2012
Industry Future Council Report

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye On The Future

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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The Equipment Leasing & Finance Foundation expresses appreciation to the following companies for sponsoring the 2012 Industry Future Council and Report

About the Industry Future Council Report

Each year, the Equipment Leasing & Finance Foundation brings together a group of industry executives to form the Industry Future Council. The IFC is tasked with exploring trends, challenges and opportunities and then evaluating how these issues may impact the equipment leasing and finance business in the next three to five years.

The annual IFC Report summarizes these discussions and attempts to bring into focus what equipment leasing and finance companies may want to consider as they plan for future growth. It is the hope of the Foundation that readers will benefit from the insights of the IFC and use this report as a resource planning tool.

2012 Industry Future Council Report: Vitality vs. Uncertainty

For several years, the Equipment Leasing & Finance Foundation's Industry Future Council (IFC) Report has revolved around some variation on the theme of "uncertainty" and "waiting." Council members were waiting for the economy to rebound, for markets to work bad credits through – or out of - the system, and for the demand-led flow of capital to resume. Or they were facing uncertainty about the health and consequent ripple effects of the commercial real estate markets, new taxes and regulations.

While this Report, summarizing the discussion of the 2012 Industry Future Council that met at ELFA headquarters in early February, cannot break with those themes, it will try to compartmentalize them and place them in context. And it will focus on the core mission of the IFC – envisioning the equipment finance industry its products, markets, customers and operations, three to five years in the future.

The IFC's vision for that future is generally optimistic, and members identified some conditions and trends that point to real opportunities in a variety of sectors over the next few years for companies that have the flexibility to adapt to evolving customer needs.

Furthermore, the conditions seem right for the re-vitalization of what was considered an endangered species just a couple of years ago – the independent equipment finance company.

After nearly four years of hard economic times, ill-defined and burdensome regulatory mandates, and anxiety about the future, equipment financiers are still standing, and still flourishing. "This industry is still vital," declared an IFC member. "It's not as lucrative as it once was, but given the value we've always brought and still bring, we are vital."

The most pronounced conclusion of the assembled industry leaders was an expression of frustration that they cannot rely as much on their honed skills and instincts to position for the future. Financial, business, and commercial experience provide little comfort when the uncertainties are primarily political. And the IFC declared the current reluctance of businesses to invest for growth to be driven by a lack of demand, which in turn, is due to the prevailing uncertainty about the direction politically-driven winds will blow for the rest of the year – both domestically, and in the global markets.

"Modestly Better"

The members of the 2012 IFC represented all segments of the industry – from large ticket transportation to small ticket office machinery. They were manufacturing captives, bank-owned lessors and independents. Some had expansive overseas operations, some U.S.-only, and some were regional.

Consequently, their reports on the markets conditions they are experiencing varied widely. A bank-owned middle market and large ticket player said "Nobody I know feels like it's '06 or '07," before the financial crisis and recession, but he described the environment as "modestly better."

Another bank player agreed, and suggested that at the current rate, his business could return to pre-recession levels by the middle of 2013.

Some segments are healthier than others. Agriculture and transportation stood out as potential bright spots, but largely because people couldn't see them getting any worse. On the other hand, the industrial equipment market is hampered by weak demand, and after-market sales are largely to off-shore buyers. As one IFC member said, "You have 8 million fewer people working today. Disposable income is down." Another said that customers in some segments won't hire or invest because of uncertainty (that word again) about the government's actions. Businesses see artificially low interest rates as indicative of general economic weakness.

Even within segments, company experiences differ. A small independent computer and technology lessor said that the recovery in demand was slow, and most business was normal "replacement" of outdated equipment. By contrast, a captive computer financier said that more than 25 percent of his company's current business was "expansion in the form of both new customers and existing customers growing."

Such growth was not being seen across the board. The IFC generally concurred that markets were slowly improving. Balance sheets are strong and volume is respectable, but in the words of one lessor, "growth looks better among fewer players."

