State of the EQUIPMENT FINANCE INDUSTRY 2010

EQUIPMENT LEASING & FINANCE FOUNDATION
Your Eye On The Future

COVER 2

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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PREFACE

The Equipment Leasing & Finance Foundation (the Foundation) selected Financial Institutions Consulting, Inc. (FIC) to prepare its 2010 State of the Industry Report. The Foundation's mission includes evaluating industry trends and their potential impact on the equipment finance industry.

FIC, a management consulting firm that focuses on developing practical, fact-based strategic solutions for its clients, centers its work on issues related to improving performance, whether related to risk management, growth, and/or productivity. It possesses extensive experience with equipment finance clients and has also assisted financial institutions in the U.S. and overseas on issues related to their small business, middle market, and wealth management segments.

FIC's methodology for this analysis incorporates statistical data, past client experience, and in-depth one-on-one interviews. The ELFA 2010 Survey of Equipment Finance Activity (SEFA) reflects fiscal year-end 2009 performance. Year-end data has been supplemented by and updated with monthly 2010 data collected as part of the ELFA's Monthly Leasing and Finance Index (MLFI).

Interviewees

Given the difficult environment of the past 24 months, both FIC and the Foundation thought it was particularly important to interview industry leaders in order to go beyond the reported numbers to more fully understand how current conditions affect equipment financing today and in the future. Therefore, in addition to presenting data from SEFA and MLFI, this report includes the insights and perspectives of industry executives, analysts, and observers. FIC conducted in-depth interviews with over 20 senior managers, representing a cross-section of company types, ticket sizes, sales channels, and functions. These interviews focused on obtaining their qualitative assessment of current market conditions and their perspectives on implications for the industry. The executives sharing their insights included:

Kent M. Adams - President, Caterpillar Financial Services Corporation
Ron G. Arrington - Global President, CIT Vendor Finance
Robert L. Boyer - President, Susquehanna Commercial Finance, Inc.
Edward Castagna - President, Nassau Asset Management
Kenneth R. Collins, Jr. – Chairman & CEO, Susquehanna Commercial Finance, Inc.
Edward A. Dahlka, Jr. - President, Assurance Asset Finance, LLC
Tony Golobic - Chairman & CEO, GreatAmerica Leasing Corporation
Eric Gross - Director of Managed Services, Bank of the West
Terry R. Hutchens - President, TCP Leasing, Inc.
Joseph C. Lane - Vice Chairman, Sinter Capital
Daniel C. McCabe - Senior Vice President, Sales & Marketing, John Deere Credit
James McGrane – President & CEO, EverBank Commercial Finance, Inc
John M. McQueen - President, Wells Fargo Equipment Finance, Inc.
Paul J. Menzel, CLP - President and CEO, Financial Pacific Leasing, Inc.
Deborah J. Monosson - President & CEO, Boston Financial & Equity Group
Allen Qualey - President, 1st Source Bank Specialty Finance Group
Walter Rabin – Senior Vice President Commercial Lending, Capital One Bank
Rick Remiker - President, Huntington Equipment Finance
Kenneth A. Turner - President & CEO, SunTrust Equipment Finance & Leasing Corp.
Vincent D. Rinaldi - CEO, PNC Equipment Finance, LLC
Jud Snyder - President, M&I Equipment Finance
William H. Verhelle - Chief Executive Officer, First American Equipment Finance, Inc.
Adam D. Warner - President, Key Equipment Finance

These interviews provided FIC with a unique tutorial on the critical issues that top industry management is facing today. All of these individuals were generous with their time and provided invaluable insights into this unique market environment, providing perspectives on the opportunities and challenges facing the equipment finance industry. Throughout the report, we provide direct quotations from our interviews; however, to preserve confidentiality, we present all quotes on an anonymous basis.

Definitions

The organizations analyzed in this report fall into three categories: Banks, Captives, and Independent Financial Services companies:

Banks - Often combine leasing and equipment finance 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 are either integrated with the traditional commercial 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 must consist of products produced by its parent and/or affiliates. Captives may also finance other companies' products.

Independent Financial Services Companies - Usually these are finance companies, offering loans and leases directly to businesses. They are unaffiliated with any specific manufacturer or dealer.

SEFA also includes analyses of 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). In addition, SEFA provides data by business model, defined as the channel through which the respondent generated at least 60 percent of its business. The business models covered are: Direct, Vendor or Captive, Third-Party, and "Mixed". Companies 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. Because of their focus, Captives are excluded from the analyses of business models.

Study Purpose

This report has a two-fold purpose: to analyze and interpret the performance of the industry based on responses to the Equipment Leasing and Finance Association's (ELFA) 2010 Survey of Equipment Finance Activity (SEFA) and, second, discuss the current state of and future implications for the industry by assessing SEFA and other economic information.

The report begins with an overview of the equipment finance industry and an analysis of the key factors impacting industry performance today and in the future.

Following the industry overview, we analyze the ELFA 2010 Survey of Equipment Finance Activity (SEFA). Our analysis highlights a number of important areas, including new business origination, profitability and funding, and credit quality. *The analysis also cites specific Tables within the SEFA; the full 2010 SEFA report is available directly from the ELFA at www.elfaonline.org.*

As strategy consultants to the leaders in the financial services industry, we also provide our perspective on how the critical issues identified will impact the equipment finance industry. Where appropriate, we also include our view concerning what providers of equipment finance can do today to take advantage of market opportunities.

Charles B. Wendel, President
Financial Institutions Consulting, Inc.

EXECUTIVE SUMMARY

The equipment finance industry in 2009 experienced, compared to 2008, reduced new volume originated and lower returns, reflecting the overall downturn in the economy. Both Return on Equity (ROE) and Return on Assets (ROA) also showed significant declines while charge-offs more than doubled from the prior year.

However, since 2009 year end the market appears to have stabilized and formed a base for future growth. While many industry experts believe that growth rates will be constrained between now and late 2011 or early 2012, most also believe that the worst is over. Our interviews and related analysis suggest that the downturn of the last 12-24 months is highly unlikely to be repeated over the next few years. One reason is that executives from the equipment finance industry state that they have examined and changed their business model. Many have reduced their cost base, dropped marginal activities, and strengthened their risk management procedures. The best managers have taken the steps required to avoid or minimize further declines in volume or quality.

The key themes that emerge from our analysis indicate that, for the next one to two years, the industry may have to manage through a slower growth environment that several interviewees referred to as the industry's "new normal." By that term our interviewees are describing a business environment in which portfolio management is given precedence over growth, risk management activities receive increased focus, and business strategies and internal operating approaches are under constant review.

The key themes resulting from our interviews and analyses include:

- *While continued market uncertainty may be the norm for the foreseeable future, the industry is now stable and moving forward.* A high level of uncertainty exists, with some players suggesting operating in an uncertain environment may remain until mid-2011 or beyond. Despite this uncertainty, industry experts believe the bottom has been reached and expect improved performance; many note that their charge-off rates are less than half what they were at the depth of the downturn. This view is further supported by MLFI results, discussed in our analysis of industry trends.

- *Confidence about the equipment finance industry is increasing.* Industry leaders, whether part of a Bank, Captive, or Independent equipment finance company, express confidence (sometimes described in interviews as "guarded" and sometimes as "strong") concerning the long-term role and viability of their industry in the critical function of capital formation. Most believe the industry will become increasingly important as the economy improves.

- *Segmentation and selectivity drive company strategies.* Many companies have used the recent downturn as an opportunity to examine their strategy, organization, and staffing and have emerged from these reviews both more productive and more targeted in focus. Doing more with less has become a standard management expectation.

- *Growth opportunities exist for some Banks.* As expected, Banks have benefited from the funding advantage that results from their parent's access to lower cost deposits; increasingly, they have managed to link their equipment finance efforts with the broader offerings of their parent commercial bank. In several cases that parent now wishes to grow book earning asset volume in leases as well as loans and is looking to its equipment finance group to provide a level of growth and returns currently unavailable from traditional bank activities.

  While some leaders of bank-owned lessors predict an increased role for their equipment finance groups, recent volume numbers suggest that the overall industry's focus on growing this business is less certain. For example, 2Q10 MLFI Quarterly Review data shows a decline of 32 percent in bank volume from two years ago. Funding and marketing strengths provide bank-owned companies with a potential sales advantage that only some Banks may try to take advantage of.

- *Well-managed Independents will continue to succeed.* As a group, the Independents experienced a very difficult 2009, largely driven by funding issues and portfolio performance. However, targeted and well-run Independents can expect not only to survive but to thrive in future years, as they continue to execute their disciplined strategies.

- *Some banks are rethinking the approach to small ticket financing.* A number of companies suffered significantly from their exposure to micro and small ticket transactions. While specialists in these segments appear to remain committed to this area, other companies are rethinking and limiting their small ticket activities. In particular, we expect a number of Banks to reduce their small ticket activities and, instead, to increase their focus on the mid-sized transactions.

- *Accounting and regulation will likely have a significant impact.* Accounting changes and regulatory oversight represent two of the largest uncertainties executives need to assess. Clarity around these areas may not occur until mid-2011 or beyond. Significant diversity of opinion exists within the industry concerning the impact of these changes both on the industry as a whole and on individual companies. These areas will receive a high level of focus over the next year.

- *Many observers expect 2010 and 2011 to be years of limited growth.* As noted above, the good news is that the worst appears to be over. Nonetheless, few industry sources expect robust growth anytime soon. Those that do tie that growth to the asset-growth objectives of their Bank or industrial owner as opposed to a positive macro-environment and will focus on taking share from others.

Overview of the Equipment Leasing and Finance Industry

Thomas Friedman, the Pulitzer Prize winning New York Times columnist and author of the bestseller *The World is Flat,* recently described his view of the current economic environment as follows: "It's like this: Things are getting better, except where they aren't. The bailouts are working, except where they're not. Things will slowly get better, unless they slowly get worse. We should know soon, unless we don't."

Fortunately, our interviews and analyses indicate that while the near term remains unclear, the longer term suggests a clearer picture of improved performance for the equipment finance industry. The pace of improvement may be slow and at times unsteady, but, nonetheless, the industry is on a better path than a year ago. As one manager commented, "You need to remember how bad things were a year or more ago."

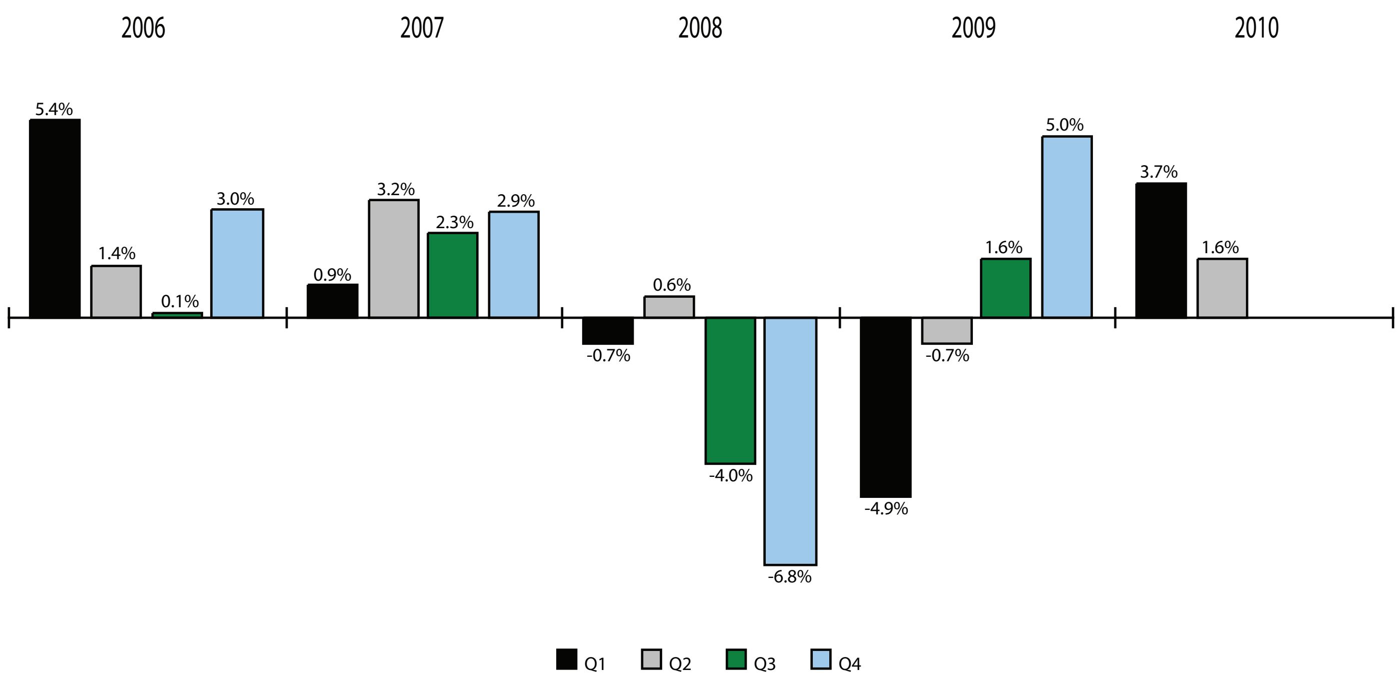
This section discusses the industry's current macro-economic environment and reviews the issues that have been raised by industry executives as being of the greatest concern to them in 2010 and beyond. The chapter following this discussion, "Analysis of Industry Trends - ELFA's 2010 Survey of Equipment Finance Activity," summarizes the results of the most recent annual survey, supplemented by the MLFI monthly updates.

