

State of the Equipment Finance Industry 2013





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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03/OVERVIEW

03

MESSAGE FROM THE CHAIRMAN

04

A YEAR IN REVIEW

06

KEY FIGURES

09/THE INDUSTRY

09

INDUSTRY & GROWTH DRIVERS

11

KEY PERFORMANCE INDICATORS

16

FINANCIAL REVIEW & ANALYSIS

47/THE FUTURE

47

LONG-TERM EQUIPMENT
INVESTMENT TRENDS

53

INDUSTRY SCENARIOS

58/NOTES

58

ACKNOWLEDGEMENTS

59

ABOUT KEYBRIDGE



Message from the Chairman

In an environment of solid performance, but increased uncertainty and competition, the equipment leasing and finance industry continues to find ways to adapt to new and uncertain circumstances and to provide customers with affordable financing and needed business services related to the operation, maintenance, and disposal of capital equipment. The 2013 State of the Equipment Finance Industry (SEFI) report intends to expand on the lessons learned over the past several years, and to help identify emerging trends that will drive the industry forward.

As we reflect on the past year, and look ahead into 2014 and beyond, the state of the equipment leasing and finance industry remains strong. The U.S. economy is improving, business investment continues to grow, and more businesses are leasing or financing equipment. As a result, equipment lessors experienced above-average growth in new business volume and outstanding portfolio performance. In light of stiff competition and narrowing spreads, successful businesses found ways to innovate, grow their market share, and reduce their costs. Maybe the best news from the past year is that many of the “downside risks” and regulatory concerns have, thus-far, had only a moderate impact on the equipment finance industry.



This year’s SEFI report provides a unique look at trends over the past year, identifies key drivers for future growth, and also lays out alternative scenarios for what the world might look like in 5 to 10 years. Industry and macroeconomic data are supplemented with key insights gleaned from interviews with industry leaders to provide a fresh look at Key Performance Indicators for the industry and an attribution analysis of growth achieved by banks, captives, and independents, respectively. Through the detailed analysis that follows in this report, there are several key themes that stand out:

- New business volume outpaced overall equipment investment – a sign that the “propensity to finance” is rising.
- However, recent data indicate that the “equipment investment cycle” may be slowing.
- Portfolio performance is near all-time highs, but is likely to return to normal as approval rates rise.

On behalf of the Board of Trustees, I hope that you enjoy reading this year’s SEFI report and that it adds value to your businesses’ operations and strategic planning. We would like to thank the contributors that made this report possible, as well as those companies and individuals who provided data for ELFA’s Survey of Equipment Finance Activity and the executives who participated in interviews for this report.

A handwritten signature in blue ink, appearing to read "Cameron W. Krueger". The signature is fluid and cursive, written over a light blue horizontal line.

Cameron Krueger
Chairman, Equipment Leasing & Finance Foundation

A Year in Review

In many ways, 2012 marked one of the best years on record for the equipment finance industry. The 2013 ELFA Survey of Equipment Finance Activity (SEFA) reveals several key statistics regarding market conditions in 2012. Most notably, new business volume increased 16.4%, charge-offs fell to near all-time lows, and profitability remained at elevated levels. Key findings from the 2013 State of the Equipment Finance Industry report include:

New business volume growth was robust, but not universal. Industry-specific dynamics (e.g., maturity of the equipment replacement cycle, rent versus lease decisions, and macroeconomic forces) drove equipment demand.

- Data suggest that the propensity to finance increased in 2012 due to continued low interest rates.
- The competitive landscape has gone through major shifts in the past five years. The past 24 months have exhibited signs of a solidification of recent trends.
- Banks are capturing market share, particularly in the large-ticket market segment. However, Banks are also highly active across most asset classes and are looking for innovative ways to drive growth. Captives remain ancillary to their parent companies. Independents are spread broadly across the marketplace and tend to find success in higher risk credits and in value-add services.

The overall availability of capital remained high, the cost of financing held steady at near historical lows, but spreads were tight.

- Relatively high yields and low charge-offs have attracted capital flows – from traditional and nontraditional sources – into the industry. This has contributed to increased competition, a degree of “commoditization” of financing, and lower margins for mostly all organizations.

By any measure, portfolio performance was at an all-time best in 2012.

- This was likely due to multiple contributing forces – more conservative underwriting standards, an improving economy, strong corporate profits, and a self-selection bias as higher quality credits were more likely to access capital markets.
- Interviewees emphasized that they were more conservative on deal structures and in risk management practices.

In addition to growth, finance companies were also focused on balancing productivity while enhancing the customer experience.

- Differentiation remains crucial in an increasingly competitive market, and organizations made adjustments in their business processes to improve their competitive position.

Profitability remained solid and improved by some measures.

- Operating margins were essentially steady from 2011, while Return on Equity has almost quadrupled since 2009.

As this report goes to publication, we just passed the five-year anniversary of the collapse of Lehman Brothers at the height of the financial crisis that spawned the worst recession since the Great Depression. Since the recession officially ended in July 2009, the equipment sector – facilitated by leasing and financing – has been one of the few consistent bright spots in the U.S. economy. Since Q3 2009, business investment in equipment alone has contributed, on average, one-half percentage point to GDP growth each quarter. This compares to a 0.3% average contribution to GDP during the economic expansion from 2002 to 2007. Additionally, investment in equipment and software is at an all-time high both in terms of dollar value and as a share of GDP. Business investment in equipment and software hit an annualized rate of \$1.22 trillion dollars (real dollars) in the second quarter of 2013, and has been responsible for 7.8% of GDP in each of the past 3 quarters.

Macroeconomic and industry data suggest that 2013 will be a transitional year for the equipment leasing and financing industry. Additionally, our forecasts and projections show that 2014 may be marked by slower growth and tighter margins.

Thus far in 2013, new business volume is down on an annualized basis according to the monthly MLFI-25 survey. Additionally, many interviewees reported that certain asset types and end-user industries have been experiencing slower growth lately. Portfolio performance remains at an all-time best. However, as lower-grade credits eventually re-enter capital markets, there is reason to believe that there could be some upward pressure on delinquency rates beginning in the coming years. The equipment replacement cycle that propelled growth between 2010 and 2012 is fading, and there are few if any growth drivers amidst a stubbornly modest economic recovery. Businesses continue to invest in equipment and software, but growth is decelerating.

Competition is likely to remain strong, which will compress spreads in the coming years. Additionally, what is likely to be a rising interest rate environment could lead to an erosion of net interest margins. Accordingly, there is a growing possibility that 2014 will be marked by relatively slow growth and weaker profitability. In this environment, companies with strong fundamentals, perceived value in the market, and high operational efficiency will compete for market share and search for pockets of growth in the industry. Economy-wide trends in the six main equipment verticals – agriculture, construction, computers & software, medical, industrial, and transportation – will play out to varying degrees.

Regulatory uncertainty continues to worry business leaders.

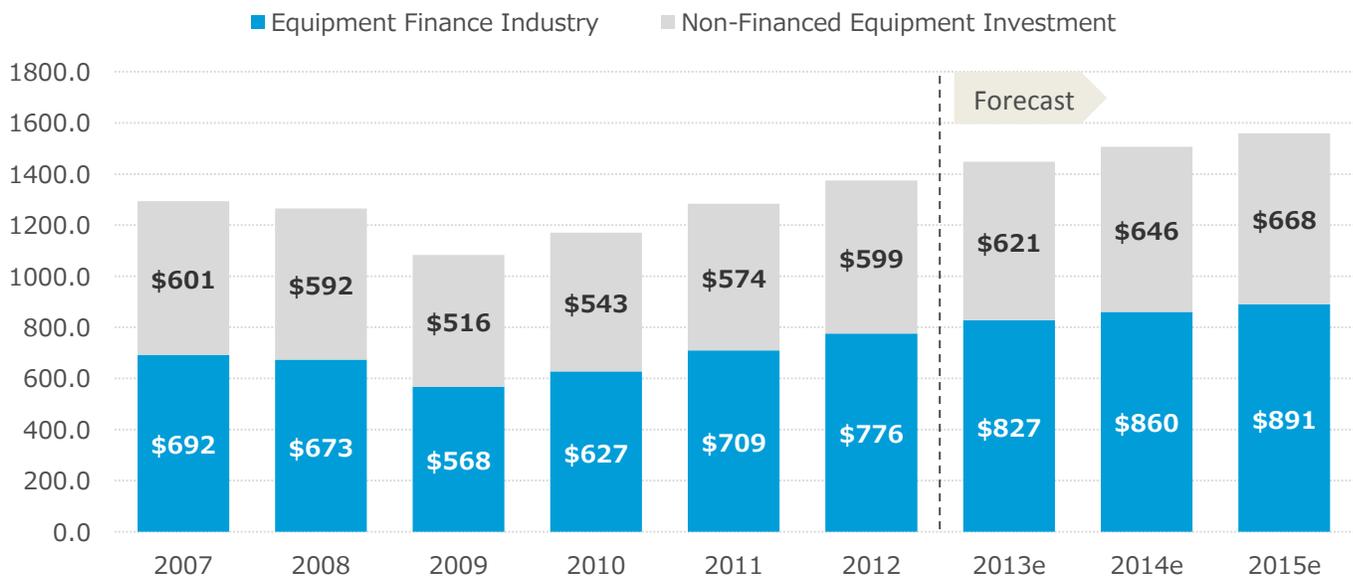
There remain many unanswered questions regarding fiscal and monetary policy, financial sector regulations, and lease accounting rule changes. Over the past several years, regulatory and policy uncertainty has stunted growth. Looking ahead, there are reasons to be both optimistic and pessimistic. On one hand, the financial sector is slowly but surely gaining clarity on the size and scope of proposed regulations. On the other hand, at the time this report went into publication, there was heightened uncertainty over both fiscal and monetary policy. Additionally, changes to lease accounting rules have been an issue for the equipment finance industry for many years, and it is still unclear whether new rules, if any, will be implemented in the next several years.

