Industry Future Council Report

2009

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

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The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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FOREWORD

Now in its 28th year, the Industry Future Council (IFC) is hosted annually by the Equipment Leasing & Finance Foundation. Bringing together leaders from some of the most active companies within the equipment finance industry, the IFC meets to examine and deliberate on trends, challenges and opportunities impacting the equipment finance industry.

The key to a successful IFC meeting, and its published Report, is a dynamic mix of "thought leaders" who challenge the group to think strategically – to focus on what could be in store for the industry and to develop a framework from which readers can apply the Council's analysis to their own businesses. Because the Industry Future Council Report is relied upon by so many different constituencies, it is critical that it reflect the input and analysis of a broad representation from the industry.

Preparing for this year's IFC, in addition to the usual package of financial, industry, legislative and economic reports that serve as the advance-reading materials, the 2009 Council participants were asked to review the book *The Black Swan: The Impact of the Highly Improbable*, by author Nassim Nicholas Taleb. The premise of *The Black Swan* is that events are, in retrospect, "predictable" based on the signposts, indicators, and signals that we recognize after the fact, but have difficulty recognizing in real time. If we were able to connect the dots beforehand, we would recognize these indicators and react accordingly. The people of England had only seen white swans, and therefore assumed all swans were white. When explorers discovered black swans in distant lands, it became evident that presumptions were based on what had been seen, not on the possibilities of what might exist. In similar fashion, the IFC set about trying to identify the signposts, the indicators that three years from now, we will look back upon and say "Aha! The signals were there, we just didn't recognize them".

Had anyone known for certain one year ago that the credit and equity markets would act as they did during the final half of 2008, they would have taken certain actions to position appropriately. Similarly, if, today, anyone knew for certain that we would be heading into an inflationary spiral, or into three years of continuing recession, or into a global credit meltdown, they would logically position appropriately. The 2009 IFC attempted to identify those indicators that – if watched carefully – would provide the signals about which direction forces will act, for how long, and to what end. The success of the Council's efforts will only be known in the future, as reasoned speculation cannot be mistaken for accurate prediction. The result of the 30 senior executives' deliberations over two days was, instead, an outline of questions that might provide a working framework for strategic planning in a very uncertain future.

Economic Cycle or Reset?

The group noted that things have changed dramatically from just a year ago. As 2008 began, short-term concerns, driven by liquidity challenges, were buoyed by long-term optimism. While there was a perceived "crisis of confidence" within the industry, IFC participants last year were comforted by the equipment financing industry's historical resiliency and ability to adjust during cyclical periods. As the year unfolded, however, these feeling were quickly replaced by genuine disbelief as the nation's economy faltered, credit markets collapsed and equipment replacement cycles slowed to a crawl.

This year, the first question the Council addressed was whether we are somewhere in an economic cycle, or whether we are experiencing a paradigm shift – a "reset" to a new reality. General consensus was that this is not a cycle – that we cannot expect to return to conditions that existed before the current "crisis" – and that we may never again see the level of highly-structured transactions and leverage that characterized the market before this correction. Everybody saw the signposts: mortgage offerings for 110% of appraised value, no-verification loans, prolific securitization of risk instruments, and free-flowing credit generally. But day-to-day pressures for volume of new business, for deployment of capital, for market share, or for achievement of the countless business measurements typical of boom-time economies caused many to prioritize differently, to chase the market, and to soften critical judgment to achieve "growth". Competitive pressures drew many into the fray. Meanwhile, regulatory and restrictive requirements for mark-to-market accounting, capital adequacy, and counterparty obligations were trip-wires which, when crossed, left no possibility for safety holds – sending institutions overnight into financial oblivion. Now the federal government is in the process of spending trillions of dollars to support and bolster a "recovery", creating a playing field that is unfamiliar at best, and treacherous at worst for those who must navigate to the new reality.

> **"The drying up of capital changes everything, from business volumes being sought, spreads expected, the number and types of people needed, composition of companies and other core aspects of the equipment leasing and finance business."**

Another executive summed up the situation succinctly, "We exist in a market of capital restraint, with precious few resources available."

The history of the equipment leasing and financing industry has seen cycles where availability of funding was the great divide between the "haves" and the "have-nots". In the 1980's only the well-funded banks, independents and captives were positioned to build portfolios. The 1990's saw securitization become the "great equalizer", providing capital availability to a much broader pool of lessors and financers, essentially leveling the playing field. Capital availability was no longer a differentiator. Recent events, however, led the IFC to speculate that the future may look more like the 1980's, where those with capital will enjoy a market driven by the supply-side. Already, spreads and terms have become more lessor/lender-favorable, as the market shifts from demand-driven conditions to supply-driven conditions. Those with available capital may see opportunities to deploy that capital more profitably, and on more attractive terms than any time in recent history, signaling a return to the conditions prior to the securitization heyday that began in the 1990's.

Now What?

Together with wider spreads and better terms, funding sources will likely enjoy an ability to tighten underwriting standards, perhaps signaling a stronger preference for the lower-risk end of the credit spectrum that will leave higher credit risk customers bereft of funding opportunities. Consequently, portfolio quality and risk/return ratios can be expected to improve in the near term for those funding new business. The products being offered in the market will likely reflect the supply-side influence, and fair-market-value leases will likely increase, while highly-structured transactions that depend on tax or accounting complexity will probably disappear.