Economic Snapshot Indicates Slow Growth. Four statistics highlight the roadblocks that need to be addressed before a strong recovery occurs and also underscore the lack of clear direction provided by much of the available data.

Low GDP growth. Growth in GDP **(Figure 1)**, while up from the recent past, remains insufficient to allow for sustained economic improvement. From the third quarter of 2008 through the second quarter of 2009, the economy's performance declined. While quarterly GDP has been positive since then, the degree of fluctuation in the numbers has been significant. The 1.6 percent growth level in the second quarter of 2010 (the most recent number available) brings the economy back to the low level of growth generated in the third quarter of 2009, demonstrating the unevenness of the U.S. recovery. Many in the equipment finance industry expect this situation to continue, whereby, at least in the near term, "good" and "bad" numbers alternate from period to period.

Figure 1

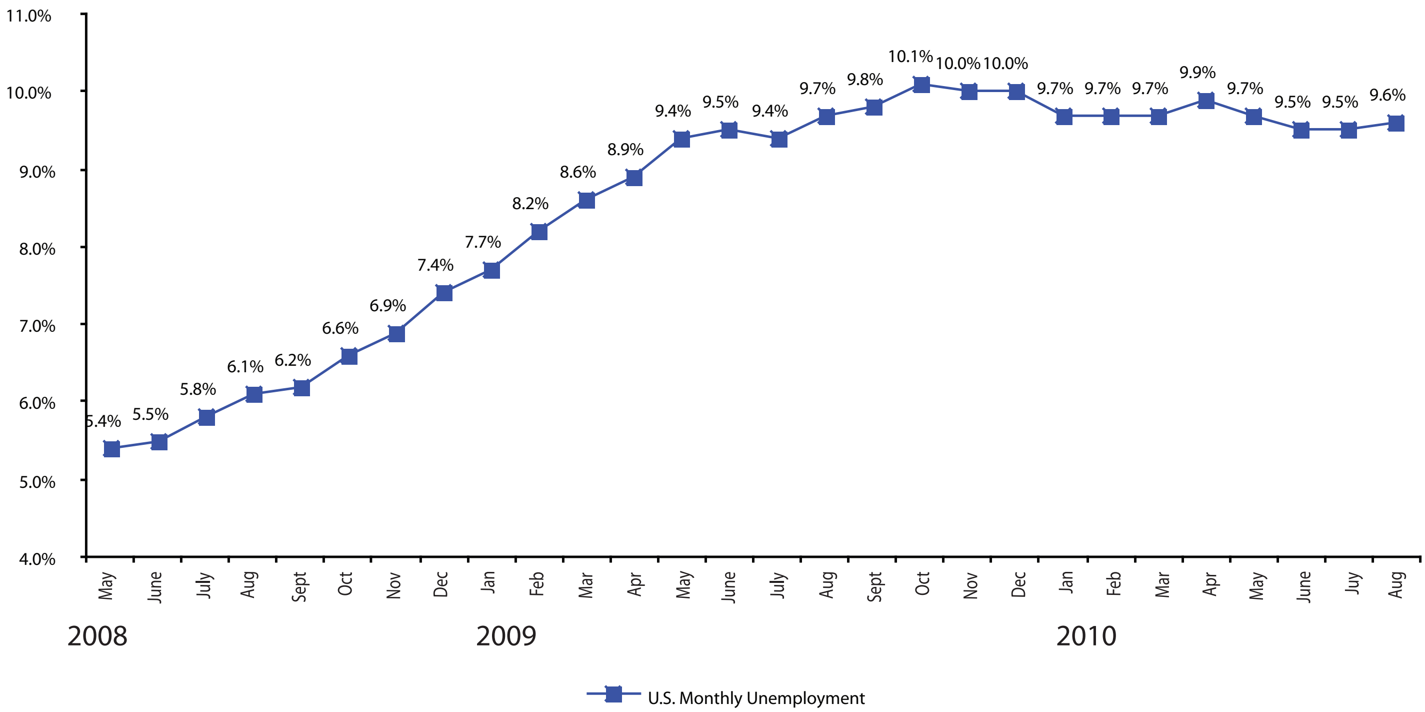
Quarterly Growth in GDP (based on 2005 dollars)



Source: Department of Commerce

Figure 2

U.S. Monthly Unemployment (percent of U.S. workers age 16 and over)



Source: Bureau of Labor Statistics

Stubbornly high unemployment. While disagreements exist concerning the "real" unemployment rate and the extent to which some workers have opted out of the labor market, the numbers provided by the Bureau of Labor Statistics continues to be unsettling **(Figure 2)**. Since May 2009, the unemployment rate has exceeded nine percent and it appears unlikely to return below that number until at least next year. Particularly disturbing is that non-farm payrolls have declined in each of the last three months of available data (through August). Those declines occurred after increases in monthly non-farm payroll from January to May, another example of this economy's failure to establish a consistent trend.

Some business commentators view the increased unemployment numbers as indicating that the economy is slowing down yet again. In the near term, the employment outlook is difficult to decipher with any degree of clarity.

Increased equipment purchases. While GDP is low and unemployment is high, some positive news for the economy also exists. The Commerce Department states that the second quarter increase in equipment purchases increased at a 21.9 percent inflation-adjusted annual rate, up from the first quarter's 20.3 percent increase. Supporting the view that equipment sales are increasing was a statement issued by the North American Equipment Dealers Association: "U.S. companies are increasing purchases of equipment and software at the fastest pace since the late 1990s. Much of the spending involves replacing older equipment after recession-related postponements or to improve efficiency _ not to raise production or boost hiring." Further, a recent report by a Nomura Securities economist points to higher capital spending through 2010 and beyond.

Nevertheless, recent results for the equipment finance industry as well as comments by our interviewees strongly indicate that any rise in capital spending has yet to generate a growth in equipment finance volume. Given strong business liquidity and the hesitancy of many companies to borrow, up to this point many of these purchases may have been made using cash or short-term trade payables.

Reduced commercial borrowing. Despite increased equipment sales, total commercial borrowing (including but not limited to leasing and equipment finance) has been decreasing. Factors impacting this decline include: reliance on company liquidity, the focus of some firms on deleveraging to clean up their balance sheets, the lack of an expansionary mood at many companies, and the reticence of some lenders in the face of increased capital requirements.

We review changes in equipment finance volumes generated by ELFA members in our next chapter. More broadly, it is worth noting that overall commercial and industrial (C&I) bank lending (also a reasonable indicator of equipment finance activity) has shown a consistent decline since 2009. As reported by the Federal Reserve, in 2007, C&I lending grew by 18.3 percent over the prior year; in 2008, the growth rate was 14.3 percent. However, for all of 2009, C&I lending declined by 18.6 percent. The first two quarters of 2010 show further declines of 19.5 percent and 15.2 percent, respectively.

One bright spot is that monthly declines are shrinking from negative 20.8 percent in April to only a negative 3.1 percent in July. Despite this trend, a Goldman Sachs analyst recently predicted that year-over-year loan growth will not turn positive until 2011. Similarly, one leader of an equipment finance group that wishes to grow assets said: “There is just not a lot of demand.”

Economic Uncertainty Continues. A slow and unsteady economy, a sticky unemployment rate, and a slower overall lending environment, all contribute to the sense of many industry players that, while the economy has improved, uncertainty exists concerning when the environment for equipment finance will turn decisively positive. One executive commented: “We are in a holding pattern”, while another stated: “Other than right after 9/11, this is the most volatile time I have seen.”

Beyond the economy discussed above, factors contributing to current uncertainty include:

- *The unknown cost of new taxes and health care regulations.* Several industry leaders mentioned that they knew of companies that were holding off hiring until they more fully understood the cost implications of these changes on both new and current employees.
- *The political environment.* Several managers mentioned that they looked forward to the November elections in the hope that some of the political uncertainties would be resolved.
- *The new accounting rules.* Proposed changes are currently only available in an exposure draft, but at this point significant disagreement exists about the likely impact of these changes on borrowers, lenders, lessees, and lessors.
- *The Dodd/Frank financial regulations bill.* Related to “FinReg,” one business leader mentioned that concerns are increasing about the new consumer protection agency. His fear is that the definition of “consumer” could be broadened to include some part of the commercial world, namely, small businesses.

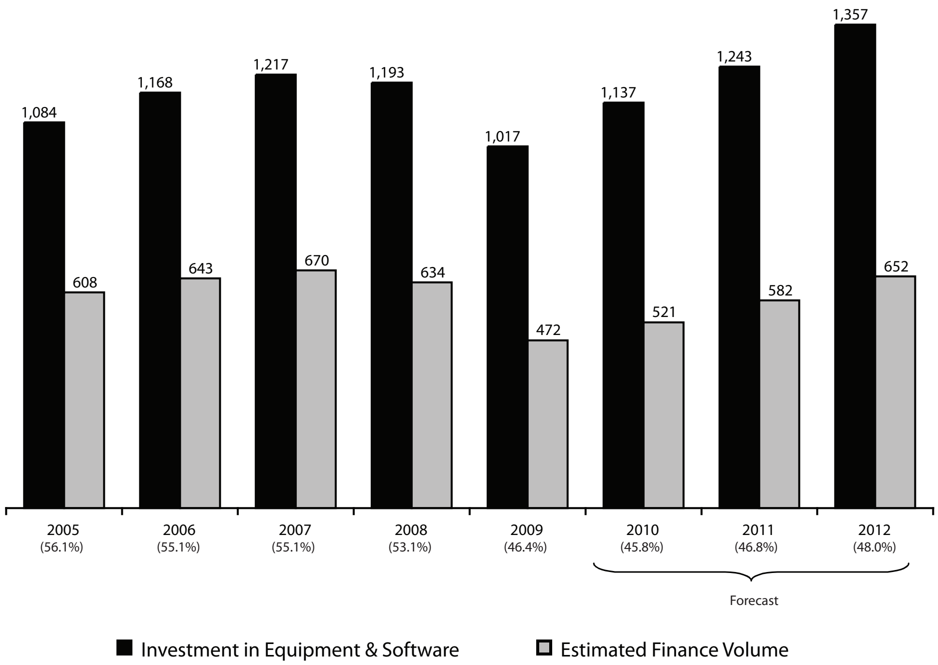
Industry leaders express their desire for greater clarity in the economic picture: “People want certainty” commented more than one interviewee. Nonetheless, many leaders of the equipment finance industry view the near term as likely full of continued uncertainty and indecision. In several cases, leasing executives mentioned that the economy looked more positive in the spring of this year than it does currently. One interviewee commented: “Last year many of us felt that a pick-up would occur in the second half of 2010. Now, we are here, but there is no sign that companies are opening up their purse strings.”

Many industry leaders point to mid or late 2011 rather than late 2010 as the period when they believe uncertainty will be reduced. The reasons cited include: the election cycle will be completed; tax and health care costs should be more fully fleshed out; much of the impact of the new accounting rules and regulatory bill will be clarified.

IHS Global Insight, the forecasting and economic analysis firm, forecasts a return to industry growth beginning in 2010. It recently developed an analysis for the Equipment Leasing & Finance Foundation that quantifies total investment in equipment and software and the related estimated equipment finance volume **(Figure 3)**. Their analysis shows investments from 2008 to 2009 declining by 14.8 percent to $1.1 trillion; equipment finance volume also declined during the same period by 25.5 percent. However, beginning with 2010, the company forecasts growth over the next three years in investments and finance volume; they forecast 2009-2010 investment growth at 11.8 percent and equipment finance growth at 10.4 percent.

IHS Global Insight’s forecast is consistent with what it terms its “control” (baseline) economic forecast that the economy will not slip into a double dip recession. In their words: “With the inventory building and fiscal stimulus boosts waning, the economy will be falling back on whatever underlying strength there is in private final demand, which is very limited as households and businesses remain cautious. Business equipment spending, while still rising at a double digit clip, will finish the year at less than half the second quarter's 24.9% pace. Following the sharp cutbacks in 2008-09, credit conditions are starting to ease -

Figure 3 **Investment in Equipment and Software and Estimated Finance Volume $ Billions (Equipment Finance Volume/Investment %)**



Year over Year Growth

	Equipment & Software Investment	Finance Volume
2005-2006	7.7%	5.8%
2006-2007	4.5%	4.2%
2007-2008	(2.0%)	(5.4%)
2008-2009	(14.8%)	(25.5%)
2009-2010	11.8%	10.4%
2010-2011	9.3%	11.7%
2011-2012	9.2%	12.0%

Source: IHS Global Insights

albeit gradually. Equipment financing (lease, loan, and line of credit) bounces back following a weak 2009 due to improving credit conditions. Despite the rebound, the share of financed equipment remains below a sluggish 2008 as favorable corporate cash flow is allowing some companies to draw on retained earnings to finance equipment."