Strong Growth & Record-Setting Performance in 2012

Amidst an uncertain macroeconomic and policy environment, 2012 was a solid year for new business volume, portfolio performance, and operating results. Industry growth was strong, as new business volume increased 16.4% – about the same rate as in 2011. The industry continued to grow most notably for the transportation sector, which represented over one-tenth of new business volume. However, growth was uneven across asset classes. Portfolio performance reached an all-time best in 2012, as delinquencies and defaults fell to historical lows for many verticals and product types. Across the spectrum of business models, equipment financing companies continued to search for ways to improve productivity; these efforts paid off in solid profitability despite a squeeze on spreads. Overall, in 2012 the equipment finance industry demonstrated its resiliency as a source of capital for the business sector and as a growth engine for the U.S. economy.

Equipment Finance Industry Size

(in billions of dollars)



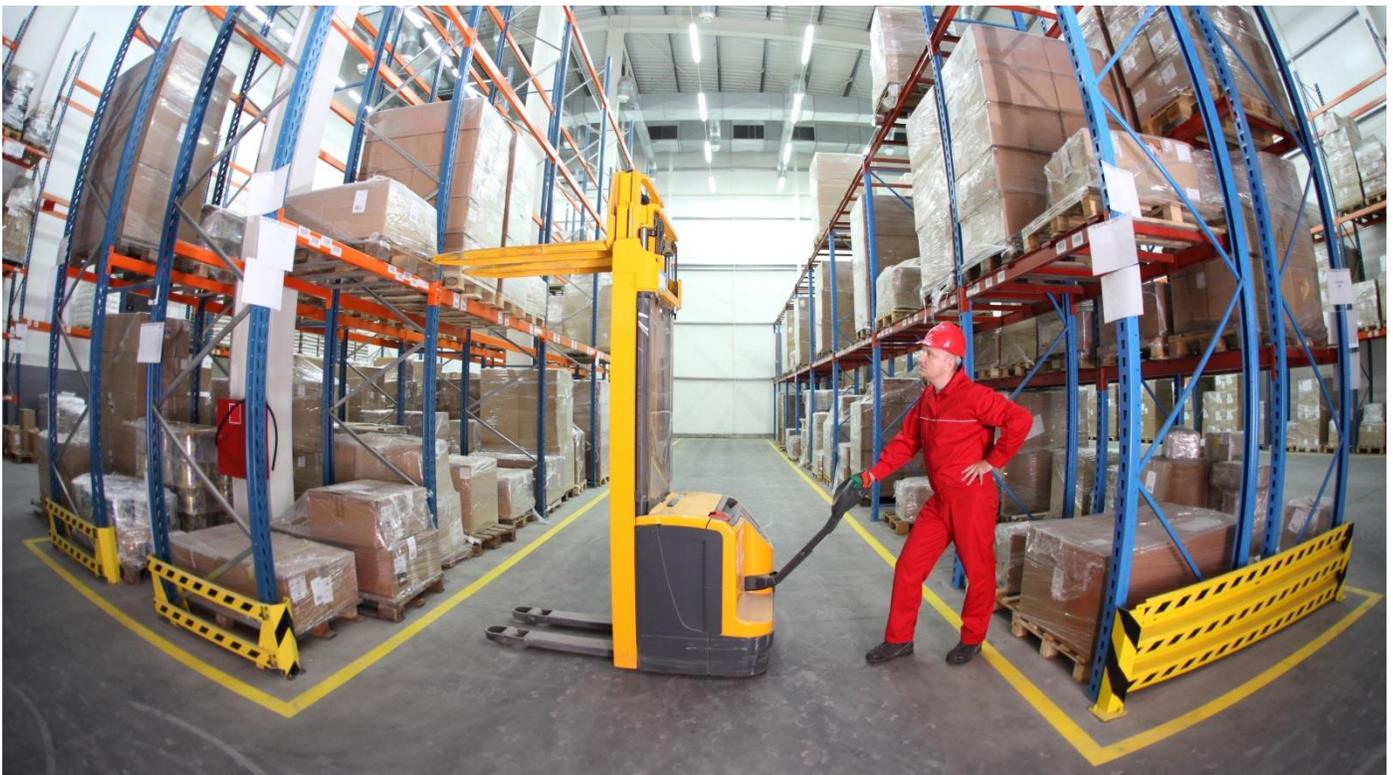
Sources: 2012-2013 ELFA U.S. Equipment Finance Market Study, Keybridge Research LLC

Why have the industry size figures changed since the 2012-2013 U.S. Equipment Finance Market Study (“Market Study”)? The size of the equipment finance industry is estimated based on businesses’ propensity to finance their investments in equipment and software. This “propensity to finance” is estimated from a survey of U.S. businesses’ capital spending and financing activities. As of 2012, the economy-wide propensity to finance equipment and software was estimated to be approximately 56% – i.e., \$0.56 out of every dollar of equipment and software

investment is leased or financed. To estimate the size of equipment finance industry, the propensity to finance is multiplied by total equipment and software investment.

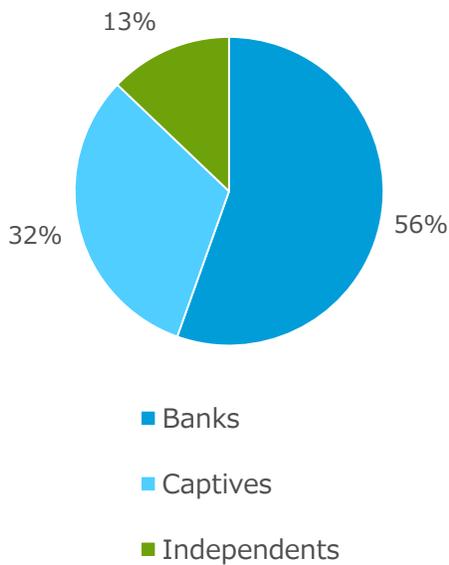
Total equipment and software is taken from the Bureau of Economic Analysis' ("BEA") measurement of U.S. Gross Domestic Product, which includes equipment and software investment for the private and public sectors. BEA continuously revises its GDP estimates, including investment figures, as new data is made available. As a result, one of the two major components of the equipment finance industry sizing formula changes on a regular basis. Since the Market Study was published, equipment and software investment has undergone a series of significant revisions, including benchmark revisions in July 2013. Every five years, the BEA conducts comprehensive benchmark revisions to the National Income and Product Accounts data. The revisions include both the re-categorization of some of the types of investment expenditures and benchmarking estimates to more current dollars. In the latest benchmark revisions, private fixed investment in equipment and software decreased compared to the figures used in the latest ELFF market sizing study.

The net result of BEA's recent revisions has been an increase in equipment and software investment. When the Market Study was published in 2012, nominal equipment and software investment was estimated at \$1,280 billion. Final BEA data for 2012 show nominal equipment and software investment of \$1,374 billion for private and public sectors, an increase of 7.3%. The Market Study's propensity to finance was estimated by an independent survey of businesses' financing activities and is therefore assumed to be applicable to BEA's revised equipment and software data. Accordingly, the equipment finance industry is estimated to have also increased 7.3%, to \$776 billion in 2012. Based on data for the first half of year, the equipment finance industry is estimated to be \$827 billion in 2013.

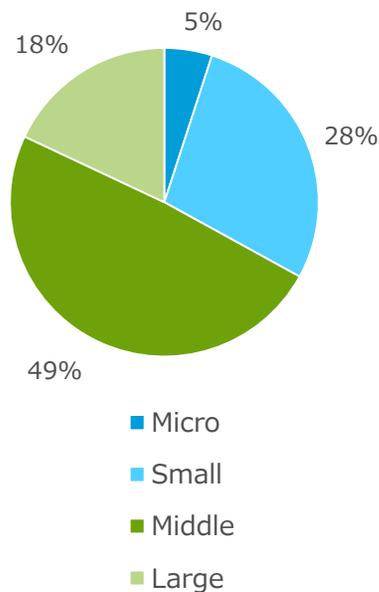


New Business Volume (percent of total)

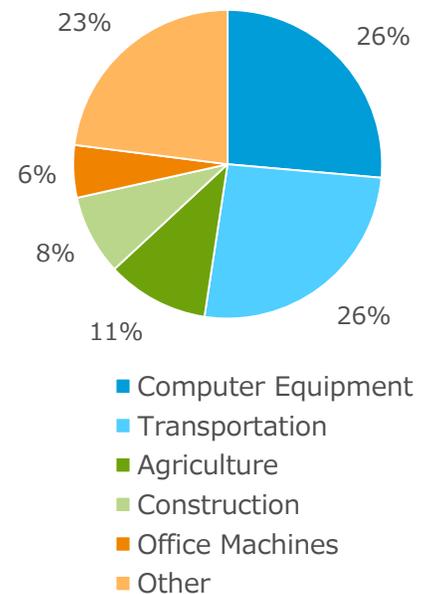
By business model



By ticket size



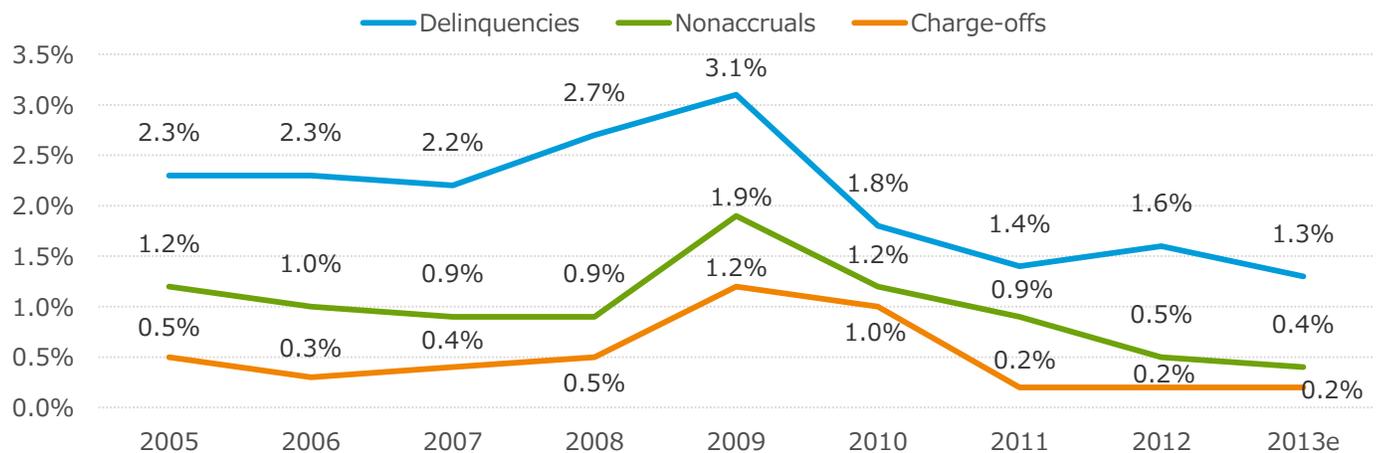
By equipment vertical



Sources: 2013 ELFA Survey of Equipment Finance Activity

Portfolio Performance (percent of assets; median)