"The flight to quality is easing a bit," reported one member. "Were getting back to normalcy in underwriting and have reached a plateau in credit quality."

Acting Our Age

Is the equipment finance industry a "mature" business? Among the IFC, it depends who you ask.

Some say yes, leasing and finance is well-understood by customers, investors and analysts. Leases have become homogenized and commoditized. Regulation is catching up to innovation and choking off creativity. Companies have become reactive, struggling to keep pace with customers and vendors.

While all that is true to some degree, other IFC members were adamant that the business has a failsafe fountain of youth built right in. "Sure, if you're a money-over-money player, you're mature, and your view of the business isn't very exciting," said one. "But if you have a unique solution and value proposition, you're "youthful" in a business sense and you have plenty of opportunities. If you take our products overseas, you'll find out they're incredibly innovative there."

Maturity, it seems, is a matter of perspective. But as they say, you're only as old as you feel.

But normal is not "business as usual." Historically, leasing companies had grown by shoring up credit risk with asset knowledge and remarketing skill.. "Not anymore," said one IFC member. "When the bottom fell out of the economy, some people found their residual estimates were 30 – 35 percent overstated." Today, as a result, "banks can go further down the credit spectrum" than some traditional equipment financiers, though as an asset class, equipment leases fared better through the downturn than other financial assets.

Others were more bullish on the core competencies of equipment financiers. "The common denominator for successful players has been equipment expertise," one stated. "Banks survived during the last few years because they had a cost-of-funds advantage through deposits. When the capital comes back for the rest of the industry, we'll thrive because we have some skills the banks don't."

That was one of several instances in which IFC members spotted opportunities for various segments and players to "thrive." First, there are hurdles to clear and, yes, uncertainties to get beyond.

On the Sidelines

"If you don't think you're going to be impacted by external forces, you won't be in business long," one IFC member observed. It's a lesson the industry's learned well in the last four years. External forces – a cyclical economy, a meltdown in another financial sector – can play havoc with the most meticulous business plan and harm the most conservative company.

"Big Government is Back" – It was clear that the unpredictability of the political climate and potential government actions remain the greatest sources of external uncertainty for IFC members and, as importantly, their customers.

"Everyone is sitting on the sidelines waiting for the election," one member asserted. "I talk to a lot of large companies, and they're scared to death to hire and spend – they have more money than ever before and yet they're pinching pennies."

The activism of the current administration – most visible in its enthusiasm for the Dodd-Frank financial regulations – is having the opposite effect on the private sector, slowing commerce. Businesses are apprehensive about tax changes and fear even more regulation. "The era of big government is back," added another member, "and it's hurting new business formation." To him, the choice facing Americans is stark: "Are we going back to free-market capitalism, or are we going to stay with this slow growth model." Even if the nation elects a more business-friendly president and congress in November, "it will take two or three years to sort out all the damage that's been done."

Uncertainty over taxes won't ease any time soon either. Members predicted that no federal tax bill would be passed until well into 2013, regardless of which party is in the majority.

The amount of regulation stifles both customers and equipment financiers. "We are professional compliers," said a bank-affiliated member. He noted that uncertainty over the pending Basil II capitalization requirements has capital frozen. "Complying with Dodd/Frank can take 40 percent off your ROE," he added. "This is a paradigm shift. We used to expect 15 percent unleveraged returns." That only 1/3 of the Dodd-Frank regulations have even been written to date, further compounds the uncertainty of regulatory burden, cost and consumption of resources.

The crisis in Europe adds a menacing layer to the unknowns facing the industry. "You may not have operations or a customer overseas," said an IFC member, "but your customer probably does." The interconnectedness of the markets means that European default and subsequent crash would impact the U.S. economy – if the U.S. doesn't incur its own Euro-style crisis first. "The lack of real austerity measures in the E.U. and here will have a big impact on us," said a lessor. Another agreed: "If we want to know what will happen here, we simply need to look at Europe today."

