates, median Return on Equity is mediocre despite the highest leverage of any business model. Similarly, median Return on Assets is low as is median Pre-Tax yield. Two areas of relative advantage for this business model include a relatively low loss rate and low cost of funds. Players operating under this model generated 38.3 percent of new business volume in 2007, a decline of 2.4 percent over the previous year.

Over the next 12-18 months, we anticipate mixed results for players operating with both the Direct and Mixed origination models. Equipment finance providers operating with the Direct model will benefit from increasing pricing and margins as well as reduced competition. However, losses will increase and, while pricing and margins do increase, they remain below other models. In FIC's view, players operating with a Mixed origination model appear to capture the worst attributes of each model, resulting in mediocre performance. Unless players become better able to leverage the advantages offered by each origination model, lackluster performance will continue.

Over the same period, however, we have a positive outlook for players operating with Vendor and Third-Party origination models. Those operating with a Vendor model will see increasing spreads and greater demand for equipment financing. Negatives for this group include increasing delinquencies and increasing pressure from their vendor partners to approve a greater percentage of deals in order to help them move equipment. Players operating with a Third-Party origination model will have opportunities to benefit from the current market environment. Players with access to funding will find an increasing availability of quality deals. In addition, these players will increasingly be able to dictate pricing terms and loss guarantees.

Concluding Thoughts

Throughout this Report, FIC has discussed the current challenges faced by the equipment leasing and finance industry resulting from the extraordinary combination of macroeconomic events. In addition, the Report also highlighted the opportunities that some players have to capitalize on these events to rethink and refocus their efforts, build sustainable market share, and increase their overall profitability.

Some players will either exit the market or succumb to consolidation due to a lack of access to funding or funding at a reasonable cost. Others will manage to survive, emerging from the current downturn alive but weak.

A handful of leaders will possess the managerial strength of character to assess their capabilities and leverage their strengths to take advantage of the opportunities available in today's market. These organizations, if they are able to execute successfully, will have the ability to take significant market share from their weaker competitors and to emerge as the new leaders, able to change the way the industry does business going forward. As one executive commented, "Our industry will emerge from this period a bit smaller in number but much stronger in fundamentals."

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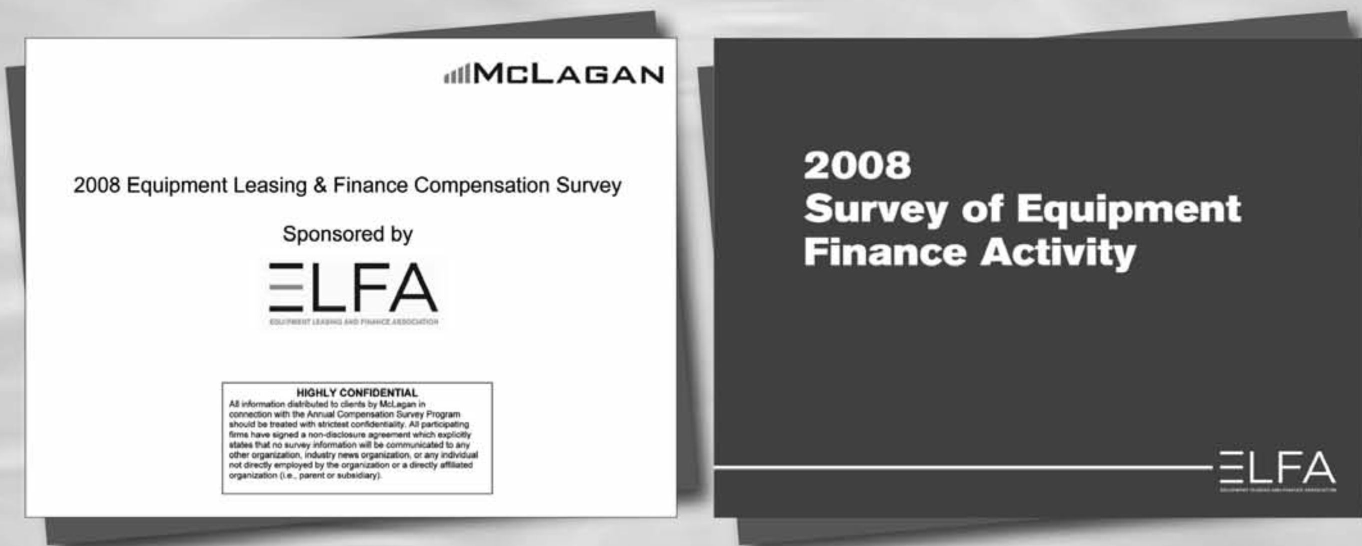

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