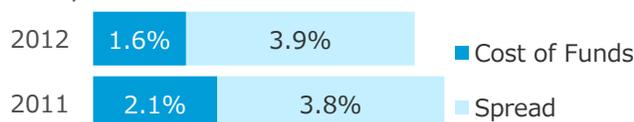
Industry wide



Source: 2008 & 2013 ELFA Surveys of Equipment Finance Activity

Yield & Funding (percent; median)

Industry wide



Source: 2013 ELFA Survey of Equipment Finance Activity

Operating Profit (percent of revenue; median)

Industry wide



Searching for Growth Amidst Uncertainty

Equipment and software investment, leasing, and financing have enjoyed solid growth over the past several years for multiple reasons, including a recovering U.S. economy, the emergence of domestic unconventional oil and gas production, the nascent housing recovery, and continued growth in demand for information technology. However, growth has not come without challenges, nor has it been even across all market segments. Economic and political uncertainties have hampered growth in some sectors, and a challenging regulatory environment has constrained the financial services sector. Overall, the equipment finance industry has exhibited solid performance and demonstrated its ability to adapt to new circumstances. The industry will be tested again as it faces new challenges in the coming years.

Modest but steady macroeconomic growth helped generate strong demand for equipment, machinery, and software in 2012. In 2012, equipment finance grew at a rapid pace. Equipment investment rebounded following several years of deferred capital spending. A favorable interest rate environment enabled businesses to finance their investments at historically low costs. Solid credit quality and portfolio performance as well as increased productivity have sustained industry profitability.

2013 is shaping up to be a good year for portfolio performance, but growth appears to be slowing. The latest MLFI-25 data show that losses as a percent of net receivables has averaged just 0.33% so far in 2013, a 9-year low. However, equipment and software investment is growing slowly, and equipment finance new business volume is down 3.0% on an annualized basis compared to 2012. These trends suggest that the propensity to finance is waning slightly this year.

Future growth may slow, as the Equipment Investment Cycle may be near a peak. Following the 2008-09 recession, the equipment investment cycle moved through several phases. During and immediately following the financial crisis, businesses either deferred capital investments or invested sparingly in new assets in order to drive worker productivity and shore up profits. These actions helped support investment in productivity-enhancing equipment such as software, a sector that enjoyed 20–30 percent growth in the aftermath of the recession, but has slowed over the last 6 months.

As the economy stabilized and growth resumed, businesses grew more confident and replaced older equipment. Subsequently, the replacement cycle has been ongoing across many equipment verticals and, in some markets, particularly transportation equipment, demand is beginning to subside as the replacement cycle nears completion. Additionally, capacity utilization has remained below 80%, which suggests that businesses are unlikely to expand production capacity in the near term and consequently will not require significantly more equipment.

Total equipment and software investment recently reached 7.8% of GDP, an all-time high. Investment has approached this level only twice before: Q3 2000 and Q1 2008. In both instances, recessions followed shortly

thereafter and equipment and software investment decelerated more rapidly than the overall economy. While not a recession signal, the ~8% “equipment & software ceiling” suggests that the equipment investment cycle is moving into its third phase — maintenance — during which equipment investment is likely to grow at or below the rate of the overall economy. Over the past 20 years, real GDP has averaged 2.6% year-over-year growth, while equipment and software investment has averaged 6.4% growth (about 2.5 times GDP growth). The implications of transitioning to a slower growth plateau are important for the equipment finance industry. For example, given the intensely competitive environment, slow overall industry growth could lead to further commoditization of equipment financing, tightening of financing spreads, and an increased emphasis on value-add services.

Pockets of growth can be found in certain industries. Energy is expected to remain a significant boost to both the economy and the equipment finance sector. Traditional and “unconventional” oil and gas production have been a boon for the mining sector and related sectors, driving investment in mining, transportation (both marine and ground), and construction. Additionally, the benefits of low natural gas prices are spilling over to downstream industrial sectors – the U.S. is already seeing large-scale investments in natural gas-intensive manufacturing which will spur job growth and equipment demand over the next 3 to 5 years. Meanwhile, demand for software and technology equipment should remain strong, but demand for transportation equipment is expected to slow as the replacement cycle matures.

Multiple sources of uncertainty continue to weigh on the economy and equipment finance sector. When will the Federal Reserve begin tapering its monthly bond purchases? How quickly will interest rates rise in response? Will the U.S. be able to solve short- and long-term fiscal issues? Will there be a renewed push for comprehensive tax reform? How will the Affordable Care Act affect the economy and the health care sector? Will federal spending be cut? If so, by how much, and in which areas? Will federal or state governments heavily regulate the oil and gas industries, particularly with respect to horizontal drilling and hydraulic fracturing? Will the Consumer Finance Protection Bureau turn its attention to small business leases? Will new lease accounting standards finally be implemented, and if so, how will they impact demand for equipment finance?

These are just some of the unknowns creating uncertainty for the equipment leasing sector and broader economy. Recent surveys (e.g., Q3 2013 Business Roundtable CEO Economic Outlook Survey¹) indicate that businesses are reluctant to make big capital investments until they gain a clearer view of the future policy and regulatory environment. This has had a dampening effect on overall equipment demand and equipment finance volumes in 2013. Moreover, equipment finance companies have become more conscious of increased regulations, and in some cases they have changed their business models in order to adapt to this new environment. If regulations become too burdensome, there is a risk that access to capital could become constrained in certain market segments, particularly for small businesses and lower-quality credits.

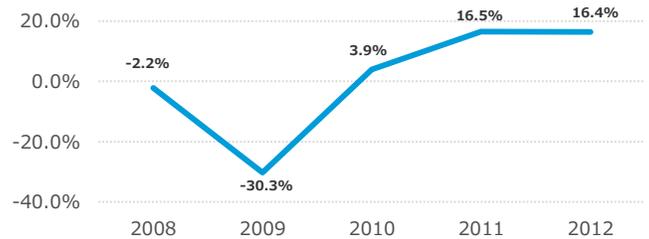
Key Performance Indicators

All data sourced from the 2008-2013 ELFA Surveys of Equipment Finance Activity

New Business Volume Performance Indicators

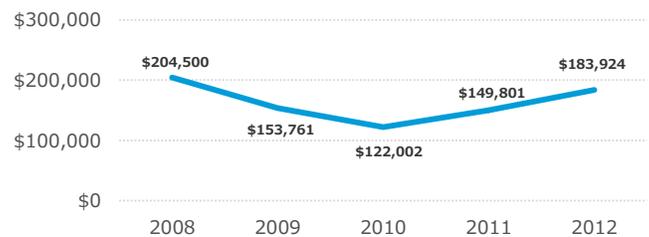
Growth in New Business Volume

Growth eased slightly over the past year yet remains well above levels seen over the past five years.



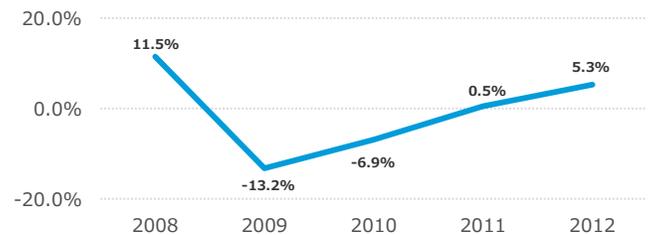
Median New Business Volume Per Lessor (\$000s)

Despite dropping during the economic downturn, median new business volume has almost recovered to its pre-recession level.



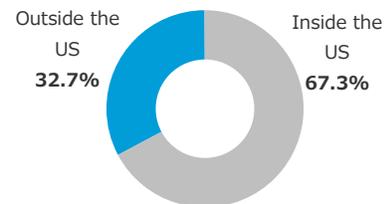
Growth in Assets under Management

Assets under management have seen positive growth over the past two years.



New Business Volume Originated by Region

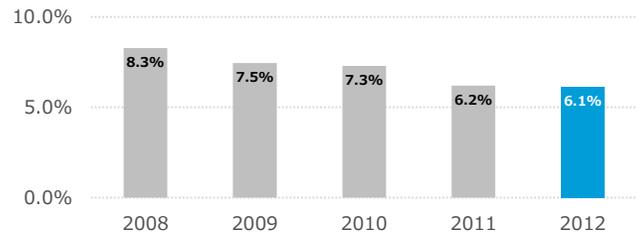
Almost one third of SEFA respondents sourced new business outside of the United States.