The numbers in parentheses at the bottom of Figure 3 estimate the percentage of finance volume versus overall equipment investment. For 2009, that percentage was estimated to be 46.4 percent, well down from the 2005 high of 56.1 percent. Over the next few years, IHS forecasts that the percentage of equipment purchases that are financed will increase from less than 46 percent in 2010 to 48 percent in 2012, still below the 2005 peak.

The Industry Believes the Worst Is Over. Indications are increasing that the performance of the equipment finance industry has bottomed out and is improving. As our review of 2009 and the first half of 2010 will show:

- Delinquencies and charge-offs are in decline. In the word of one executive, since 2009, "Most credit issues are behind us."
- An emphasis on operating efficiency is improving long-term productivity.
- While in some cases spreads have declined from six months ago, typically, they remain higher than several years ago. For the industry, spreads in 2007 and 2008 were 2.93 percent and 3.08 percent, respectively. For 2009, spreads rose to 3.85 percent.
- Both pricing and risk management discipline have strengthened in recent years.

Signifying that the industry has passed through its low point, one executive of a bank-owned equipment finance company commented: "If you have made it to this point, you are OK." In his view, a bottom has been formed from which the industry is beginning to rise. For one bank lessor, the bottom occurred in 2009 with charge-offs exceeding three-quarters of a percentage point. For 2010 he expects a much reduced one-half percent and in 2011 has set a quarter percent loss as his goal. Another company, this one operating in the vendor segment, has reduced charge-offs to 1.2 percent from 2.3 percent at their highest. While the absolute numbers differ significantly between companies, most of our interviewees state they are experiencing a similar dramatic percentage drop in 2010 losses. Many citing significant portfolio improvements over the last six months.

Risk Management Rules! Most companies have increased their focus on risk management. One leasing executive commented: "We added more people and conducted more analytics. We are more sensitive to the risk rating process that drives our reserves, and we are quicker to downgrade customers."

Similarly, many are strongly emphasizing portfolio management over asset growth. One head of a bank-owned lessor stated: "Charge-offs move the needle much more than a few percentage points of growth." Another executive commented in a similar vein that his senior management is much more concerned about loss ratios rather than growth rates.

Aspects of this enhanced focus on risk management include:

- Increased diligence in the credit analysis process
- Pricing discipline
- Enhanced collections procedures
- Narrower business focus
- Greater focus on the pros and cons of credit scoring

Increased diligence in the credit analysis process. Over the past year, an increasing number of equipment finance companies conducted an individual client review of current risk ratings in light of the changed economy. For example, one lessor stated that customers with a "4" or "5" rating might be re-rated to "5" or "6", respectively. Being downgraded brought with it significant implications for that client upon consideration of additional transactions as well as existing transaction renewal or renegotiation. Potentially, this included a reduced term to the agreement, higher down payment/equity requirements, and an increased rate.

Another lessor stated their approval policies remained consistent "in good times and bad," saying: "Our standards did not change, the quality of our customers did." However, that company did tighten up deal structures, requiring a higher down payment or cross-collateralization of transactions. In this environment, exceptions to policies also declined, with one comment capturing the sentiment expressed by several interviewees: "Who [today] would be so brave to reach and take a swing at a [difficult] credit?"

Pricing discipline. As indicated by 2009 results as well as management comments, the industry focused on improving margins and better aligning risk and return. Several lessors stated that before the downturn the linkage between customer risk and the required spread was inadequate. Appropriately, better credits commanded lower spreads but in many cases poorer quality credits were not priced with an adequate risk premium. Currently, the expectation of many lenders has shifted to what one termed "higher net interest margins and more revenue from the same capital." This includes introducing interest rate floors into customer contracts to protect spreads in a low rate environment and an increased focus on risk-based pricing.

Enhanced collections procedures. The tougher economy saw many equipment finance companies tighten their collections procedures and strengthen their capabilities. One indication is the increase in the percentage of staff working on collections with an emphasis on hiring to improve their company's functional expertise in this area. Some also instituted policies to call more frequently, with one interviewee commenting: "We are on the phone early and often."

Narrower business focus. Companies used the downturn as an opportunity to evaluate the components of their portfolio and, as appropriate, exit poorly performing segments. From a geographic perspective, while national players and many regional banks continue to operate across the U.S., several bank-owned lessors now limit their activity to areas in which they have a physical branch presence.

In addition, some lessors exited or reduced their exposure to industries or segments generating sub-par results. One executive who refocused his marketing emphasis noted: "We recognize what we are good at and what we are not too good at, and we do not venture too far afield." Another commented: "Our focus is sharper as a result of the last four years. We are 'doubling down' [meaning increasing the company's emphasis] on what we know best."

Greater focus on the pros and cons of credit scoring. During 2009, most equipment finance companies used credit scoring as an input into their small ticket decision making process. Many used an auto decisioning model for smaller transactions, whereby, they employed a predictive model to decide whether to provide credit to a small ticket borrower. Largely because of cost considerations, lessors often selected a generic credit scoring model, meaning one that has not been customized to a specific company's approach and past credit experience. In a number of cases, those lessors stated that the generic models resulted in high losses in the portfolio and a move back to having a credit officer review each application.

One manager at a bank-owner lessor with a significant small ticket portfolio commented: "Credit scoring models were not predictive. They had never faced this type of stress situation before in which companies go out of business without any advance indication. We had companies that we termed "pop-ups" that went from current to charge-off over one payment period and others where the FICO score went from 710 to 490 in three months." However, one lessor who invested in internally developed and managed proprietary models stated that their modeling process allowed them to react effectively and quickly to economic changes: "Proprietary models are more reliable."

A cautionary note. Signs exist that recent disciplines may be disappearing at some lessors, replaced by more aggressive approaches. Several industry executives shared the view that spreads have been compressing, as competition for deals increases. One lessor noted that "More people are chasing less business." Several executives expressed the view that some of their more aggressive leasing competitors have begun to compromise on and loosen structures in order to win deals. Another lessor commented that "Some are buying too deeply", meaning they are approving higher risk transactions in order to build volume.

Growth Is a Priority… for Some. In most cases, senior leasing and parent company management are emphasizing portfolio maintenance and quality. However, while quality remains key, several Independents and bank-owned players stated that their company's growth expectations were high.

In particular, the parents of some bank-owned equipment finance companies are looking to leasing to replace the reduced level of activity in other businesses: "Equipment finance is supposed to make up for the lack of growth in commercial banking." One bank leasing executive highlighted his 50 percent growth goal for 2010, while another cited a 30 percent year-over-year goal, both reflecting their flat performance in 2009 and their banks' recommitment to the business line. In this environment, these growth oriented players will need to focus on taking market share from others, with this increased competition likely resulting in thinner spreads and more concessionary terms.

Operational Efficiencies and Close Monitoring Will Remain Critical. Our review of last year's performance shows a decline in equipment finance industry employment of almost six percent from the prior year. Companies reduced headcount as a result of decreased business volumes and an internal focus on achieving more internal operating leverage.

The economy also encouraged managers to assess their personnel and rethink their staffing requirements. One leasing executive said: "We used this as an opportunity to purge out the bottom performing 10-15 percent of employees. Getting rid of them dramatically improved our efficiencies." In his case, the reductions included low performers in both staff and line areas.

A second executive, focusing on sales staff, commented that deals coming in from poor sales performers had lower approval ratings, since those sales persons were "just desperate." Still another viewed his company's efficiency review as a positive. He said that it has allowed his company to "thrive," which he defined as allowing his company to provide strong customer service with fewer people. He added: "We had a call to action...We improved our processes and workflows and how we delivered to our customers." This company has significant growth goals over the next two years; however, over the next five years it does not expect to get back to its 2008 employee levels.

Sales people were a major target of the efficiency process: "We found that marginal sales people bring in marginal deals. Those deals required more hand holding and operational intensive process. These deals also clogged up the pipeline and increased our cost of origination. Frequently, these were also the deals that went bad." The result for this less was that eliminating these sales persons not only decreased sales personnel expense but also collection costs and write-offs.

In addition, one leasing head stated that his company "fired" some of its vendors, citing their poor credit performance and the lack of a strong relationship. This change also resulted in a productivity and quality boost: "Downsizing resulted in our not wasting time, the need for fewer credit analysts, and a more educated vendor and employee…Everyone [at the lessor] now has a different attitude about the level of production required."

A number of companies have instituted additional processes to evaluate the performance of sales staff and profitability of customers on a much more rigorous and detailed basis. These processes include developing formal personnel reviews for all staff, quantifying the profitability of the business generated by sales personnel, and evaluating customer profitability.

Accounting and Regulatory Issues Are of Concern
The FASB and the International Accounting Standards Board (IASB) recently released an exposure draft concerning proposed lease accounting standards. The comment period ends on December 15; the effective date of the new standards is likely to occur in January 2013.

The major proposed change requires companies to capitalize at least some of their operating leases and move them onto the balance sheet, increasing both the transparency of the transaction as well as the amount of recorded debt. However, an analysis published by the ELFA in August ("What You Need to Know About the Lease Accounting Exposure Draft) suggests that additional reporting requirements could both overstate and front-load expenses related to a transaction. The industry's concern is that the resulting increased leverage and expense could make these transactions unattractive.

Currently, industry response to the SFAS 13 proposal ranges from "much ado about nothing" to significant concern about the impact of the changes on the equipment finance industry. However, the impact will vary depending upon the type and number of companies affected.

Most interviewees believe that the impact of any changes on small ticket transactions will be minimal. Similarly, one middle market player stated that few of his lessees using an operating lease actually required off balance sheet treatment. Another lessor said that 15-20 percent of his customers were "motivated by the off balance factor," meaning that a major reason for their completing a leasing transaction rested on their being able to remove the asset from the corporate balance sheet. However, he added that for many of these customers the opportunity to improve cash flow will still make these transactions attractive. Those views contrast with another lessor who stated that for middle market and larger companies, "It will play havoc with their balance sheet."

In general, executives think that proposed changes will most impact larger transactions. Even in this area, however, opinions are mixed. One business head, whose company has a large ticket emphasis, said he believes there will be limited impact from the new accounting rules. In his view, most of his larger customers are public companies whose bankers and analysts already scrutinized footnotes related to off balance sheet exposures. He felt that the transparency of these companies and their transactions was already high. In contrast, a rating agency analyst recently stated that, if the exposure draft changes were implemented as is, his firm would have to make additional adjustments to a company's financial statement.

Uncertainty also exists related to the new set of financial regulations, now being developed as a result of the Dodd/Frank regulatory reform bill (commonly termed "Fin/Reg"). While "Who knows?" was a frequent response to questions about potential impact of the bill, several lessors express concern about the new Consumer Financial Protection Bureau (CFPB). In particular, they raise the possibility that the CFPB could define the "consumer" to include small businesses. The general sentiment expressed related to the new regulation is that "FinReg" will increase costs, and we will have to pass those costs on to the customer."

Another recently proposed change, this one viewed by most as a positive for the industry, involves the extension and expansion of the bonus depreciation for equipment purchases. If enacted, businesses will be able to deduct the full value of equipment purchases from their taxes through 2011, although the full value of this accelerated equipment depreciation will not be fully enjoyed by those lessors trapped in an alternative minimum tax rate position which will further drive company differentiation.

Today, Banks May Operate with a "Natural Advantage", but Commitment Varies. 2009 was a year in which Banks believe they were able to exploit their funding advantage versus competitors, particularly Independents. Further, they continue to work on developing what should be a marketing advantage, namely taking advantage of the in-house customer base that their bank parent serves. At the same time, the degree of parent commitment to the equipment finance business and the extent to which top management views equipment finance as a growth engine for the larger Bank varies widely.

Virtually all players owned by Banks believe they have a significant funding advantage. Their comments confirmed this:

- "Someone not working for a Bank in this business will have a rough time [due to capital and funding issues.]"
- "It is a good time to be owned by a Bank."
- "There are established finance companies today that are hamstrung for financing."

As for their marketing advantage, more Bank-owned equipment finance groups are focusing on serving their parent company's current customer base. However, at others, the current customer represents no more than 10-25 percent of equipment finance activities with the lessor continuing to rely on an independent sales effort.

The cross-sale of leasing related products to bank customers continues to frustrate many lessors. Many of the roadblocks that exist today do not differ from those of past years. They include:

- Traditional commercial bankers lack knowledge of the equipment finance product.
- Commercial bankers feel threatened by equipment finance specialist. One specialist observed: "Equipment finance is a competing product with conventional lending; it takes away from the loan product."
- Equipment finance bankers are frustrated in trying to enlist the active involvement of commercial bankers.
- Commercial bankers want to be incented to introduce and sell what they view as a competing product.
- Internal account capabilities may not allow for effective performance tracking.