Who Will Survive?

This unprecedented era presents many unique obstacles and opportunities for the industry. Given the liquidity crisis and recessionary forces at work, the IFC members concurred the ultimate key to survival in the current environment focuses on a company's ability to secure adequate funding. Accomplishing this rests in part on an organization's position within the equipment leasing and finance space.

> **"The future is all about how you're going to fund yourself."**

The IFC identified three primary categories of players which would be likely to emerge from this correction:

1) Banks and deposit-gathering entities, especially those who enjoy FDIC or other government backing of their deposits,

2) Well-funded and diversified conglomerates, whose financing activities represent a relatively small component of overall earnings, and

3) Captives, whose parents recognize the need to provide financing to their customers to support the sale of product or services.

While others will continue to be present in the market, limited sources of funding will likely show the dominant influence of the three categories cited above. The influence of the funding sources on the products offered in the market will likely mean more simplified or homogenous products, and the opinion of the IFC is that this will further dampen or reduce the differentiation between leases and loans. The IFC discussed the likelihood that deposits, down-payments, covenants, and other features of loan-like products may find their way into the lease-like products, fueled by the supply-driven market conditions and a tendency to create consistency of offerings.

"We used to think of our industry as countercyclical, but we may not think of ourselves in this way anymore" said a seasoned bank lessor. "When banks struggled and exited the market, lessors came in to fill the void. Now the largest companies are de-leveraging and there's been a dramatic change among the significant players. If we're looking to the future, it may not be about growth but instead about funding."

Smaller finance providers may come out of the economic crisis faster than larger companies. "If you weren't heavily involved in leveraging like some of the larger players in our industry, you may be very cautious now but you still have resources," said a bank executive. "The people that have the problem now are the very large institutions that were into a lot of securitizations." These also tend to be the same ones facing greater scrutiny and may have tarnished reputations. "Some of the big names in finance don't have the luster they once had", he added.

New Entrants

Discussing the conditions and the characteristics of likely new entrants to the leasing and financing marketplace, the IFC generally concluded that private equity and hedge funds, which had until last year been considered the most likely new entrants, would be less likely to move into the market in the near term. Sovereign funds and non-US banking institutions were cited as likely new participants as yields improve and competition lessens in the market.

"What companies finance, how they finance it, what are the new sources of capital….it was only a few years ago we were all talking about private equity as the next great source of funding. Now the US is becoming its own sovereign fund, investing in institutions and providing underpinning for industries in trouble," said an exasperated participant.

The Council discussed at length the appeal of the industry to young or transferring professionals, agreeing that there are fewer differentiating characteristics than has been the case historically. While the lure of investment banking has been diminished in the last six months, and while that sector has historically been a competitive pull for new human resources, a general sense that slow growth will probably characterize the industry in the near future suggests that it will continue to be difficult to attract new talent. Smaller companies, fewer players, flattened organizational structures, and tighter budgets now characterize the landscape, whereas the unregulated, frontier-like environment of creative deal-making attracted many of the now-aging practitioners. The search for talent and the need for creative, driven individuals to maintain the industry's vitality was the topic of serious discussion by the IFC.

What Does The Future Hold?

A back-to-basics approach would be a logical means to achieve transparency requirements of regulators. "Commoditized offerings from a structural perspective will be most popular. Providers, however, will be expected to maintain flexibility in regard to terms and conditions, as well as customer service," a vendor finance executive noted. That could be the differentiator in a struggling market. An unprecedented era is being ushered in, with many familiar business practices, such as securitization, highly structured transactions and high leverage, no longer viable. "These changes are affecting how business fundamentally gets done, altering the landscape for virtually everyone in the industry," commented one captive lessor.

The IFC agreed, growth in financing opportunities will eventually return because the fundamental demand for business assets is at the core of economic growth. However, there is concern that even after the economy improves the overwhelming desire to preserve cash and limit spending will remain for years. "Buying habits have been transformed and 70 percent of the economy is driven by the consumer", said a vendor finance executive.

Improved pricing is expected for at least the next couple of years. Finance companies are looking for opportunities to bundle profit-generating services and fees into more lease agreements. "Funders with expertise in very specific asset classes," one member suggested, "may find opportunity for some residual upside."

While the group acknowledged many sectors of the industry are struggling, most notably aircraft, transportation and construction, there are some promising spots. One participant noted the demographic shift with a population that is aging and the corresponding increase in demand for services provided by the nation's healthcare system. This could indicate greater demand for both basic and specialized medical equipment, particularly in the imaging sector. Another participant noted that there are other promising markets for equipment financing, but they may take time to develop. These include renewable energy and commoditized intellectual property.

What are the Indicators of a Turnaround?

So what are the indicators – the signposts to watch as companies plan for short, medium and long-term positioning in the market?