Yield and Funding Performance Indicators

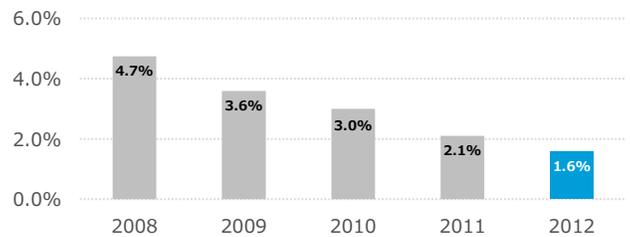
Pre-Tax Yield (median)

Yields have steadily declined since 2008.



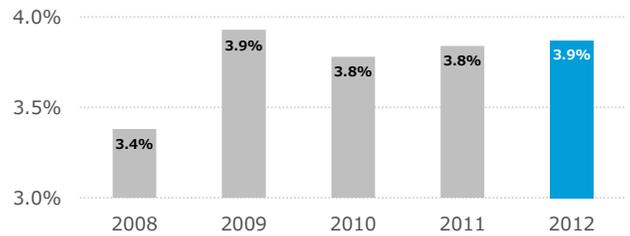
Cost of Funds (median)

Costs of funds continued to decline amidst the low-interest rate environment.



Pre-Tax Spread (median)

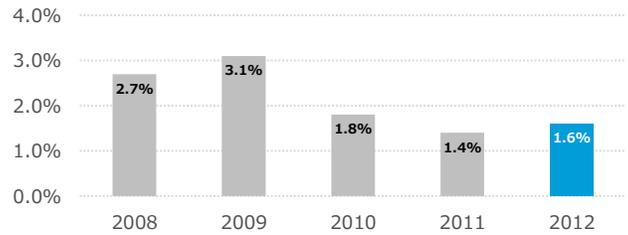
Spreads have been relatively flat over the past three years.



Portfolio Performance Indicators

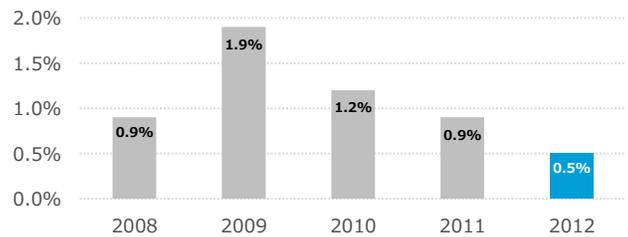
Delinquent Portfolio Over 30 Days (weighted average)

Delinquencies ticked up slightly from the previous year, but remain relatively low.



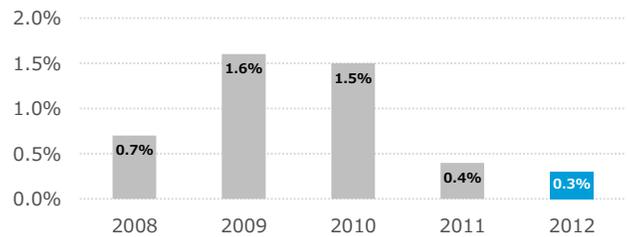
Non-Accrual Assets as a Percent of Receivables and Non-Accrual Assets (weighted average)

Nonaccruals are at a five-year low.



Net Full-Year Loss (Charge-Off) as a Percent of Full-Year Average Receivables (weighted average)

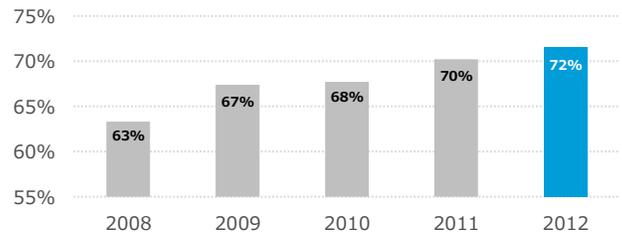
Charge-offs have declined over the past three years after spiking in 2009.



Business Processes Performance Indicators

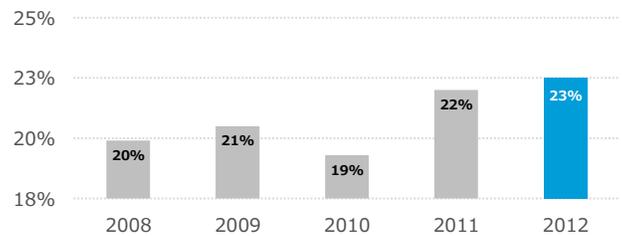
Applications Booked & Funded/Sold as a Percent of Approved (based on \$ amount)

Business productivity has improved in terms of booking contracts



Residual or Salvage Position as a Percent of Original Equipment Cost

Residual values are steadily increasing after a low in 2010



New Business Volume per Full-Time Equivalent (FTE)

New Business Volume per FTE has returned to pre-crisis levels.



Sales, General & Administrative Expense per Full-Time Equivalent (FTE)

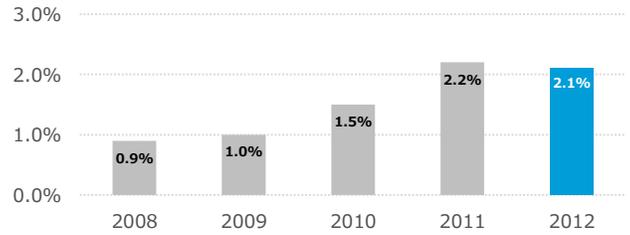
Expenses per FTE continue to decline and are at a five-year low.



Financial Performance Indicators

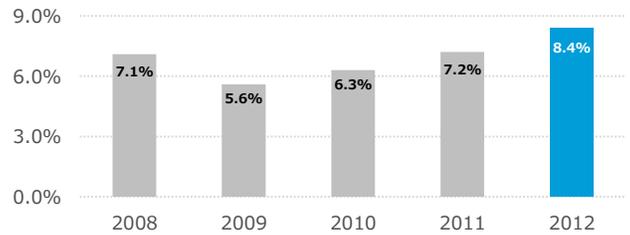
Return on Average Assets (median)

Despite ticking down slightly from 2011, return on assets is still well-above recent levels.



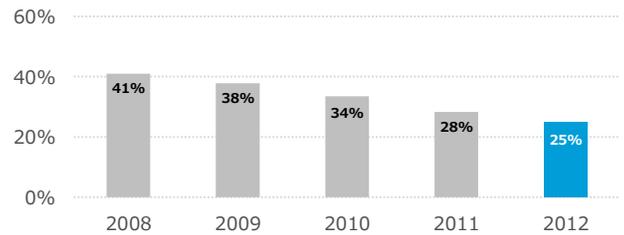
Sales & Marketing Expense as a Percent of Total Revenue (median)

Sales and Marketing expenses have steadily increased as a percentage of total revenue.



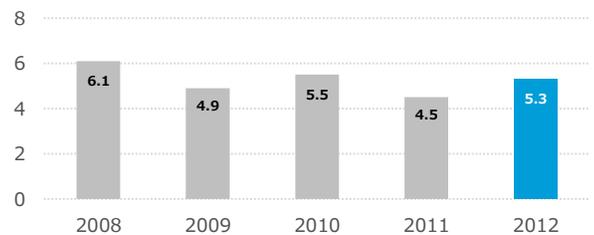
Interest Expense as a Percent of Adjusted Revenue (median)

Due to low costs of funds, interest expenses have declined as a percentage of adjusted revenue.



Debt to Equity (median)

The corporate sector deleveraging cycle is mostly finished, and some companies are taking on more debt.



New Business Volume

In 2012, growth in the equipment leasing and finance industry continued to outpace the overall U.S. economy. Total new business volume increased 16.4% while nominal GDP grew 4.6% and nominal equipment and software investment increased 8.1% over the same period. Banks were generally better positioned to benefit from rapid new business volume growth in the large-ticket market and, as a result, outpaced the industry average and grew at more than twice the rate of Captives and Independents. New business volume growth was driven by end-users in the transportation, utilities, services, and mining sectors. Similarly, transportation and mining equipment were among the fastest growing asset types. Through August 2013, annualized new business volume is slowing compared to 2012 levels. Both short-term leading indicators and longer-term cyclical trends suggest that the equipment finance sector may continue to slow over the next 12–18 months.

Thousands of Dollars or Percent	Industry	Banks	Captives	Independents
2012 Median New Business Volume	\$183,924	\$386,785	\$215,720	\$91,865
Growth in Total New Business Volume, 2011-2012	16.4%	22.2%	10.8%	7.4%
Growth in Assets Under Management, 2011-2012	5.3%	7.3%	6.5%	-0.9%
Five Year Growth in Median NBV	23.6%	37.6%	-15.4%	-3.0%

Source: 2013 ELFA Survey of Equipment Finance Activity

Total equipment and software investment has fully rebounded from the 2008-09 recession. In 2012 Q1, total real equipment and software investment reached an annualized rate of \$1,176.6 billion, exceeding the pre-recession peak of \$1,158.3 billion in 2007 Q4. As of 2013 Q2, real equipment and software investment totaled \$1,226.7 billion — nearly 6% higher than pre-recession levels.