Some Banks appear to have determined the formula for coordinating traditional banking products with equipment finance:

Compensation and internal accounting. Unless the commercial banker is incented to introduce and sell the equipment finance group's capabilities, few sales will occur. One Bank ties individual banker compensation to the return on a loan or lease transaction. Since equipment deals usually generate larger spreads versus typical loans, the commercial banker now actively sells leasing.

Another bank leasing manager believes his firm has solved the compensation issue: "It is not just talk here. Leasing is part of the scorecard, and we measure the results. Bankers who bring in leasing business get more recognition and credit for doing so [because of the higher yields those deals generate]."

Sales liaison. The equipment finance group needs to invest in selecting several experienced sales persons from its unit to work with and educate the commercial bankers. Several executives mentioned that some patience was also required, as transferring knowledge and wearing down resistance in the traditional commercial bank can require several years.

Senior management. If this type of cross-sell initiative is to succeed, senior management must fully understand its value and support it as a long-term commitment. Several bankers mentioned how their management "gets it" with regard to their product: "[Our CEO] loves asset finance and knows it is subscale," meaning that he believes that leasing should expand its activities.

Regional focus. In several cases, Banks have restricted the activities of their equipment finance group to the geographical areas in which the traditional bank operates, in part to encourage cross-sell by equipment finance specialists.

The economic downturn and accompanying capital constraints caused some Banks to begin what one manager termed a "period of assessment" related to the equipment finance business and its role within the larger Bank. One head of a bank-owned lessor stated: "We needed to evaluate the value we provided to the Bank. That included: low risk assets, portfolio diversity, some new clients, and even new deposits." However, increased deposit generation continues to be a challenge for bank-owned equipment finance groups: "We are still lousy at this. Our deposits total two percent of loans; we want to get it to more than ten percent on five years. In cases where we are the lead dog, we want the operating account."

Independents Can Remain Strong Players. 2009 results indicate that, as a group, Independents had a very difficult year. Many faced limited access to capital and, in addition, funding became a paramount concern. At this stage, however, past funding clouds may be lifting for the Independents. One bank lessor observed: "Liquidity is returning for the Independents. Banks are flush with liquidity, and some of the excess bank liquidity will trickle down to the Independents," as Banks explore areas for increasing their loan volume with a new willingness to consider rational financing to non bank equipment finance organizations.

While some Independents pulled back due to the downturn, others will continue not only to survive but to thrive. The best performing Independents appear to share several characteristics:

- *Visionary leader.* Many of these companies are headed by a long-time leader who either created the company or has been a major factor in developing and maintaining its focus.

- *Corporate culture.* Due to the company's focus and the leadership offered by senior management, these companies operate with a consistent corporate culture. One Independent emphasized its rigorous hiring process as a key part of culture building. This company recruits extensively from outside of the industry, based on aptitude and attitude rather than equipment finance knowledge. Another dedicates a staff member to manage organizational development and culture.

- *Focus.* Top Independents concentrate on developing a "unique" offer that differentiates them from others and is difficult to emulate. The offer may be based upon product, service, information provided and/or other qualities ("The product is not money.") It also includes a strong emphasis on risk management ("We know we are risking our own money.")

- *Customer service.* The best Independents provide extraordinary responsiveness. Some may provide customers with a dedicated account manager who has detailed understanding of a customer's needs. One Independent head said: "We want to become expert in an industry and determine what we can do differently for the CFO of a company." Others develop customized structures for clients or take other actions that result in what one Independent termed "customer intimacy" based upon a high service model. At least one Independent also provides services that help customers manage their business more effectively. This includes assistance in areas related to technology and human resources.

- *Pricing premium.* Since Independents usually operate at a funding disadvantage versus competitors, the high quality service they provide needs to result in higher spreads. Estimates for the pricing premium available to a well performing Independent in today's market range from 25-50 basis points.

- *Selectivity.* One Independent stressed that the niches he worked in featured investment grade customers and that his recent losses were well below industry averages. He tries to, in his words, "pick" his customers based upon his view of their credit quality.

- *Funding availability.* Listed last, but arguably of highest importance, top Independents have developed varied approaches to obtain sufficient funding. They range from reliance on one provider with whom they have a long relationship to non-recourse discounting, commercial paper facilities, and multiple bank lines. One Independent leader commented: "Independents with good credit quality can get funding." However, Independents focusing on riskier segments will face continued funding challenges. A bank lessor commented: "Funding sources are more skeptical about companies that build in to their operating model five, six, seven percent losses."

"True" Captives Well Positioned. Captives as well as companies that service this group believe that they stayed very close to their customers during the downturn and, for the most part, turned a negative economy into a long-term loyalty-building opportunity. One executive said that his firm was "willing to do things that others were and are not willing to do."

Captives contrasted their willingness to cooperate with customers to the reticence they say was exhibited by many Banks and Independents: "Banks and Independents moved away from many clients. They had no choice, given their capital issues." One executive at a Captive stressed what he considered his firm's more effective approach: "We don't quit on a customer until they quit. We want our customers to be successful. If we ride it out during a downturn, it leads to more financing." Another echoed that comment: "In bad times, we are not leg breakers. We want to keep the customer for the long term; we will restructure a transaction and will stay with them. In most cases we know our customers and their financial condition better than bankers do."

Even during the depth of the downturn, some Captives emphasized their closeness to the customer. One company discussed how they tried to anticipate emerging client problems by "being proactive before the customer got into trouble." At that Captive, sales personnel, given an enhanced role, approached customers proactively before a problem occurred in order to assess the customer's cash flow, determine whether its contract required modification, and evaluate other issues that could impact the payment schedule.

Since they are part of a manufacturer, Captives are able to leverage their equipment knowledge and integration with the parent's equipment sales force to manage risk. This equipment expertise may be the key competitive advantage Captives enjoy over Banks and Independents. Captive management believes they are better positioned with their customers than other financing sources: "All that the banks can provide is a low interest rate versus our knowledge and consistent presence in the market… Some customers will buy on price and take advantage of the good times as they return. We think our customers will focus more on the loyalty and commitment we have shown." One bank-owned lessor agreed with that assessment stating: "If you win a deal [from a Captive], you need to ask why."

Diversity in Industry Performance. Recent industry performance and growth rates differ significantly. Agriculture has been one sector that shows growth and long-term potential both in the U.S. and globally. One company with a focus in this area described it as a "sweet spot" and "very strong." Another lender with a major agricultural focus expects it to remain strong for decades: "The world population will grow from six to nine billion by 2050. The food requirement will increase by 100 percent… due to the increase in meat purchases and the grain required to support them." A second industry mentioned by many is Health Care, with several companies mentioned that they expect competition to increase in both areas.

Assessing sub-categories shows significant performance differences within the same industry category. For example, in general, corporate jets performed very poorly while turboprops showed greater stability. In another case, Construction transactions showed a declining performance, with the exception of financings related to road building and infrastructure projects tied to Federal stimulus dollars. While differences between and within industry categories remain, lessors state that most industries have begun to rebound and that asset values have stabilized.

Rethinking Small Business. As noted above, several lessors cited poor experience with credit scoring models and mentioned that they suffered a disproportionate share of losses from the small ticket space. Some of those companies, mainly Banks, also expressed concern about the increased cost of originating loans to and servicing the micro-and small ticket customers: "We are doing fewer transactions below $250,000. These deals require a lot of touches and are more process-oriented than we like." Another bank lessor summarized the cost and productivity issues related to this segment: "We underwrite a $25,000 deal the same way as a $25 million deal." One vendor specialist stated that emphasizing larger ticket transactions (above $500,000) "improves the profile of vendors, obligors, and increases our efficiency."

For many bank-owned equipment finance companies, small ticket is a segment their corporate parent wishes them to serve. Some find it difficult to price for the risk involved in these transactions; in addition, some bank-owned companies mentioned that the higher loss rates generated by smaller ticket loans conflict with their company's approach to credit management. One Independent executive commented about Banks: "They see three percent losses and they freak. They can't do it culturally." A bank-owned lessor confirmed this view: "We don't have a business model for this type of approach [a high spread, high loss business]. Independents are better positioned for this business."

A number of bank lessors stated that they expect to deemphasize selling to and servicing micro and small ticket customers, instead focusing on mid-sized or larger ticket transactions. Some cite their lack of expertise with the operational and process requirements of smaller transactions including standardized applications, streamlined approval processes, standardized documentation and closing procedures, and a reliance on credit scoring technology.

Going forward, micro and small ticket activity may become concentrated in fewer Banks and Independents, reflecting the increased investment required in process and technology and the significant challenges related to managing smaller transactions.

Redefining Innovation. Relatively little innovation related to new products or technology is currently occurring within the industry, with the exception of a continuing focus on green technology, in particular wind and solar power. Nonetheless, several lessors view the industry as "more innovative than we have ever been." By this they meant that lessors were challenging their traditional approaches to the business and rethinking their organizations, business models, and internal systems in light of the current operating environment.

Others believe that current innovation centers on disciplined execution of the basics of the business: "We are now maniacal about the basics: rigorous risk adjudication, high quality transactions, clear communication with our vendors. We focus like a laser beam in the fundamentals, and we do what we said we were going to do."

Other Areas of Importance. A number of other areas were also highlighted during our interviews with industry executives.

International. Companies that conduct business outside the U.S. (SEFA Report: 18 percent of Bank respondents, 26 percent of Captive respondents, and 27 percent of Independent respondents) find growth opportunities to be much more substantial in emerging markets versus the U.S., Canada, or Western Europe. Countries mentioned as providing high growth include: the BRIC countries (Brazil, Russia, India, and China), Mexico, Chile and other areas in Latin America. One leader of a lessor with an international focus said: "We expect flat growth from the U.S. but double digit growth elsewhere."

Funding. For most well performing players today, funding has declined as an issue over the past 12 months. Bank funding, CP conduits, even the securitization term market are all mentioned as having improved for companies that are performing well. Poor or mediocre performers continue to find that their funding options are limited and at a higher cost, assuming availability.

Technology. Many companies squarely faced the limits of technology in 2009, whether in credit decisioning or in operations. In the past, some lessors had automated complex processes rather than rethinking them from the ground up. As noted above, in the past year some companies did "reinvent" themselves. They expect their use of technology to increase future operating leverage. Several mentioned the need to use technology to "do more with the same resources." Emphasis includes: vendors inputting transactions electronically, reduced use of paper, online tracking of the approval process, electronic billing, asset level tracking, and overall improved communications between lender and borrowers. The advent of new FASB-required lessor accounting, driving associated system changes with potentially substantial incremental costs, may drive a renewed willingness to consider new available lease system platforms available in the marketplace.

Third-party paper. The buying and selling of paper remains active. Buyers stress that they are being more selective and deal only with sellers with good track records. The reason to buy includes the desire to put excess liquidity to work and the ability to establish reciprocity with potential purchasers of paper. Sellers emphasize the desire to improve returns by increasing near-term fee income as well as limiting portfolio exposures.

Private Equity. While several years ago expectations were high that Private Equity firms would play a significant role in the equipment finance industry, the current view is that their involvement will be limited and will require these firms to recalibrate their return expectations: "Private Equity firms need to reset their expectations [lower] related to IRR and ROE." Reasons for limited Private Equity activity include: likely slow growth over the next several years, alternative investment opportunities for Private Equity firms, uncertain exit strategies within a relatively short time frame and, frankly, hesitancy on the art of some executives to work with Private Equity players.

De Novos. Market disruptions usually create the opportunity for new market entrants. Suggested niche opportunities center on segments that have performed poorly in recent years and/or have been abandoned or fallen into disfavor by others. These include: transportation, corporate aircraft, construction, and small ticket. However, as indicated in the Private Equity section, obtaining capital for these initiatives may be a major stumbling block, particularly if one observer is correct in saying "Capital is chasing companies that have made it through the downturn, not *de novos*." Bottom line, other than Banks entering or reentering the market to grow assets, a significant number of new competitors entering the equipment finance business appears unlikely under present circumstances.

The Future. Industry experts share a close to unanimous view that the likely near-term scenario points to low growth until at least mid-2011. As some level of certainty returns to the market, equipment finance leaders view the longer-term picture for the industry as much more positive. One commentator captured the spirit of many of his colleagues: "The industry is still robust. We remain critical to the growth and future state of companies that need alternatives to grow and fund their businesses."

Further, even though insiders expect a "long, slow, arduous recovery" and suggest the need for "patience and prudence", they also emphasize that "the industry is not going away." Certainly, the consensus view is that by this time next year, greater stability will be apparent with stronger expectations for 2012: "Ours is an adjustable industry. There will always be a need for credit and equipment finance." The many companies that have spent part of the past 12-18 months refining their strategies, streamlining their processes, and/or eliminating weak or unnecessary personnel are among those most likely to benefit from the inevitable upturn in the industry.