The first and most important indicator of future direction appears to be a **return to "normalcy"** by banks playing their traditional role in the chain of commerce. Curtailed lines of credit, bank letters of credit that support import/export business, and other commercial loans that fuel the conduct of commerce among companies has stifled "normal" business. If this continues, the likely trend will be toward restricted growth, increased business failures, and protracted economic malaise. If this begins to show signs of "recovery", companies can resume more normal trade and commerce, spurring economic recovery. Seeing financial institutions "pay back" TARP and other government support will be a strong positive indicator.

Job creation – not unemployment figures (which tend to reflect pockets of geographic or industry distress) - but actual increase in job creation will indicate a coming recovery. Several members of the IFC noted that recent equipment sales in the secondary market included machine tools. Sales of machine tools indicate that the sellers have resigned themselves to the assumption that demand may never return thus keeping capacity is no longer cost effective. When this trend reverses, it will indicate that manufacturers believe demand will return (even if not immediately) and will be an optimistic indicator about the future.

An **increase in transportation equipment** (such as railcars) will signal more anticipated movement of commodities and raw materials, which quickly translates to more finished products moving to market.

A **return of venture capital (VC) to the market** will indicate broader expectations of recapitalization opportunities, or "exit strategies" that rely on infusion of new capital. Until VC's see the opportunity to recoup initial investment, the signals indicate sustained market depression.

An **increase in merger and acquisition activity** will signal companies' belief that it is time to pursue growth opportunities, which then leads to additional equipment acquisitions, and investments in plant and materials.

How to Prepare for the Future

It is an undisputable fact that change is taking place faster than ever in the industry, driven by an improbable but very real credit crisis. The shape of the industry is changing, and it is unlikely we will return to the status quo of recent years. A paradigm shift in how companies operate and do business is underway. Daunting business challenges lay before us, with little historical reference for how to respond. To survive, a new mindset must be adapted by virtually everyone, as the industry rapidly consolidates, new players emerge and opportunities materialize.

Given this reality, the IFC suggested these elements should be integrated into a company's business strategy this year:

- A refocus on core competencies
- Back-to-basics risk management and underwriting
- A careful evaluation of business relationships
- Development of new solutions to increase financing returns

- A fresh look at how leasing and financing fits into the parent company's operations
- New partnerships to expand resources

As one long-time industry executive said, "We're living in a world where there's a new standard. Capital is only deployed in terms of what the real risk-adjusted return will be." Another added even more forcefully, "Funds will only be available to those who can prove they understand risk and can demonstrate the ability to pay it back at an acceptable rate of return." To mitigate this risk, one IFC member said he expects to see more sharing and partnerships emerge among industry players. "Deals will most likely represent a diversity of funding sources," he said.

A prudent strategy during these times will be to emphasize frequent and creative dialogue with both customers and suppliers who are also trying to navigate uncharted conditions. Nothing can be taken for granted. "We need to challenge ourselves to think not about what we used to do, but what we could do in a new reality," said an industry veteran.

Do you see the signals?

How To Prosper?

The questions which managers of companies should be asking themselves, their customers, suppliers, employees, and others should focus on the following indicators, which may help identify the continuing need for caution, or the potential for opportunistic expansion:

- What are my funding sources? How reliable are they? What could change? Where would I go to pursue alternative sources?
- What is my competitive advantage? Is it sustainable? Who are the competitors today? Who are the potential new competitors?
- What are my return objectives? Is this an opportunity to increase price, or improve terms? What is the value of customer loyalty? How elastic is the market regarding pricing? How far should I push?
- Where do I look for new people resources? What are the career opportunities I can offer? Do I offer training or look for already-trained resources? How flexible and interchangeable are the resources?
- What equipment types are best suited to today's opportunities? Can I/should I take real residual risk? Can I manage re-deployment or re-marketing of assets as a value-add component of my offering?
- What is the flexibility of my business planning? If current conditions prolong themselves, can I survive? If things begin to change, can I react quickly to exploit the opportunities?
- What would be the impact on my business if the value of the dollar changes in the global markets? How would I change the way I do business if the US position in the global economy changes?
- Am I taking full advantage of the shift from demand-driven market conditions to supply-driven?
- When I saw the signposts in the past why didn't I act upon them? Based on that learning, how do I change going forward?
- How do I become a true partner with my funding source? "Partnership" meaning a true reciprocal relationship with mutual understanding.
- Am I woven into the fabric of my parent company? If not why do I exist? Is the existence sustainable if the parent's direction changes?
- Does the size of the lender / lessor matter in this new world or is availability of liquidity the new measure?
- Will the industry ever return to the 2007 levels of employment? Should it?
- Is the equipment leasing and finance industry relevant in this new world to it's shareholder (Bank's, Manufacturer's, etc.)? Are we a good use of capital in a world of limited capital?

The Industry Future Council hopes readers of this report, and their firms, will use the questions posed within to prepare for the future and recognize the signals of change.

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The Equipment Leasing & Finance Foundation, established in 1989 by the Equipment Leasing Association, is dedicated to providing future-oriented, in-depth, independent research about and for the equipment finance industry. Information involving the markets, the future of the industry and the methods of successful organizations are researched to provide studies that include invaluable information for developing strategic direction within your organization.

Your Eye on the Future

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