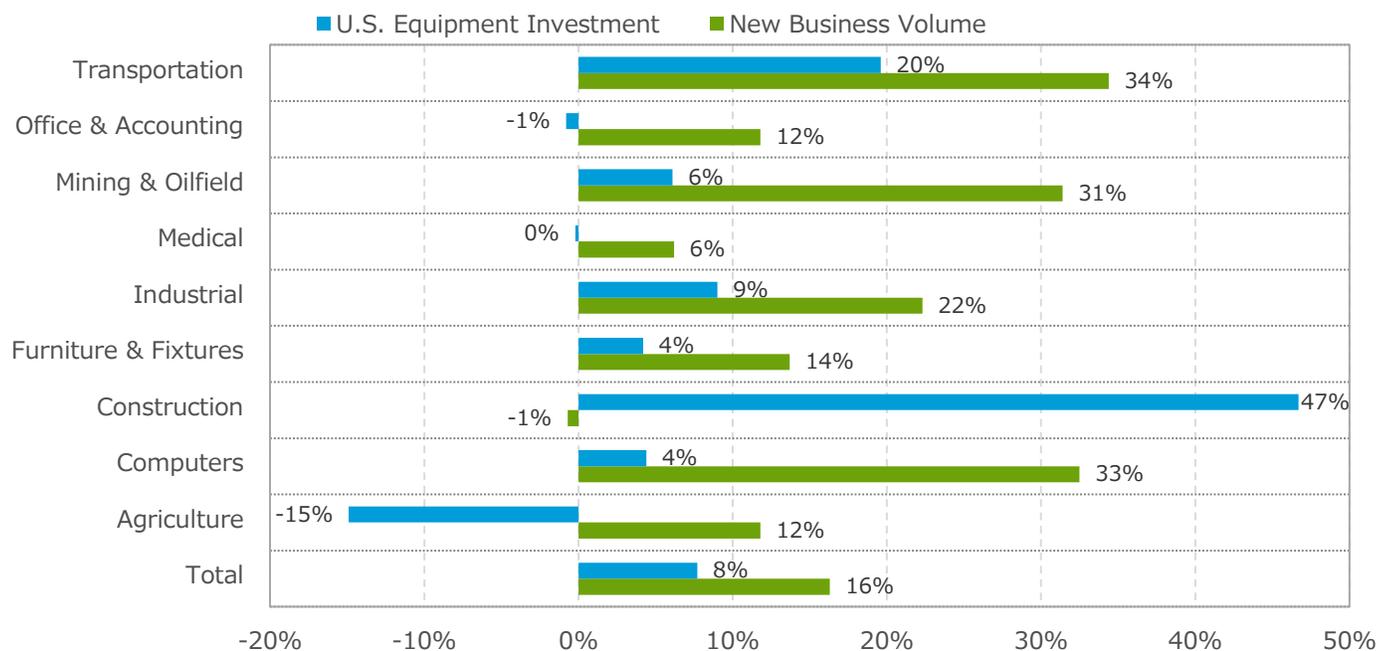
Equipment and software investment experienced strong overall growth in 2012, driven by mixed results across asset types. Growth was led by transportation and construction equipment, which posted 30%–40% annual growth rates throughout 2012. In the context of a relatively weak economic recovery, strong growth in these asset categories suggests that they are in a replacement cycle. However, some other major asset types have been growing more slowly or even contracting. For example, since 2010, medical equipment and agriculture machinery investment have averaged 2.0% and -8.1% annual growth, respectively.

Growth rates across nearly every major asset type have decelerated over the past several years. Total equipment and software investment grew 2.9% year-over-year in 2013 Q2, the slowest annual growth rate since 2009 Q4, and well below the long-term average growth rate of about 6.4%. According to the latest MLFI-25, new business volume for equipment finance is down about 3% on an annualized basis.

The propensity to finance increased for most asset classes in 2012. An analysis of SEFA and the Bureau of Economic Analysis’s total equipment investment figures reveals several interesting nationwide trends regarding the propensity to finance. In particular, growth in new business volume outpaced BEA’s equipment investment figures for transportation, mining, and amusement assets. These data suggest that end-users were more likely to finance these equipment types than in previous years.

Equipment Finance Penetration

(2012 annual growth rate)



Source: 2013 ELFA Survey of Equipment Finance Activity, Bureau of Economic Analysis

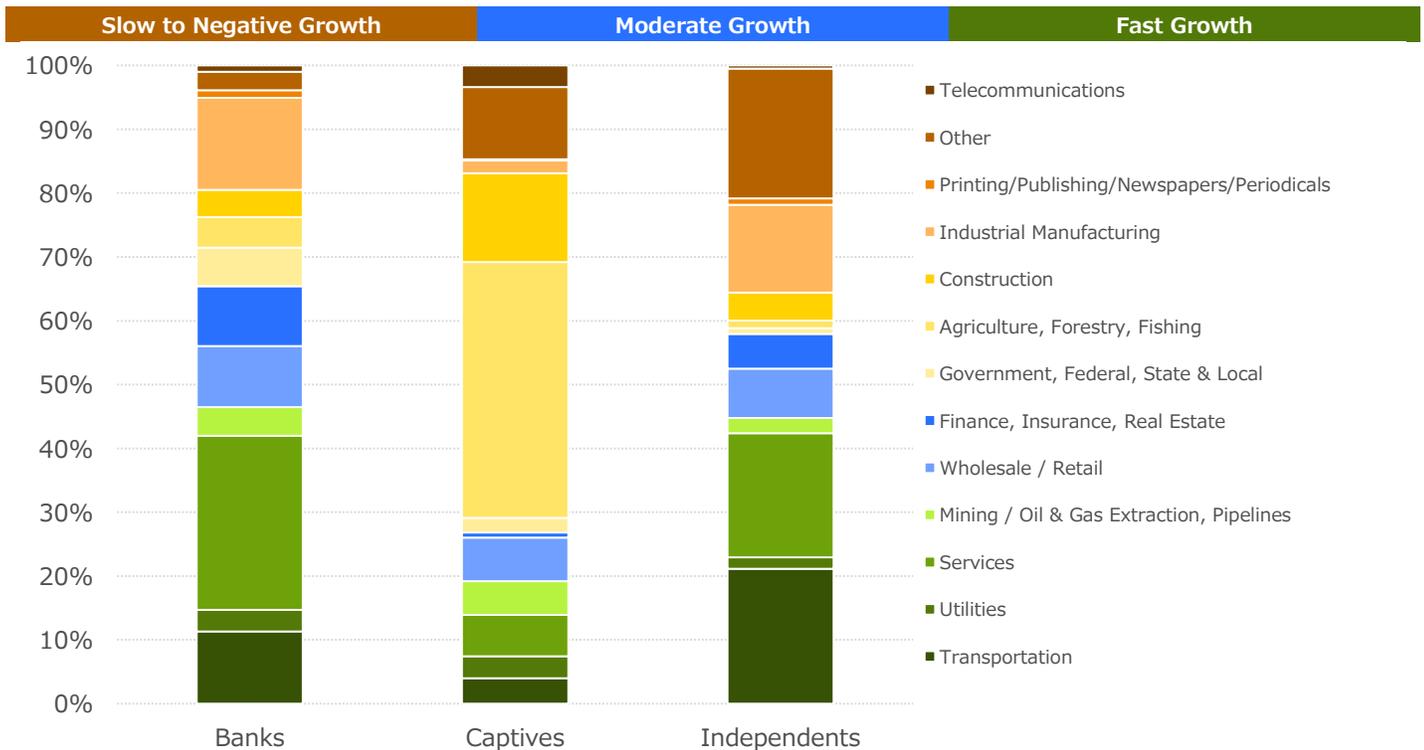
Banks’ mix of business propelled their growth past industry peers. Banks’ new business volume continued to grow at a rapid pace, exceeding 19% annual growth for the second straight year. Banks grew faster than Captives and Independents for the first time since 2008, driven by superior market shares in the fastest growing market segments and presence diminished profile in slower growing segments. For example, Banks had the highest market share of large-ticket transactions, which was the fastest growing segment of the industry. Captives’ new business volume growth has showed remarkable consistency, increasing 11% for the third consecutive year. Independent finance companies experienced a deceleration in new business volume growth after being the industry leader in 2011. Business volume for Independents declined sharply during the 2008-09 financial crisis, and this segment has yet to fully attain the annual new business volume they achieved prior to the recession.

New business volume was strongest for the transportation, utilities, and manufacturing industries. By end-user industry, new business volume increased the most for the Trucking industry (62%), Utilities (36%), and Metal/Machinery Manufacturing (26%). Strength in the Trucking industry was a plus for Independents, as it made up 17% of their 2012 new business volume, but it did little for Captives, for whom Trucking made up less than 4% of their portfolio. Banks and Independents were both able to benefit from growth in new business volume for the Metal/Machinery Manufacturing sector, with 8% of Banks’ portfolios and 5% of Independents’ portfolios going to the sector. New business volume decreased the most for the Federal Government (-41%), Telecommunications (-26%), and Air Transportation (-8%). The drop-off in investment from the Telecommunications sector had a noticeable negative effect on Captives, given the large share of their portfolio (6.3%) devoted to the sector in 2011.

End-Purchaser Growth Attribution

(percent of new business volume)

Note: Each column represents the composition of new business volume by end-purchaser. The color-coding refers to the pace of growth for each end-purchaser. For example, Independents had a relatively large share of new business volume from the transportation industry compared with Captives, which grew significantly faster than new business volume from the telecommunications industry.