Analysis of Industry Trends: ELFA's 2010 Survey of Equipment Finance Activity

The 2010 Survey of Equipment Finance Activity (SEFA) incorporates the responses of 106 completed surveys, based upon 2009 results. Respondents included 70 percent of the ELFA members who appear in the 2009 Monitor Top 100 list of leasing and finance companies.

The 2010 analysis provides readers with significant insights about recent performance and emerging trends. The survey also offers some takeaways for further consideration and analysis, some of which were already highlighted in the earlier chapter, including:

- The industry has been able to improve its pre-tax spread
- Banks continue to operate with a funding advantage but may be able to improve their pricing
- The industry has reduced employment and altered its staffing mix due to shifting requirements
- Captives have increased their role in equipment finance
- Independents and smaller lessors need to address continuing challenges
- Based on MLFI data, the industry appears to be recovering from its low point and beginning to grow, albeit at a slow and irregular pace

In order to make our analysis as current and relevant as possible, we supplement the annual SEFA data with data from the ELFA's Monthly Leasing and Finance Index (MLFI). This index collects the performance of 25 major ELFA members. Monthly information is limited to five key indicators: new business volume; aging of receivables; average losses; credit approval ratios; and, total number of employees.

Our analysis of industry performance centers on:
• Financial Performance
• New Business Volume
• Portfolio Performance
• Yield and Funding
• Comparative Performance

Financial Performance

The Survey of Equipment Finance Activity shows that the industry's balance sheet shrank in 2009. Total assets as reported by survey respondents, declined by 9.3 percent from $315.7 Billion in 2008 to $286.5 Billion in 2009, with net earning assets dropping by 11.0 percent. Net worth also declined but only by 4.3 percent. At year end, industry net worth approached $103 Billion. The industry was in alignment with the deleveraging that occurred across financial services in 2009: total liabilities to net worth fell to its lowest level in five years, 6.1x while total assets to net worth declined to 6.9x. That contrasts with five-year highs of 7.9x and 8.8x in 2007.

Total off balance sheet assets also declined, to 5.9 percent from 8.9 percent. The components of this change included: securitized assets dropping from $7.3 Billion down to $3.4 Billion (54 percent decline); syndicated managed assets increasing to $9.7 Billion (up 14.4%) while other off balance sheet serviced assets declining by 78 percent to $2.5 Billion.

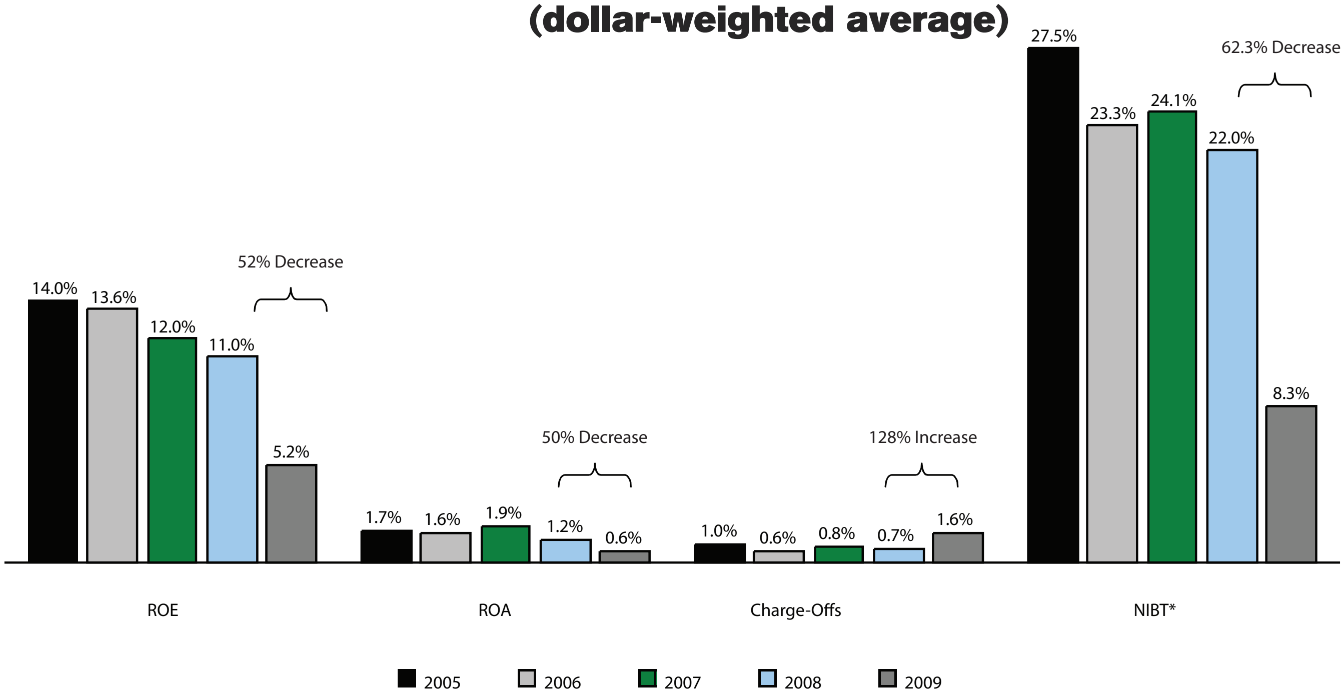
Revenues adjusted for depreciation dropped by almost 14 percent. The five-year trend for overall bottom line performance shows an industry suffering from declining results, with results at their worst level in the last five years. The industry's return on equity (ROE), while positive, dropped by over 50 percent from 2008 **(Figure 4)**; return on assets (ROA) and net income before taxes (NIBT) also dropped sharply, by 50 and 62 percent, respectively. Beyond new business volume declines (which we will review in the next section), increased charge-offs eroded profitability. The 1.6 percent of losses experienced in 2009 was 128 percent higher than in 2008 and 100 percent higher than in 2007.

Expenses increased dramatically as a percentage of industry total revenue **(Figure 5)**, reaching 90.5 percent from 81 percent the prior year. Interest expense was the only category to decline (to 32.9 percent from 35.1 percent), reflecting the decrease in interest rates. While depreciation and SG&A expenses increased, the provision for bad debts was the main cost increase for the industry, rising from 6.6 percent in 2008 to 14.8 percent in 2009, a jump of nearly 125 percent.

Operational efficiency numbers for 2009 reflect significant changes both in the number of employees and new business volume. The number of employees dipped below 14,000 **(Figure 6)**. However, not all categories declined.

Figure 4

Five-Year Historic Financial Indicators (%) (dollar-weighted average)

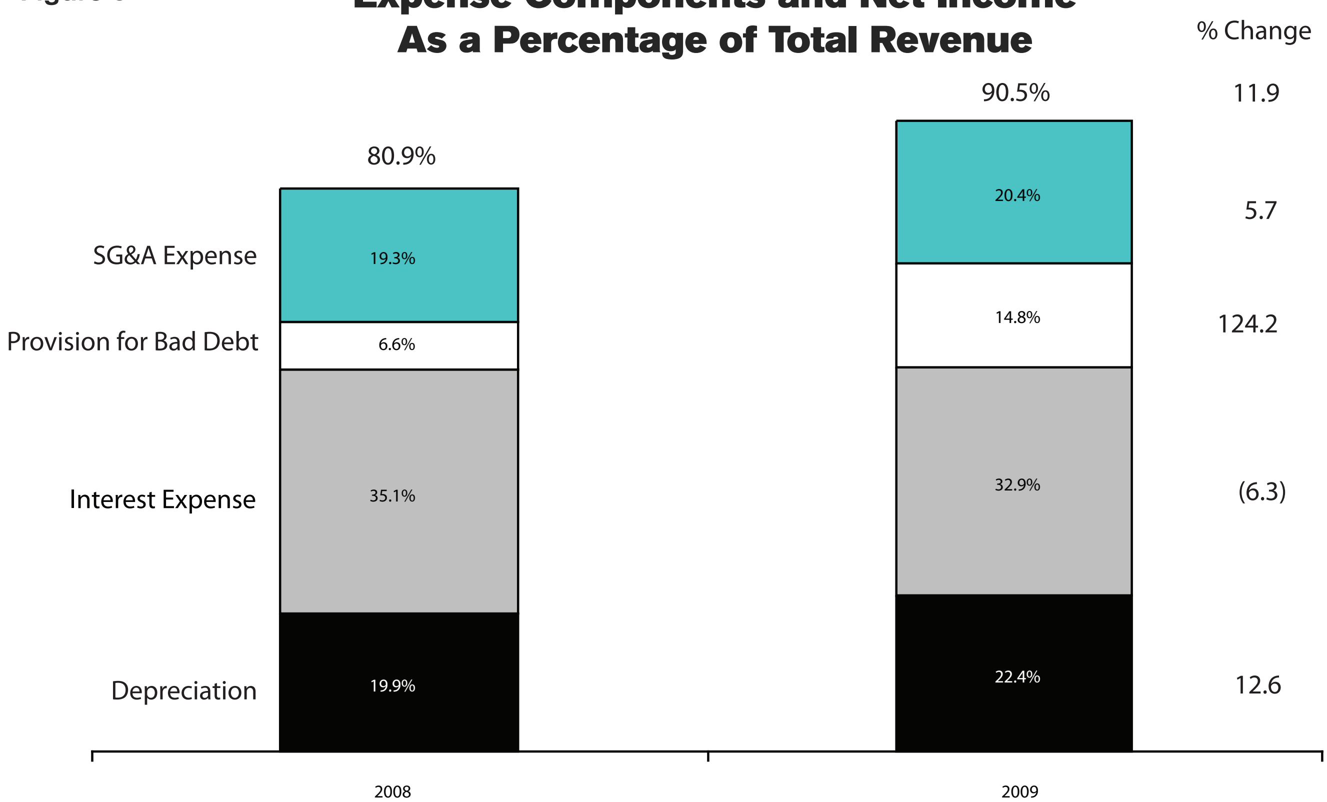


* As a percentage of total revenue

Source: 2010 SEFA, Tables 17a, 19a

Figure 5

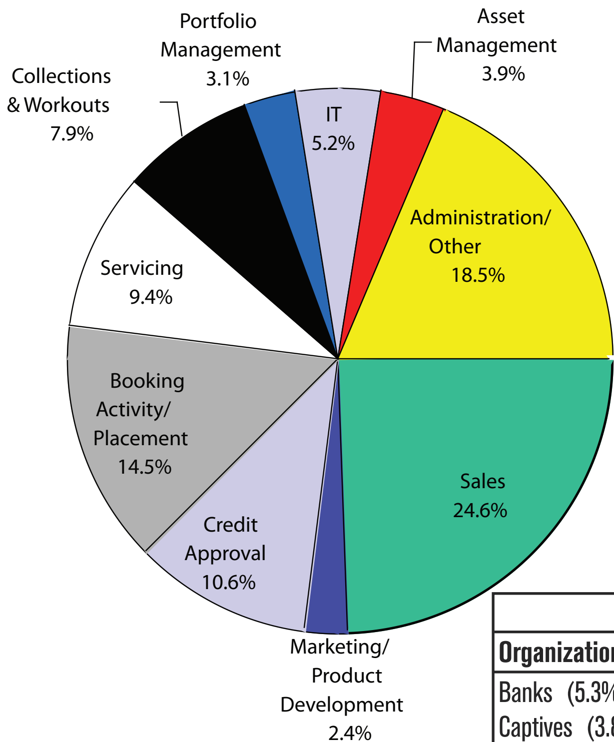
Expense Components and Net Income As a Percentage of Total Revenue