Innovation Stagnation – "We haven't seen much innovation since the recession began in 2008," one industry veteran said. "In previous down-turns we came up with new products and services and showed our resilience. This is the first time I haven't seen that."

Some at the table agreed, blaming the unpredictability of regulators and legislators. "The word 'bank' is considered a four-letter-word on Capitol Hill these days," a bank lessor stated. Also, if you want to draw the kind of attention no one enjoys, just say the word "structure" ' All our creativity is now hurting us. We don't know when some government regulator is going to wake up one morning and decide he doesn't like a product – not just going forward, but even what has already been done."

Another bank lessor agreed, saying, "there are so many unknowns stemming from regulation these days, you can't come up with new product ideas and feel comfortable they will survive."

The industry certainly is no longer the unregulated "wild west" of yore, in which lessors enjoyed latitude to respond to market changes and customer demands quickly and creatively. But the changes don't all have to do with regulation. The narrowing of spreads has left no room for the lease advisors and brokers who commanded large fees, but drove product innovation.

However, some IFC members weren't so convinced there isn't much innovation within the industry. It's just not in product structures. Finance companies are instead focusing on systems efficiency. As one member said, "In this environment, not many people can grow the top line and or take on more risk. But they can invest in operations."

Optimization and streamlining of processes has been a long-term trend, and there was a general sense among IFC members that there was no game-changing product or service innovation on the immediate horizon.

The Who and Where of Opportunity

Perhaps there's currently no Next Big Thing for equipment finance products, but that doesn't mean there aren't plenty of opportunities. The industry may have lost some of its unregulated advantage, but whether it's 1982 or 2012, present a roomful of equipment finance executives with a set of conditions and problems, and watch the wheels start to turn.

Growth Sectors

In 2011, the IFC identified alternative energy and cloud computing as promising sectors for equipment finance. Asked this year to identify the segments that would be in growth mode in three to five years, the IFC said it would be construction, transportation, agriculture, health care and efficiency improvements in non-alternative, traditional energy. It is worthy of note, that on deeper investigation, some of the categories were included because the group felt "it has to improve because it cannot get any worse."

Other areas where IFC members expect growth include commercial airliners, general technology, medical, industrial equipment (subject to economic and political factors), machine tools and office equipment.

On the downside, they cited telecom and copiers as flat or down over the next few years.

Banking on It – In the wake of the financial meltdown, bank-owned companies have borne much of the scrutiny and regulation that stifles the business. It necessarily impacts their conduct, especially if equipment finance isn't the core business.

This has two implications. First, large banks, which a decade ago seemed to be entering the business at an aggressive pace, have slowed their non-organic growth, leaving their former acquisition targets – the regional banks – to establish their own presence in the market. In the words of an IFC member from one of those large regional bank lessors, "The top quarter of banks have really slowed their pace of acquisitions. The industry is still over-banked, but there's a lot of counter balance" to the weight of the banks.

The Case for Captives

"Manufacturers have little incentive to create a captive today." Is that really so? Yes and no, according to an IFC member who's a high-tech captive. "It depends on how robust the manufacturer's balance sheet is, how global they are, and whether they really need financing to sell product."

The real issue facing captives, at least in high-tech equipment, is that manufacturers are moving "toward including software and services, and you can't rely only on your expertise in equipment residuals." Something else facing existing captives recently, according to another IFC member, is "private investors being disruptive, encouraging parent companies to consider selling their financing business."

The high-tech captive grinned and said, " 'Make my day.' That's an argument we'd be happy to have. We provide a lot of value in supporting sales."

IFC consensus was that the captives who succeed over the next three to five years will be "strategic thinkers." They'll position themselves as close as possible to the customer, they'll be able to demonstrate that they understand what the customer really wants, and they'll be a strong component of customer satisfaction and retention.