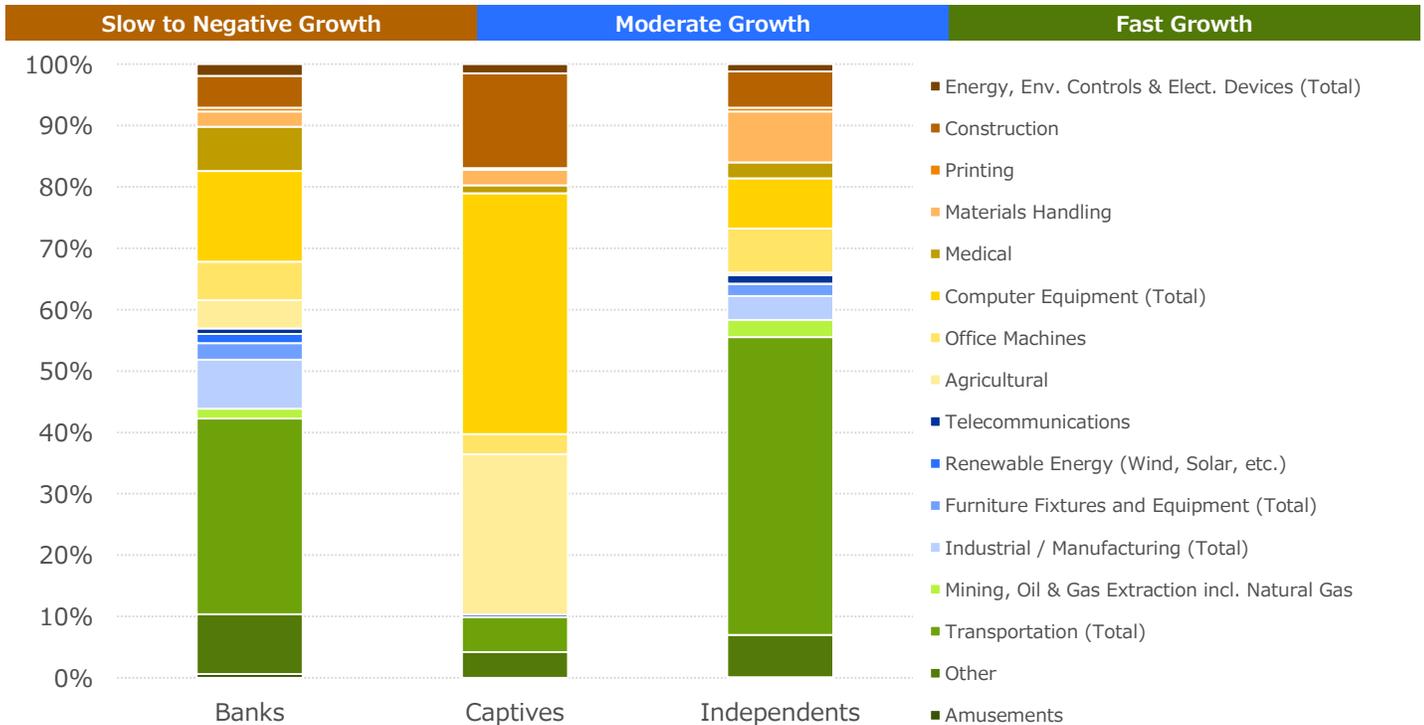
Source: 2013 ELFA Survey of Equipment Finance Activity, Keybridge Research

Among asset types, new business volume was strongest for amusement, transportation, and mining equipment. By equipment vertical, amusements (40%), “other” (38%), transportation (34%), and mining (31%) equipment were top performers. Banks and Independents capitalized on these rapidly accelerating asset types, while Captives – which are beholden to their parent companies – generally operated in slower-growth markets, including computer (8%), agriculture (12%), and construction (-1%) equipment.

Equipment Vertical Growth Attribution

(percent of new business volume)

Note: Each column represents the composition of new business volume by equipment type. The color-coding refers to the pace of growth for each equipment type. For example, Independents had a relatively large share of new business volume in the form of transportation equipment compared with Captives, which grew significantly faster than new business volume in the form of construction equipment.



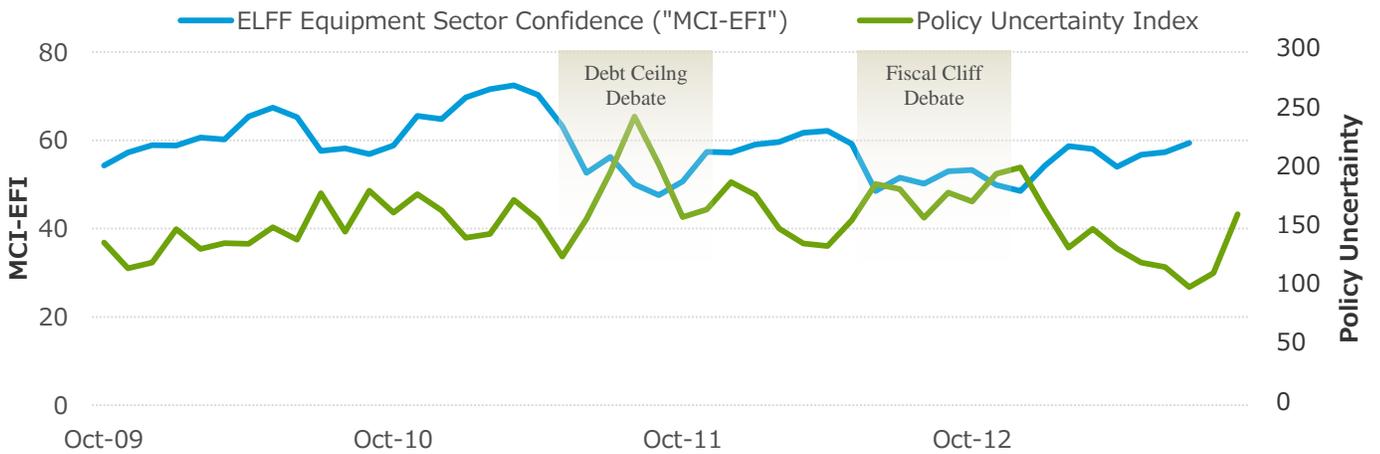
Source: 2013 ELFA Survey of Equipment Finance Activity, Keybridge Research

Industry leaders have mixed emotions about future growth prospects. Although new business volume saw healthy gains in 2012 and while 2013 is shaping up to be another strong year for growth, industry leaders are concerned about an unusually wide array of economic and regulatory uncertainty. Indeed, the chart on the following page shows that the Equipment Leasing & Finance Foundation’s Monthly Confidence Index of the Equipment Finance Industry (“MCI-EFI”) is negatively correlated with policy uncertaintyⁱⁱ. Uncertainty subsided during mid-2013, but jumped in September due to monetary and fiscal policy issues. There is a general sense that politically-charged roadblocks are curtailing business fixed investment, and in turn slowing growth in the equipment finance industry.

The Manufacturers Alliance for Productivity and Innovation (“MAPI”) released a report in August that highlights these concerns – 83% of MAPI members predict that the Affordable Care Act is having or will have a negative impact on economic growth in 2013; 79% think that U.S. tax policy is a drag on growth, and 74% believe that “other” regulatory pressures are hurting growthⁱⁱⁱ. Moreover, regulatory uncertainty has reportedly caused some equipment finance companies to curtail lending, alter the products they offer, or avoid some market segments altogether. In general, the consensus view is that recent growth has been fueled by the equipment replacement cycle, but with that source of momentum dissipating, further expansion of capital spending programs may be difficult to justify in an environment of slow growth and persistently high uncertainty.

Policy Uncertainty and Industry Confidence

(index values)

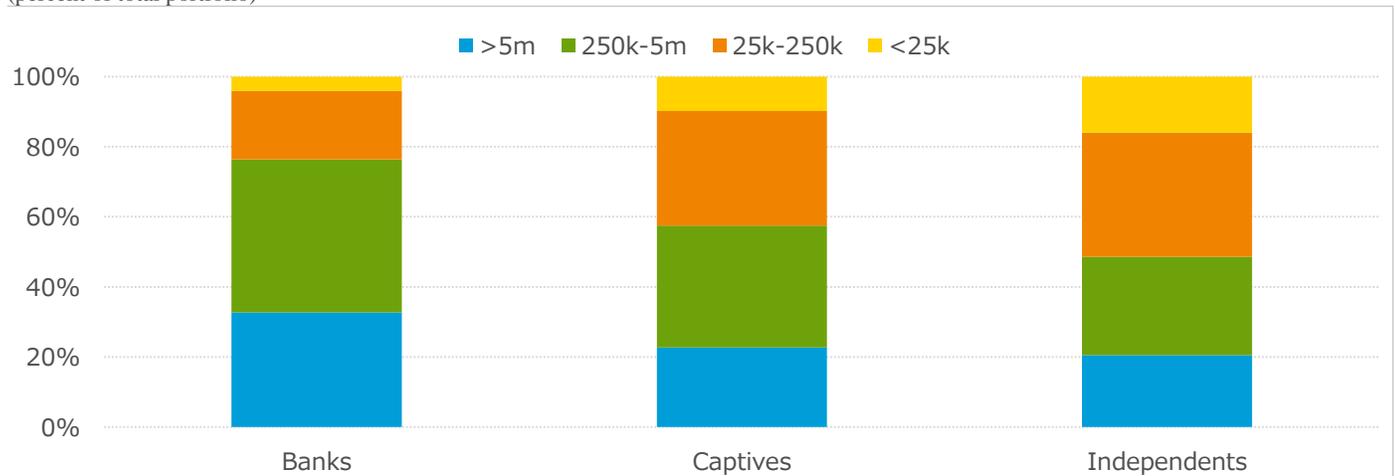


Source: ELFA, Haver Analytics

Growth in new business volume increased with transaction size. The middle-ticket market (transaction size between \$250,000 and \$5 million) grew 16%; small-ticket (transaction size between \$25,000 and \$250,000) saw 13% growth; and the micro-ticket market (transaction size less than \$25,000) contracted by 5%. These rates compare weakly with a 31% increase in new business volume in the large-ticket market (transaction size greater than \$5 million). The reason for the disparity appears to be the comparative lack of confidence held by smaller firms, which represent the smaller-ticket markets. According to the NFIB Small Business Optimism Index, optimism fell in 2012, with the Index decreasing 6.3% through the year, after averaging a 2.3% increase over the prior three years. Meanwhile, larger firms are relatively more confident and have continued to spend.

Share of Portfolio by Transaction Size

(percent of total portfolio)



Source: 2001-2013 ELFA Survey of Equipment Finance Activity

Organizations that were able to capture market share in the fastest-growing market segments outperformed the industry as a whole. For example, Banks' relatively strong growth is attributed to an overweight allocation of large- and medium-sized ticket deals. By end-user industry, Banks benefited from a relatively large percentage of new business from the services and transportation industries. Additionally, Banks were underweight industries with subpar growth; for example, Banks largely avoided end-users in the "other" category, which dragged down growth for Independents. Conversely, Independents experienced the slowest growth in 2012 new business volume, which can be attributed to an overweight in small- and micro-ticket transactions, which grew at a relatively slow pace. Meanwhile, the largest share of Captives' new business volume came from the agriculture, forestry, & fishing industry, which experienced average growth in 2012.