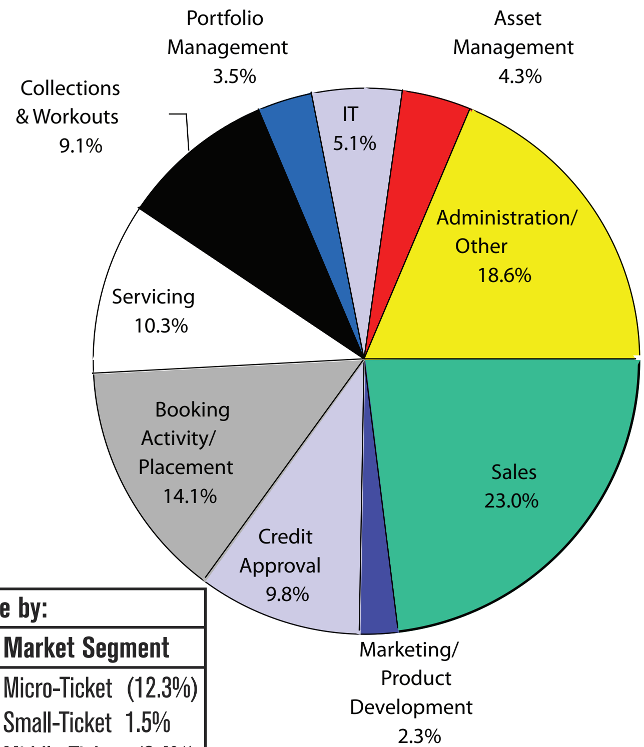


Source: 2010 SEFA, Table 16a

Figure 6

Full-Time Equivalent Employees





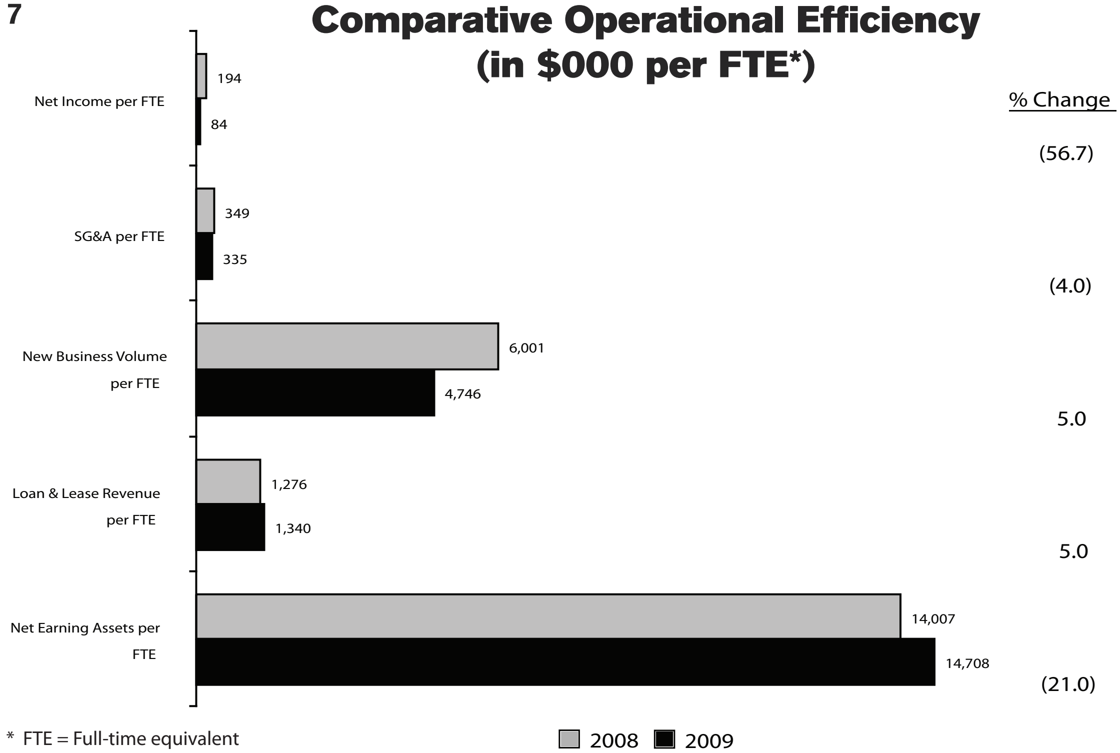
Change by:

Organization Type	Market Segment
Banks (5.3%)	Micro-Ticket (12.3%)
Captives (3.8%)	Small-Ticket 1.5%
Independents (9.7%)	Middle-Ticket (9.4%)
	Large-Ticket (10.1%)

Source: 2010 SEFA, Table 27b, 27d

Figure 7

Comparative Operational Efficiency (in $000 per FTE*)



* FTE = Full-time equivalent
Note: 2008 data table from prior survey

Source: 2010 SEFA, Table 29a

Areas such as sales and credit approval were reduced. Servicing and collections areas increased staffing as a percentage of total employees, reflecting the greater emphasis in those areas by many lessors. Largely due to the 21 percent decline in New Business Volume (NBV), net income per FTE **(Figure 7)** declined by almost 57 percent from 2008 to 2009.

MLFI 2010 Update. In August, employment for the MLFI 25 was approximately 9,700, seven percent lower than for the same month in 2009. However, from July to August employment rose by about 200. Industry interviews suggest that employment levels will show little if any improvement during the remainder of 2010.

New Business Volume (NBV)

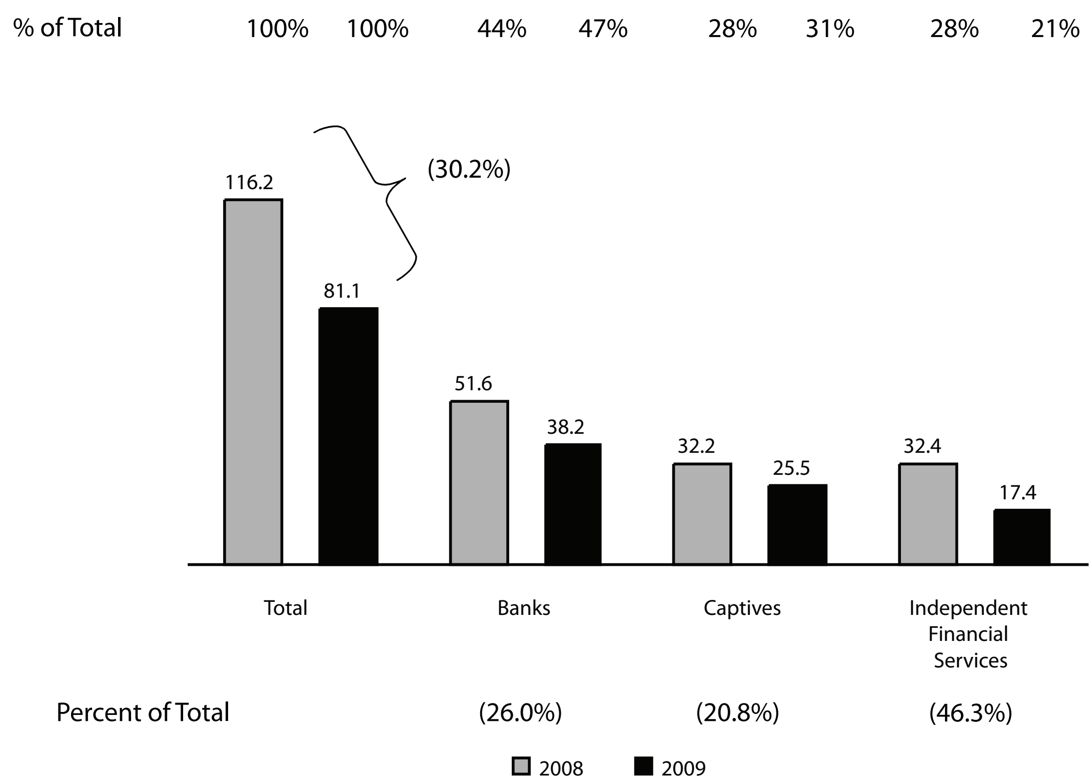
For full year 2009, NBV dropped significantly for the industry. From over $116B in 2008, total NBV sank to $81.1B, a 30.2 percent drop **(Figure 8)**. The entire industry shared this decline with almost 72 percent of all respondents stating that their new business volumes had declined.

NBV at Banks dropped by 26 percent; over 70 of all bank-owned respondents suffered a decline. Captives had an overall drop of 21 percent with slightly more than half of those companies stating their volume was down. Most notably, Independent NBV declined by almost half, 46.3 percent; over 80 percent of Independents cited a volume decline. Based on NBV, market share or Independents declined to 21 percent from 28 percent the prior year.

Just as all organizational types showed a decline, so too did all market segments, all companies no matter their market size, and all companies no matter their origination method **(Figure 9)**. Beyond the overall impact on Independents, significant changes in growth included:

- A 39 percent decline in large-ticket business versus only a 14 percent decline in micro-ticket NBV.
- A 76 percent drop in NBV by companies under $50 million in assets, resulting in part from the limited funding available to some smaller players. The largest companies, those over $1 Billon, with their presumed stronger origination capabilities and more substantial funding resources suffered the smallest decline, 29 percent.

Figure 8 **Total New Business Volume by Organization Type ($ billions)**



Source: 2010 SEFA, Table 1a

Figure 9

Changes in New Business Volume Summary 2008 - 2009

By...	Strongest	%	Weakest	%
Type	Captives	(20.9)	Independents	(46.3%)
Market Segment	Micro-Ticket	(14.2%)	Large-Ticket	(38.5%)
Annual Volume	Over $1 Billion	(29.4%)	Under $50 Million	(75.8%)
Business Model	Third Party	(15.2%)	Direct	(52.6%)

Source: 2010 SEFA, Tables 1e, 1f, 1g, 1h

- Companies with a focus on direct origination showed more than 50 percent volume slide versus third-party originations with only 15 percent.

The distribution of new business volume may suggest some longer term trends rather than just a one-year occurrence:

- Bank NBV as a percent of total new business has increased slightly over the five-year period to just above 47 percent but is down from the prior year. Banks have a history of rethinking their focus on this business, and this could be an indication that at least some in the industry are doing so once again. Interviews indicate that some banks are limiting their small ticket exposure and that some senior bank managements are reducing their overall equipment finance exposure.
- Market segment activity has remained relatively constant, with some slight increases in micro, small, and middle-ticket occurring.
- $1 Billon+ companies still generate over 80 percent of total new business volume
- Over the past five years, direct origination activities have changed from being the dominant channel with 44 percent of NBV down to less than 14 percent. Captive NBV (other than "mixed" origination) now dominated with 31 percent of volume, up from 25 percent. In order to support corporate sales, Captives appear to be increasing their activity as they step up to fill what some view as a financing void for some customer groups.

No financial product area increased in absolute dollars from 2008-2009. As a percent of total NBV, Conditional Sales Contracts, and Direct Finance Leases and Tax Exempt Leases increased slightly (Tables 7a and 7b of SEFA). More "exotic" instruments, such as off-balance sheet loans and leveraged leases, declined in use as a result of greater focus on risk mitigation and toeing the regulatory line.

Service-related companies are of increasing importance to the equipment finance industry, particularly in light of reduced manufacturing growth. Three of the top five end-user industries generating NBV were service companies: Finance, Insurance, and Real Estate, Health-related services, and Services-other (arts and entertainment, accommodations and food services, education, transportation services, among others) with 11.2, 10.5, and 8.5 percent of NBV, respectively.

The type of equipment financed is fragmented with the top five equipment types capturing less than 40 percent of total NBV, below the level of a few years ago. No category reaches ten percent of the total: Agriculture - 9.3 percent, Trucks and Trailers - 8.3 percent, Construction Equipment - 7.7 percent, Office Equipment - 7.2 percent, and PCs and Workstations - 9.3 percent. Construction Equipment experienced the greatest year-over-year change with share of business dropping by 3.5 percent, tied to the overall decline in construction nationwide. It is worth noting that the 2008 report showed corporate aircraft as the second largest equipment category, based upon the 2007 survey. However, in 2009 it represented only four percent of

Figure 10

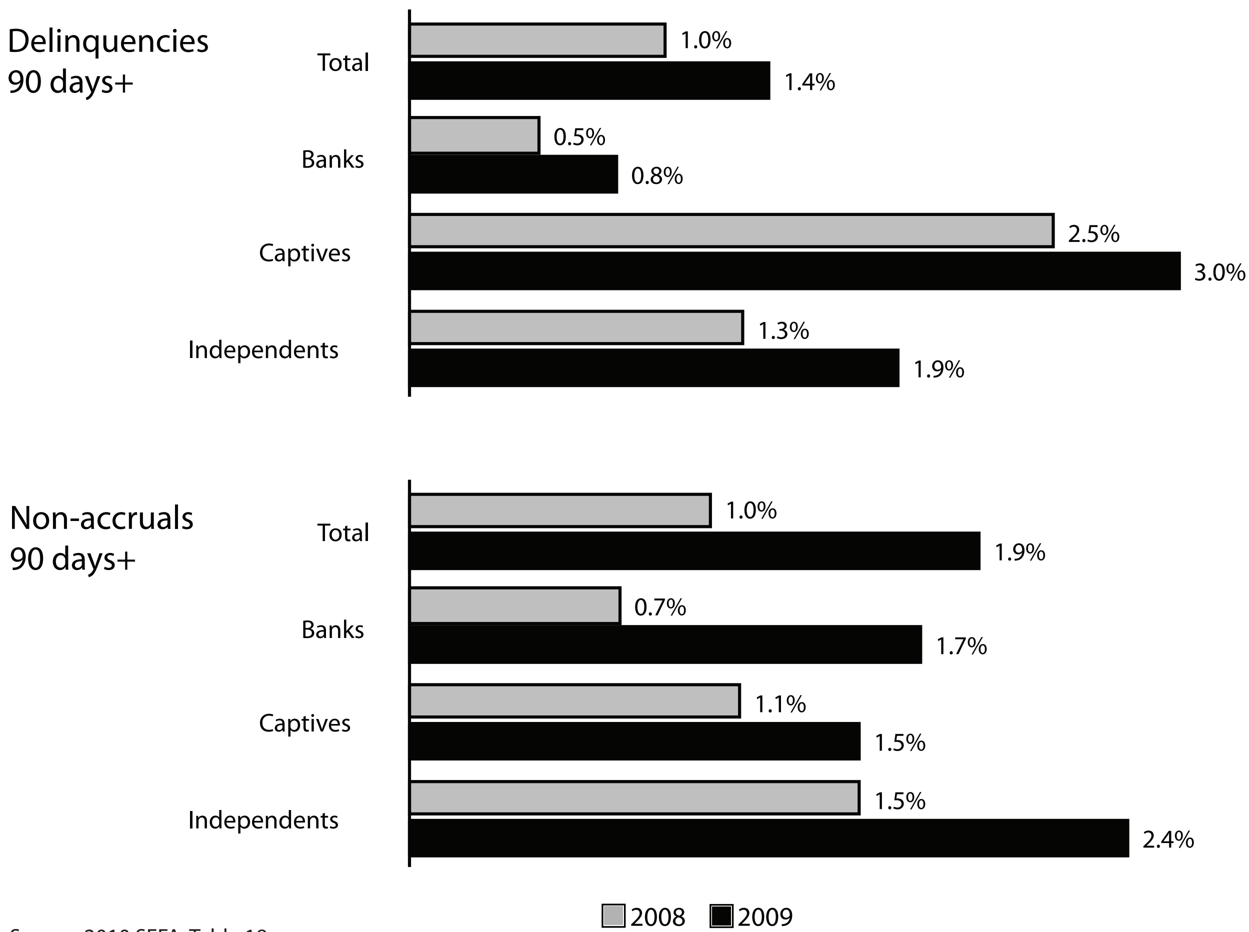
Profitability Quality 2005 - 2009

	2005	2006	2007	2008	2009	2008-2009 % Change
Delinquencies 90 days +	0.8%	0.6%	0.6%	1.0%	1.4%	40%
Non-accruals	1.2%	1.0%	0.9%	0.9%	1.9%	100%
Charge-offs	1.0%	0.6%	0.8%	0.7%	1.6%	128%%