And there's likely to be more. One member remarked that banks are currently selling assets to private equity firms who are "not necessarily interested in acquiring the finance platform, they just want the assets." (However, given that "structure" is an incendiary word to legislators and regulators, highly structured assets aren't exactly in demand.) That's a trend he expects to accelerate when pending accounting changes are finalized and banks' motivation to sell assets may be even greater.

Another member noted a similar phenomenon in the vendor finance segment. For banks looking to exit that market, "their inclination is to just cut off funding and exit the business." But the vendor is still there, and still needs funding, creating a potential growth opportunity for other entities.

But banks don't have to completely exit a finance sector for their movements to create opportunities for others.

If, as one IFC member said above, some "banks can go further down the credit spectrum" than other players, it's by no means all banks. Another IFC member observed, "There's a lot of liquidity out there, and banks would like to underwrite deals, but the ratings agencies don't like it." Nor do regulators.

Cue the surprising reversal in prospects for:

Independents — Just a few years ago, the IFC talked about the existential threat to the independent equipment finance company. Increasing bank presence and captive market share was squeezing them out. They couldn't compete on cost-of-funds, and product homogenization was devaluing their flexibility. To a bank hungry for market share and new revenue streams, gobbling up a profitable independent was often the most cost-efficient move.

Today, those banks that bought independent lessors still want to deploy money, but they seem more inclined toward funding portfolios, companies, or larger blocks and less inclined toward individual transaction origination, leading one IFC member to say, "we have to ask if bank-owned lessors are relevant anymore." This comment reflected the group's observation that bank influence has continued the migration of the differentiated leasing product toward a more debt-like product. Whereas the traditional "lease" was constructed to achieve accounting, tax and residual optimization, today's portfolios are dominated by "leases" that primarily transfer the risk and reward of ownership to the user, and are therefore less distinguishable from other loan-like product.

"Banks have grown as a proportion of the industry," said another. "But regulators won't let them take risk." On the other hand, "Independents are positioned better than banks to take risks, but they have to get their leverage right."

With more banks interested in lending, and fewer lessors competing for capital, funding shouldn't be an issue for those independents, at least initially.

Another opportunity for independents, according to an IFC member: "Manufacturers have less incentive to create a captive today," due to conservation of capital and the relatively low returns generated through financing. If that's the case, independents and banks should find plenty of opportunity to provide generic or private label vendor financing programs. But not everyone agreed. Another member said that creating a captive "is very much a one-off decision. Some manufacturers are moving away but many are moving towards captive programs."

Inbound Traffic – For many years, when the word "international" was used in relation to the equipment leasing and finance industry people mostly meant companies doing cross-border leasing or expanding their business into foreign markets. However, some 2012 IFC members spied a different kind of international opportunity. Foreign manufacturers – Chinese companies in particular – entering the U.S. will require financing assistance with their inbound products. Given the fledgling nature of leasing in many emerging markets, along with the usual differences in laws, regulation and custom, firms with U.S. market expertise should be well-placed to provide that assistance.

What Customers Want Now

Before the IFC could make assumptions about the needs and demands of customers three to five years in the future, they made sure they had a handle on what customers are demanding right now. For the purpose of this discussion, the IFC differentiated between the universal demands of customers and the "sometimes" demands.

Universal

- Capital
- Low rates
- Fast approval
- Convenience/ease of use
- Flexibility and customization
- Transparency
- Reliability

Sometimes

- Service (install, maintenance, repair)
- Consumables (ink, etc.)
- Use, not ownership (remarketing, tax arbitrage)
- Asset management
- Relationship
- Advice/expertise

Customer Evolution

If independents are to regain major player status in three to five years, they'll have to meet customer demands that have evolved and will keep evolving. The IFC dedicated much discussion to getting a sense of where customers are headed, and how equipment finance will have to adapt to go there with them.

Who Are We? Why Are We Here? – When customers begin the process that eventually leads to an equipment lease or financing – a process that these days probably begins online, whether or not it remains so through the transaction – what are their motivations and expectations? How do they perceive what they need?