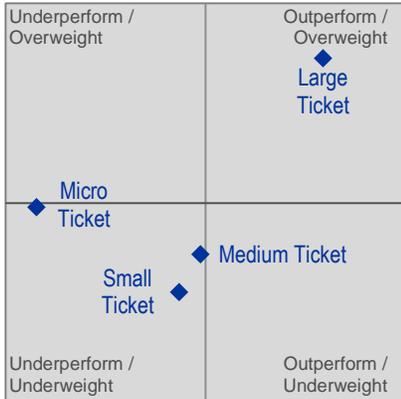
The charts below attribute the relative growth rates of Banks, Captives, and Independents across three factors – ticket size, equipment type, and end-user industry. The charts display each organization type's relative weighting in sectors that either grew faster or slower than the industry average of total new business volume (16.4%). For example, large-ticket transactions made up 32.7% of Banks' new business volume in 2012, compared to the industry average of 18.2%; and large-ticket new business volume grew at an annual rate of 31.1%, compared to an industry average of 16.4%. Subsequently, large-ticket transactions were a major reason Banks outperformed the overall market growth rate. Similarly, Banks were also underweight micro-, small-, and medium-ticket transactions which all grew slower than the industry average.

In this context, organizations can actively outperform the market in two ways: overweight fast-growth sectors, and avoid slow-growth sectors. Naturally, active business strategies are more applicable to Banks and Independents than Captives. In 2012, some Captives had the misfortune of being tied to relatively slower growth sectors, such as agriculture and construction. Independents' performance was dragged down by an overweight position in certain slow-growth sectors (e.g., micro- and small-ticket), but saw positive gains by being overweight in the transportation sector.

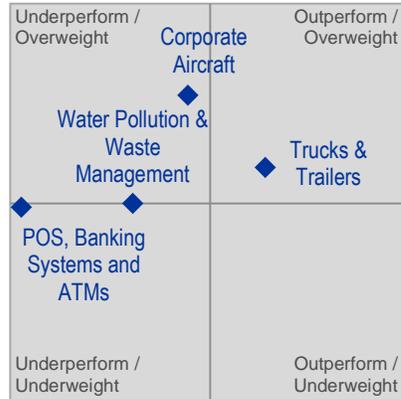
Equipment Finance Industry Performance Attribution Analysis

Banks

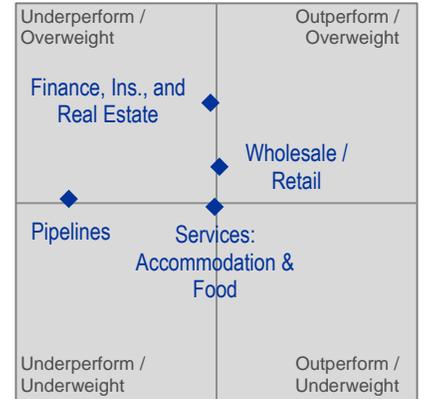
by ticket size



by equipment type

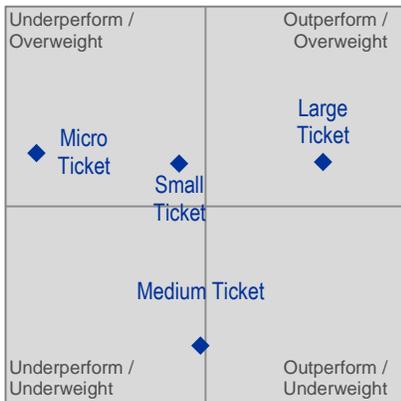


by end-user industry

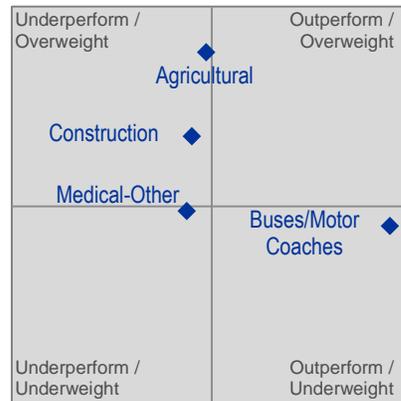


Captives

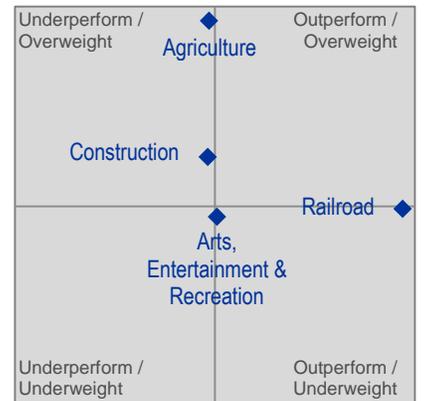
by ticket size



by equipment type

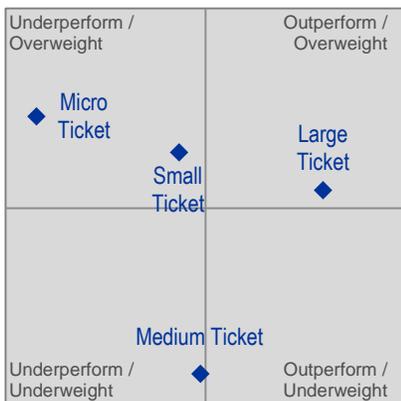


by end-user industry

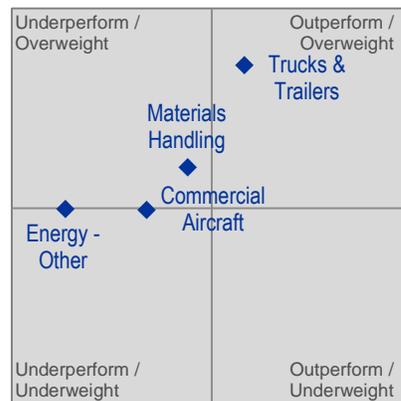


Independents

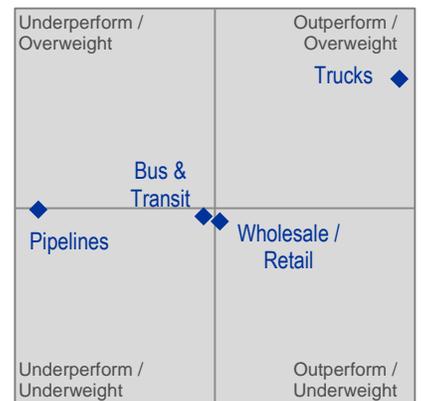
by ticket size



by equipment type



by end-user industry

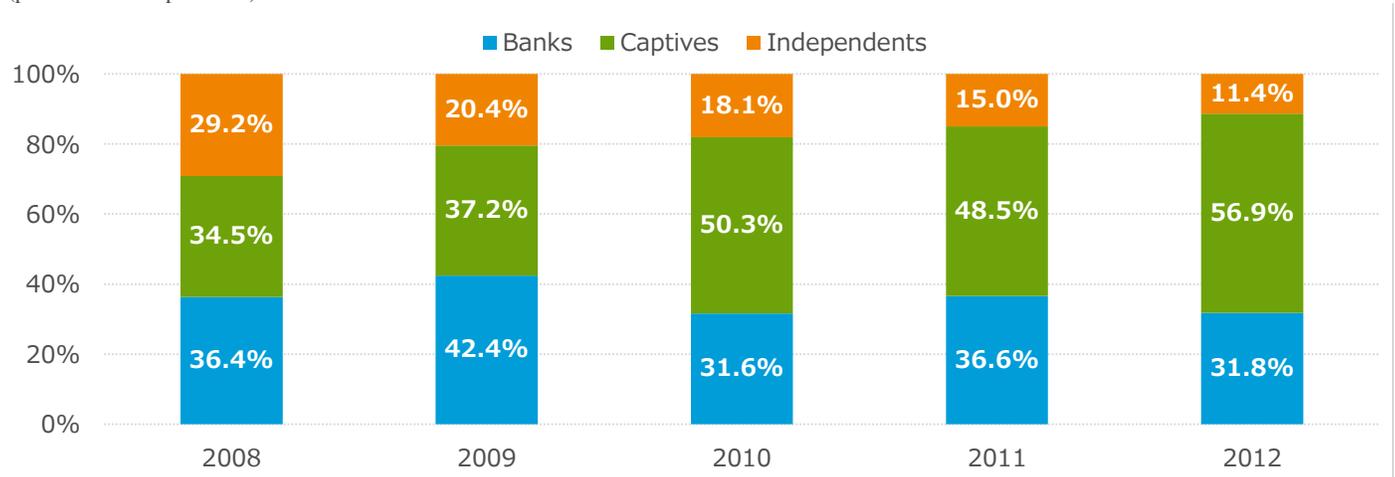


Source: 2013 ELFA Survey of Equipment Finance Activity, Keybridge Research

Small-ticket new business volume increased by just 3.8% in 2012 after increasing 9.3% in 2011. Although growth slowed, it was a marked improvement from the contractions between 2008 and 2010. Among the subsets of small-ticket equipment finance, small- and middle-ticket volume grew 6.1% and 7.2% in 2012, respectively, while micro-ticket volume declined 9.1%. At the organizational level, Banks led the small-ticket sector with 11.8% growth, followed by Captives with 2.7% growth and Independents with a decline of 9.4%.