Source: 2010 SEFA, Table 18n

Figure 11

Portfolio Quality – Delinquencies and Non-Accruals Type of Organization (weighted average)



Source: 2010 SEFA, Table 18c

equipment financed, down from 5.3 percent the prior year. This may reflect both the weak economy and the reticence of corporate executives to make such a high profile purchase.

MLFI 2010 Update. Recent volume numbers suggest slow but uneven improvement in volume growth. For the MLFI 25, as of August 2010 new business volume increased over 16 percent versus the same 2009 period. However, compared with the prior month, August volume declined from 5.6 billion to $4.3 billion, the same NBV generated in March of this year. Since January 2010 NBV monthly growth has varied significantly. Monthly volume numbers are as follow: January: $3.4B, February: $3.2B, March: $4.3B, April: $4.7B, May: $4.4B, June $5.5B, July $5.6B, and August $4.3B.

Our interviews support the view that 2010 volume versus the prior year will increase. However, given the operating environment, the rate of growth will not be in a straight upward line. As previously stated, most volume growth appears to be tied primarily to replacement requirements rather than investments tied to expansion.

Portfolio Performance

In light of the economic downturn, portfolio quality suffered dramatically in 2009 from previous years **(Figure 10)**. Ninety-day delinquencies hit 1.4 percent versus 1.0 percent in 2008 and 0.6 percent in 2007. Non-accruals reached almost 2.0 percent, more than double the level of the prior year. Similarly, charge-offs were also much higher at 1.6 percent in 2009, up from 0.7 percent in the prior year.

The pain related to portfolio quality was shared by all players in the industry **(Figure 11)**. As has historically been the case, Captives had the highest delinquency rate at 3.0 percent; however, Independents suffered the greatest year-to-year increase, up to 1.9 percent from 1.3 percent, close to a 50 percent rise. Non-accruals also increased. Independents had both the highest level of charge-offs (2.4 percent) and the greatest increase from 1.5 percent in the prior year, a further indication of one key factor eroding their performance.

The portfolios of small ticket players showed the highest non-accruals and charge-offs. Micro-ticket and small-ticket players had charge offs of 7.9 and 1.3 percent, respectively. Companies under $50MM and those between $50-250MM had the most strained portfolios with charge-offs of 1.9 and 2.0 percent, respectively.

MLFI 2010 Update. Most recent industry numbers available, as well as the anecdotal evidence offered by comments from a cross-section of industry insiders, indicate that portfolio quality has rebounded from its low point and will continue to improve over time. Receivables over 30 days at 4.3 percent in August show significant improvement over their level of 5.0 percent one year ago. This improvement exists despite a decline in last month's performance. Receivables over 30 days for the MLFI-25 increased to 4.3 percent in August from 3.5 percent in July, the first month-to-month increase since March 2010.

Nonetheless, overall quality trends remain positive for the industry. For example, charge-offs as a percent of net receivables declined to 1.3 percent in August from 1.5 percent in July, the lowest percentage since late 2008. Compared with a year ago, August charge-offs were 36 percent lower.

Yield and Funding

While industry average pre-tax yield on a dollar-weighted basis hit a five-year low **(Figure 12)**, pre-tax spread increased by 25 percent while cost of funds declined by almost 22 percent. Overall industry funding costs were over 90 basis points lower than in 2008. The economy also allowed the industry to strengthen its pricing substantially. Average spreads rose to 3.85 in 2009 from 3.08 percent in 2008. Interviewees suggest that little to no pricing pressure existed during 2009, except for top tier quality customers.

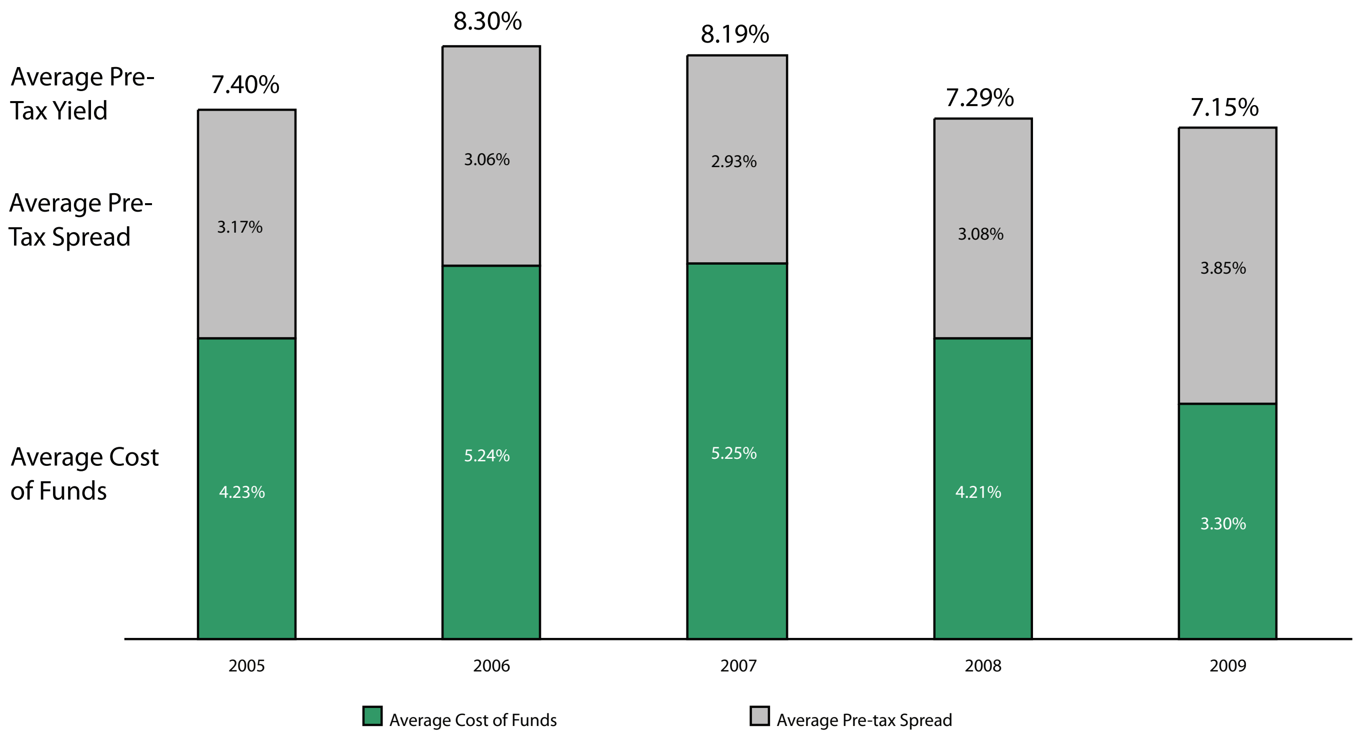
Costs of funds, spreads, and yields differed significantly by type of company, size of company and market segment focus:

Cost of funds. Banks held a significant funding advantage **(Figure 13)**. Their median cost of funds averaged 2.9 percent versus 4.1 percent for Captives and 5.0 percent for Independents. Whether on a weighted average or median basis, Banks benefited from a much larger drop in cost of funds versus competitors.

Larger companies also had a significant funding advantage **(Figure 14)**. Companies under $50 million had an average cost of funds of 4.6 percent; companies over $1 Billion

Figure 12

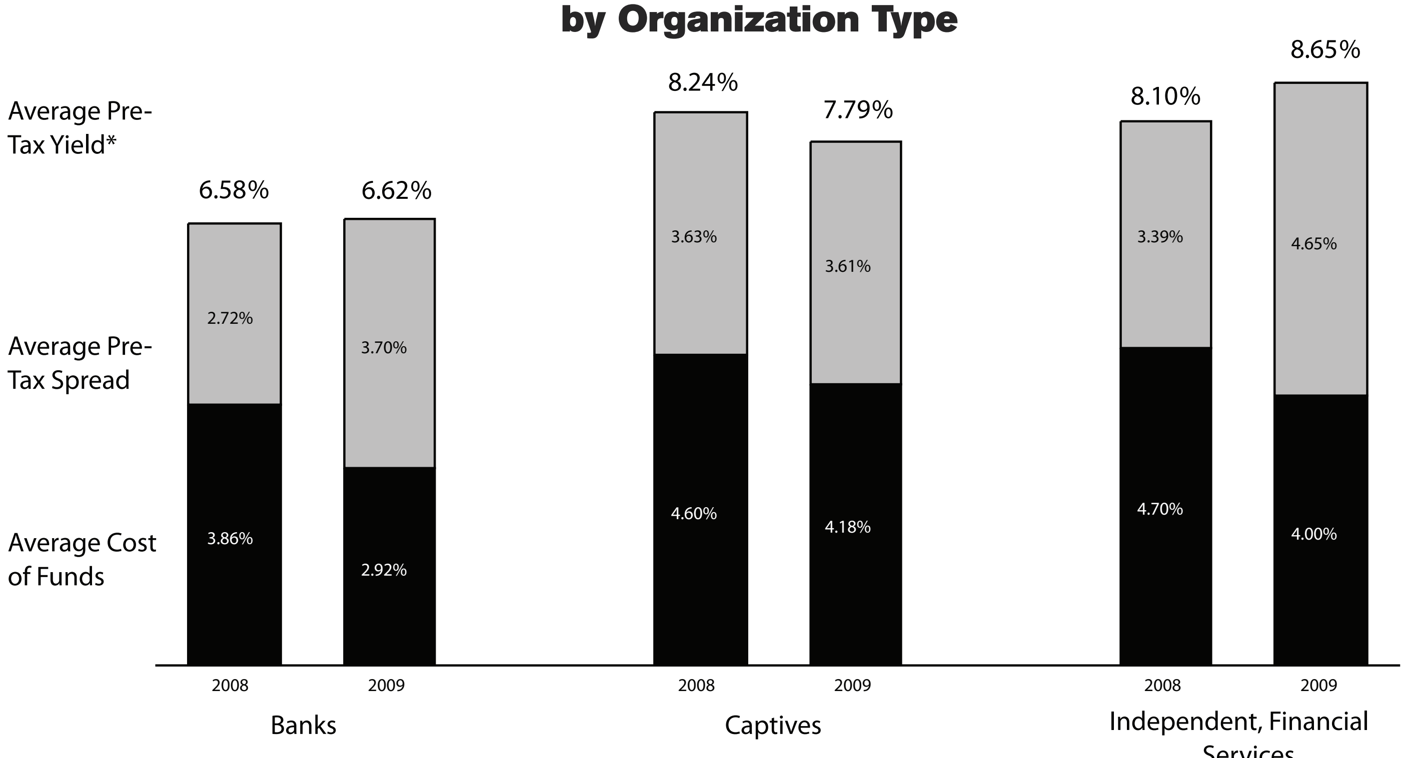
Pre-Tax Yield, Cost of Funds & Pre-Tax Spread Five-Year Trend (Dollar-Weighted Average)