These are crucial questions, and they lead IFC members into back-to-basics thinking. "We're here because someone wants a piece of equipment," stated a bank lessor. "No," said an independent small ticket lessor, "they want whatever that piece of equipment does, and they want our help acquiring that capability"

Providers of "financing" are being asked (or expected) more and more to provide a "solution" – a means of financing not just the item of equipment, but the processes surrounding that item's operation. The consequent mixing of services, software, maintenance, and other intangible-but-real costs, creates both challenge and opportunity. While all agreed the B2B acquisition process is increasingly perceived through the lens of the B2C shopping experience, an online market place for equipment finance on the model of Lending Tree for loans – essentially, an Amazon.com for equipment leasing – isn't going to happen anytime soon. Aggregators must build critical mass of either buyers or providers. Until they get one, the other won't happen.

And that seems to be all right with most IFC members. The industry has always resisted being made synonymous with consumer finance. As one member put it, "For finance providers, the Amazon model is the next step toward extinction."

That's not to say the equipment finance market of the future won't in some ways bear a closer resemblance to the consumer market. The IFC saw future customers, be they vendors or end-users, demanding a streamlined experience, including a single touch decision process at point-of-sale, web delivery and self service where possible.

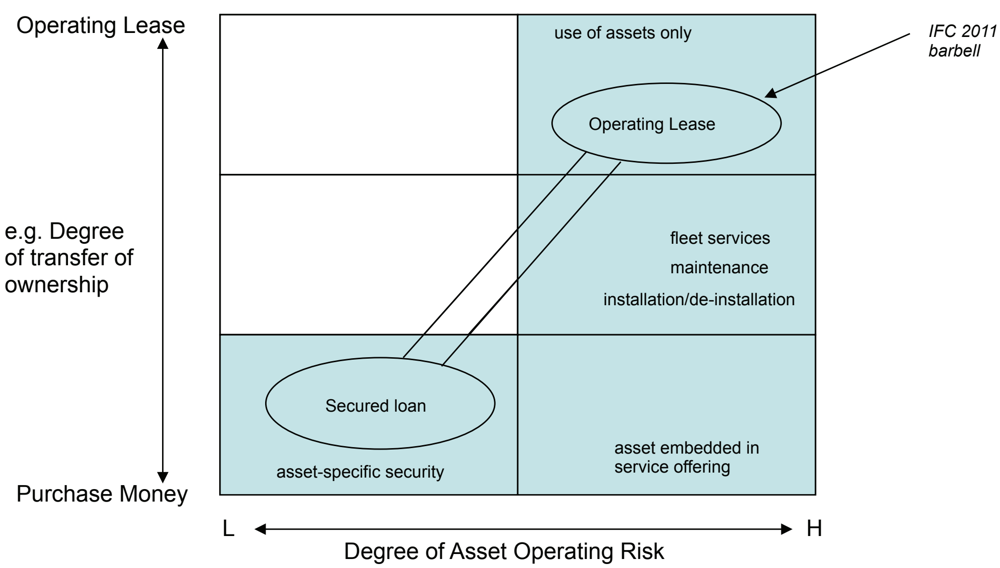
But an IFC member asserted that they'll "continue evolving toward solutions, not necessarily toward consumer models."

"Solutions" was a word that came up again and again. Customers will be looking for "comprehensive solutions," not components. That means "outsourcing the performance risk," in the words of an IFC member. Increasingly, "they want you to take equipment risk, to manage the equipment for them, and charge them for units of output"." Responsibility for knowing and maintaining equipment is shifting from the customer to the finance provider, and it will continue to do that.

In addition, customers want things not traditionally found in financial product offerings. A small ticket vendor finance lessor explained that "vendors are scrambling to be flexible in meeting customer needs, which means we have to be more sophisticated. Much of our portfolio now consists of soft items and intangibles." That de-emphasizes equipment. "It's about building and supporting the relationship between vendor and customer."

Talk of de-emphasizing equipment again cuts to the heart of how equipment financiers see themselves. If equipment is less important, so too is the equipment expertise that's always been a hallmark of the industry. Is it now more about "asset" finance than "equipment?" *(The chart on this page reflects the IFC's discussion of the place of asset management within possible finance company offerings.)*

Introduction of Asset dimension



Potential Section differences:

Competition- Some company types can't operate in some sections

Returns – ROAs vary by service component

Employment – Mix of finance professionals and service professionals differs by section…also some sections headcount intensive, others are capital intensive

Revenue source diversity – Revenue on left depends on spread over cost of funds…Right side incorporates other revenue streams

Examples of "Operating Risk"…varies by Industry Segment::

Fleet Services – More mechanics than HP12 people, risk of bad maintenance schedules and bad repair advice, cars don't perform, customer not getting the utility, service levels missed, customers terminating, assets not holding value, money is lost

Embedded assets facilitate per-unit charges (eg. cost per page, cost per hour, cost per mile, etc.) More IT techs and engineers than HP 12 people, own refurb facilities, risk of techs performing poor refurb, mismanaging inventory, ineffective at remarketing, money is lost

Some see it moving that way. “More and more, vendors are selling total solutions. We’ll have to get away from thinking in terms of the physical product.”

But the IFC wasn’t ready to agree that the term “residual value” will disappear from the lexicon. Indeed, equipment knowledge and asset management are the critical differentiators that create the value-add if not the raison d’être of the industry. “We provide more than money,” declared a lessor. “We sell knowledge, expertise and the ability to take risk.” All that depends on understanding the equipment at the heart of the transaction. “It makes no sense to compete for money-over-money transactions. If someone can come up with money cheaper than we can, we’re gone.” The current trend may make it even more important for the finance-provider to deal with all aspects of equipment essentially “behind the scenes”, offering the customer a “solution” that use of – but not specific identification of – equipment.

The business was founded on offering more than just financing. “I remember talking to customers many years ago,” said a veteran. “I’d tell them, “I can’t sell you money, but I can sell you X,Y and Z. And here’s how X,Y and Z help you: …”

“It’s a challenge to grow new business when the CFO of almost every prospect has a pre-formed opinion of leasing.”

A large bank lessor was adamant about the place of equipment expertise. “Within the bank, we keep leasing distinct. Leasing maintains its distinctiveness through equipment expertise.”

Europe is currently providing a cautionary lesson on the value of equipment knowledge. The European industry is “about where we were at the lowest part of the recession,” in the words of an IFC member. European players’ suffering is exacerbated by the fact that “they never became true lessors. They just made loans with collateral, sold price and undercut the market. Now the banks are trying to sell their leasing businesses and the other money-over-money lenders are going away.”

Conclusion

The 2012 IFC by and large continued the themes of the last several years – waiting for the economy to turn a corner and enduring the uncertainty and strictures of an activist government and anti-business political climate. Because it engages in structured transactions, equipment finance was, in the words of an IFC member, “tarred with the same brush as Wall Street and structured finance.” And because nobody can be sure what sort of punitive regulations and tax provision will be coming from Washington, companies are flush with money and unwilling to employ it.

Hardest hit by regulation and perceptions are banks, some of whom are selling off equipment finance assets and considering the possibility of exiting the sector. That phenomenon creates conditions for the most surprising conclusion of the Council’s discussion: the next few years hold numerous excellent opportunities for independent companies. Whether exploiting foreign companies’ need for U.S. product financing or filling a vendor void left by banks, nimble independents have a chance to thrive in the next several years.

Those independents will have to be flexible and creative in meeting customer needs, adapting to a market in which equipment is just one component of the deal, and figuring out how to fund a portfolio in which services and even consumables are suddenly included among their offerings.

But flexibility and creativity are this industry’s hallmarks, and the source of its historical vitality. They’ll remain so well beyond the three to five years on which the 2012 IFC focused.

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