Source: 2010 SEFA, Table 10a

Figure 13

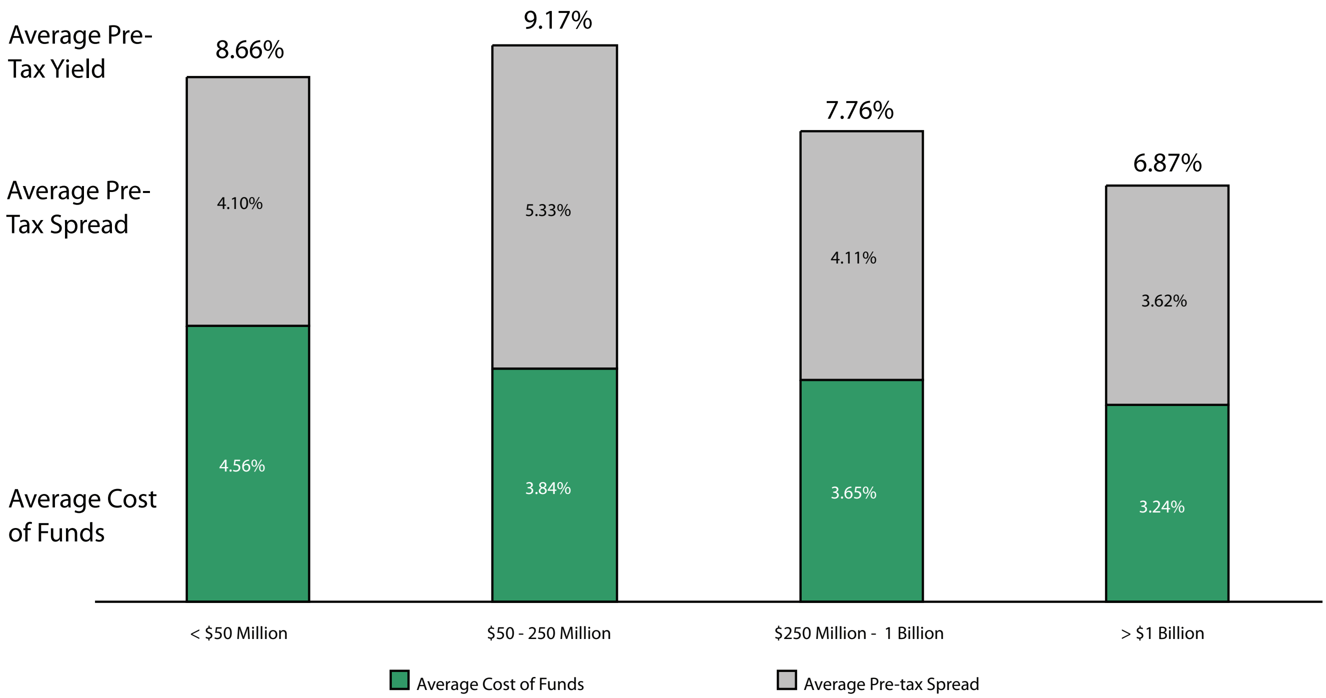
Pre-Tax Yield, Cost of Funds & Pre-Tax Spread by Organization Type



* May not total due to rounding
Source: 2010 SEFA, Table 10c

Figure 14

Pre-Tax Yield, Cost of Funds & Pre-Tax Spread by Organization Size in Annual Volume



Source: 2010 SEFA, Table 10e

in size benefited from a cost of funds that was more than 130 basis points lower at 3.24 percent.

Spreads. While Banks benefited significantly from a lower cost of funds, they gave much of that advantage up in the spread they charged their clients. Whether for relationship or competitive reasons, Banks averaged 3.8 percent spread versus 3.7 percent for Captives and 5.4 percent for Independents. While bank-owned lessors may disagree, several of our interviews with the staff of Captives and Independents suggested that, with some exceptions, Banks were commodity players and priced their equipment finance product like a commodity. The lower spreads generated by Captives indicate their focus on assisting in the sale of their parent's equipment. It also reflects their ability to liquidate the equipment, if necessary.

The higher spread for Independents may result from one or more of a number of factors: the customized nature of the transactions they underwrite; the strong relationships they have with their customers; their focus on customer responsiveness and service rather than price. Furthermore, given their pricing disadvantage they need to capture as much pricing premium as possible. In some cases the compensation of the sales staff of Independents is closely tied to the spread they generate on a deal, an additional incentive to increase the spread.

We noted above that smaller lessors operated with a funding disadvantage. In 2009 they also had a spread disadvantage. Average pre-tax spread for companies less than $50 million was 4.10 percent; only the largest companies had a lower margin at 3.62 percent. Interviews indicated that, many of the largest companies focus on investment grade clients that can merit and demand lower margins. However, smaller companies are typically focusing on small to mid-sized clients, an emphasis that should allow them to charge higher spreads. The combination of highest cost of funds with close to the lowest spreads needs to be addressed by small payers in the industry.

Micro and small ticket transactions provide equipment finance companies with the most attractive spreads. In 2009 the average spread for micro transactions increased to 11.1 percent versus 10.3 percent the year earlier. Small ticket transactions also benefited from increased spreads to 3.9 percent from 3.2 percent. Similarly, mid-ticket transactions increased from 2.7 to 3.4 percent. (Large corporate transactions yield were not available due to small sample size.)

Yields. Absolute yields may be of limited value in judging performance versus looking closely at its two components, cost of funds and spread. Nonetheless, it is worth noting that microbusinesses offer the highest all-in yield across any category. Banks and those focusing on the mid-ticket market share the lowest yields. One takeaway from this: bank-owned lessors may have a pricing opportunity with their clients based upon increasing their spreads, if they can instill a culture of pricing discipline. As noted in the first section, however, spreads are already beginning to compress within the industry as the more aggressive players try to build volume.

Securitized Funding. The level of securitized assets did not drop significantly (7.1 percent) from 2008-2009 to $9.2B from $9.9B. However, the components of the total did change significantly. In 2008, commercial paper (CP) conduits represented over 24 percent of the total; in 2009 that number dropped below to 9.9 percent of the total. CP conduits are of critical importance to Independents. One larger Independent commented that in 2009 the CP funding avenue had been eliminated for many smaller players, indicating why CP dollars dropped by more than 63 percent from year-to-year. As CP conduits as well as private placement dollars declined, public offers increased by almost 80 percent to $4.2B from 2.4B.

Third Party/Broker/Intermediary Related Transactions. While the percentage of companies selling transactions in 2009 showed a small drop from 2008 (53 percent from 59 percent), the dollar amount of transactions sold declined by 45.9 percent in 2009 to $7.9 Billion from $14.6 Billion. The 20 companies larger than $1Billion in size generated over 80 percent of the total sold transactions of $7.9 Billion, even though the amount sold by this group declined by close to 47 percent.

Those most impacted by the drop in sales were Independents, whose total dollar sales declined by almost 83 percent year-to-year and Captives with a 54 percent drop. Smaller companies (under $50 million) suffered the greatest decline related to organization size with a 48 percent decrease.

Banks represented 83 percent of the volume purchased in 2009 with Independents in second place with 10 percent. One change that is small in dollars but could be important in the longer term was the increase in the volume of individual investor purchases, defined as including public funds, income funds, limited partnerships, etc. While this group purchased only 2.1 percent of total volume, that figure was up from 1.2 percent the prior year, a possible indication of an emerging new investor group.

Over the years, little change has occurred in the reasons why companies sell transactions. Portfolio management (exposure/credit management, asset concentration) is cited as the main factor (57 percent), followed by the desire to generate fee income (19 percent). In addition, 16 percent mention “funding source” as the main reason. One exception to this involves companies under $50 million for which the fee income is the most important factor (41 percent).

As mentioned in several interviews, a reciprocal agreement exists between lenders whereby they sell deals to others in exchange for buying deals from the same players: “You buy in order to sell” was the comment made by one bank purchaser.

Comparative Performance

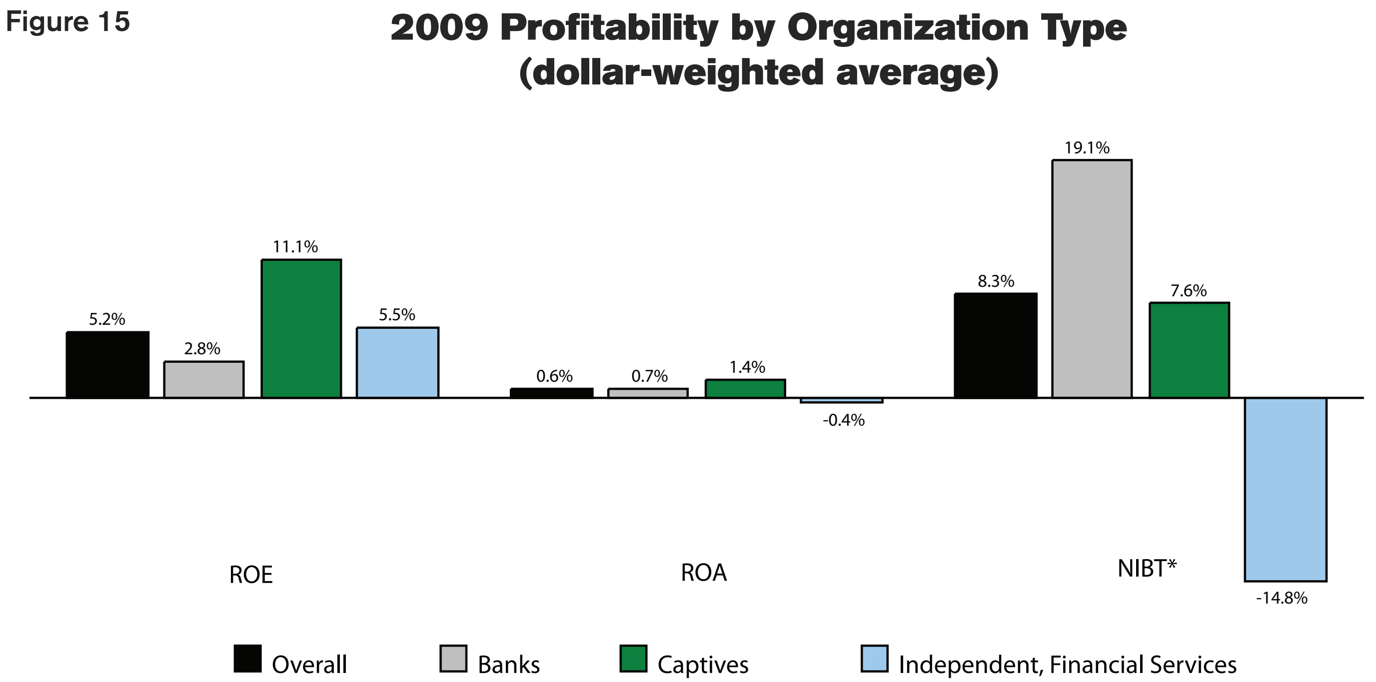
In 2009, some groups clearly outperformed others and are better positioned to take advantage of the economic rebound.

Banks represent 50 percent of the industry’s total assets versus 23 percent for Captives and 27 percent for Independents. While each group saw a decline in total asset dollars, the Independents drop was the most substantial at close to 21 percent. The net worth of Bank players increased slightly while Captive net worth declined 11 percent. Because of the limited capital resources available to many of them, of greater concern is the 9.4 percent decline suffered by Independents.

As noted earlier, industry assets under management declined by 13.2 percent, a $40 million decline. Independents were responsible for almost $25 million of the total decline. The key components of this were a $8.6 million drop in off balance sheet assets and an $18.7 million drop in net earning assets.

A profitability snapshot **(Figure 15)** shows that Captives lead in pre-tax returns with Independents barely achieving profitability. In fact both the lower 25th percentile of Banks and Independents were unprofitable in 2009. As for expense management, other than in depreciation, Captives show the lowest expense percentages in key categories.

Figure 15



* As a percentage of total revenue

Source: 2010 SEFA, Tables 17a, 19a, 17i

Category	*Low*	*High*
SG&A Expense	Captives- 13.4percent	Independents- 34.5 percent
Debt Provision	Captives- 7.4 percent	Banks- 20.1 percent
Interest Expense	Captives- 28.1 percent	Independents- 36.8 percent

Independents have higher origination-related expenses because many lack the preferred parent relationship that benefits some bank-owned companies and Captives. Interest expense for Independents exceeds competitors because of the high cost of borrowing, particularly for smaller players. The higher debt provision shown by Banks may be indicative of the conservative nature of their internal policies as well as the closeness with which they are regulated.

Concluding Thoughts

Despite a difficult 2009 and continued uncertainty in the operating environment, the equipment finance industry remains remarkably resilient and well positioned to finance the replacement and growth requirements of companies of all size.

While some weaker players, whether Banks, Captives, or Independents, have reduced their activity as a result of the downturn, many equipment finance companies have responded with determination and rigor to address the challenges they face. The net result is a stronger industry, one in which risk management disciplines are enhanced, risk/return tradeoffs are given increased prominence, the marketing focus is sharper than it has ever been, and doing more with less is the expected way of conducting business.

Managing through this environment requires more effective management. Fortunately, the industry has many strong managers across different types and size of organization. Two years ago, this Report concluded by quoting a manager whose words are even more relevant today than they were then: “Our industry will emerge from this period a bit smaller in number but much stronger in fundamentals.” Events of the past 24 months have proven the accuracy of those words.

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