Share of Small-Ticket New Business Volume by Organization Type

(percent of total portfolio)



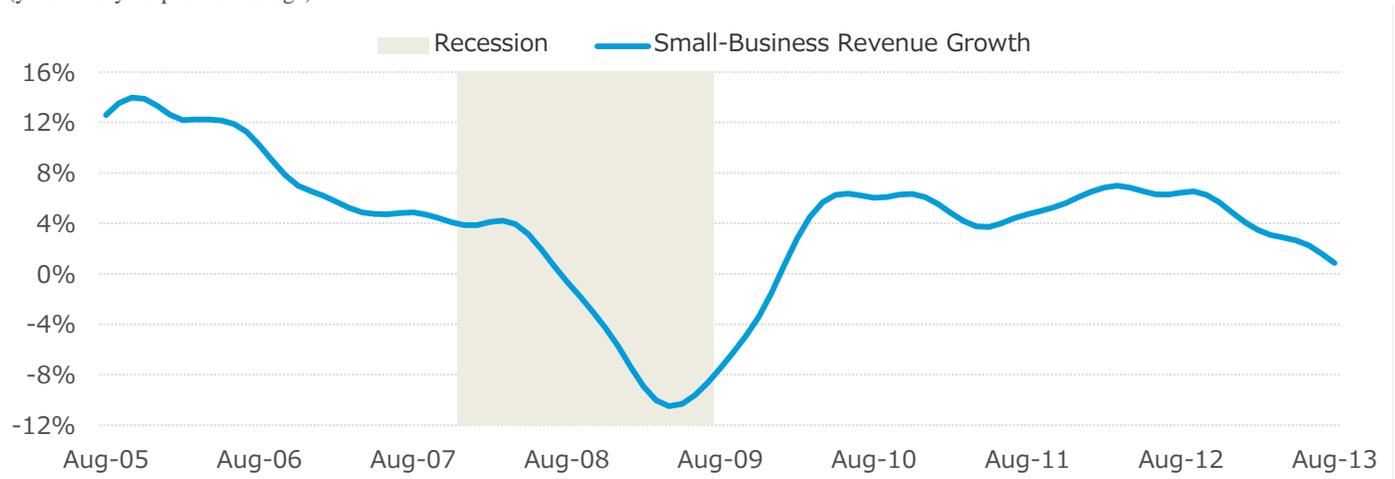
Source: 2013 ELFA Survey of Equipment Finance Activity

Although banks’ experienced the fastest growth in 2012, their overall market share declined. Market share also declined for Independents, while it grew substantially for Captives. Captives continue to increase their share of small ticket new business volume, yet the growth rate suggests that these gains may be slowing. Captives had almost 60% of total new business volume in 2012, while Banks and Independents had roughly 30% and 10% market shares, respectively. Since 2008, Captives have grown their share of small-ticket new business volume by 22.4 percentage points at the expense of Banks and Independents.

The lackluster trends in small-ticket equipment finance are indicative of a still-weak economy for small businesses. After the recession, small businesses shed employees in large numbers, experienced precipitously declining revenues and profits, and delayed capital expenditures. Amidst the recovery, small business owners have been particularly concerned by heightened regulatory and policy uncertainty and whether demand will return for their businesses. Some key data for small businesses are indicative the difficult environment in which they operate. For example, the chart below displays the Intuit Small Business Revenue Index (a monthly composite index of revenues for small businesses) which shows a clear deceleration in small business revenue since early 2012 to a near stand-still as of August 2013.

Intuit Small Business Revenue Index

(year-over-year percent change)



Source: Haver Analytics

The trend over the past few years clearly shows that revenue growth for small business has been weak, which has led to a decline in the appetite to lease and finance equipment for expansion. At the sector level, the Intuit indices show particular weakness in health care & social assistance; accommodation, food services & drinking places; and retail trade. These are a few industries that often rely on leased or financed equipment for their operations, which does not bode well for the equipment finance sector. Slow revenue growth has been a persistent deterrent for small business equipment demand, and the latest trends suggest tough times are ahead.

Small businesses have also explicitly stated that there are numerous deterrents to increasing capital expenditures. The most recent Wells Fargo/Gallup Small Business Index sheds light on why small businesses remain hesitant to expand operations. In the survey, only 25% of respondents reported an increase in capital spending over the past 12 months, and only 26% of respondents are planning to increase capital spending in the next 12 months. Two of the largest cited reasons were concern about the overall state of the economy (64%) and uncertainty in the future of their business (57%).

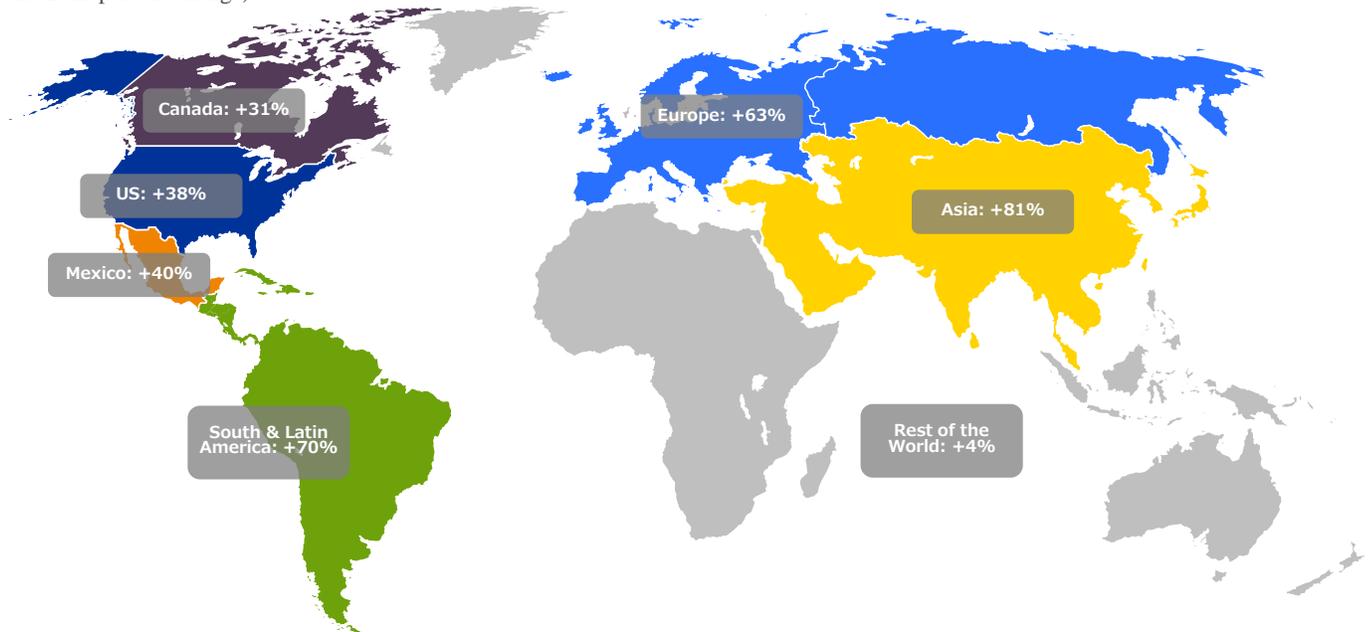
International business volume increased from 29% to 33% of total new business volume, after falling the previous year. International equipment investment in 2012 was a tale of two halves. Emerging market economies experienced strong growth during 2012, as accommodative monetary policy and further industrialization fueled investment demand. According to the latest IMF World Economic Outlook, developing Asian economies' GDP grew 6.6% in 2012, while South and Latin American economies grew 3.0%, both of which outpaced growth in much of the developed world. In particular, Chinese fixed investment in equipment and instruments increased 20.2% in 2012, a sharp rebound from 5.4% in 2011^{iv}, while interest rate cuts and deregulation in Brazil were aimed at catalyzing new investment projects, particularly in renewable energy sources. The strong demand for capital in emerging markets was matched with strong growth of new business volume sourced in emerging markets in 2012.

Economic growth and equipment investment in developed economies was abysmal in 2012. GDP in the euro area contracted 0.6% in 2012^v, while equipment investment was even bleaker. Austerity measures and record-low confidence levels deterred business from making investments in equipment and software, as the euro area lurched from debt crisis to debt crisis. Gross fixed capital formation in major categories of equipment and software declined 2.7%.^{vi} Investment in metal products, machinery, and transport equipment also all fell in real terms. These disappointing figures are offset to some extent by the 63% growth in new business volume sourced in Europe, which is the result of lessors expanding their business operations in European areas to fill a credit gap in underfunded sectors with acceptable risk levels.

In Canada, GDP growth slowed from 2.6% in 2011 to 1.8% in 2012, mirroring the slowing of growth in the United States. Unemployment remained stuck in the 7 percent range throughout 2012, while business climate conditions were muted amidst slow global growth and uncertainty stemming from the United States. Growth in equipment investment in Canada slowed from 8.6% in 2011 to 5.2% in 2012, matching the slowdown in new business volume sourced in Canada^{vii}. Among some key verticals of equipment investment in Canada, industrial equipment grew 5.7%, while computers and peripheral equipment grew a meager 2.6%^{viii}.

International New Business Volume

(2011-2012 percent change)



Source: 2013 ELFA Survey of Equipment Finance Activity

Yield & Funding

Perhaps more than any other area of the industry, the cost of funds and equipment financing yields have been heavily impacted by overall macroeconomic trends. Starting in 2007, the Federal Reserve began cutting interest rates, and by the end of 2008 the target federal funds rate fell to 0.125%, where it has remained ever since. Additionally, the Federal Reserve has implemented unprecedented measures, dubbed quantitative easing (or “QE”) to lower long-term rates. In this era of historically-low interest rates, investors have been searching for yield anywhere they can find it. As a result, money has poured into the equipment leasing and finance sector, which has historically achieved attractive yields with relatively low risk. In their search for yield, even non-traditional investors (e.g., private equity) have found their way into equipment leasing. While increased access to capital is good for consumers, rising liquidity has compressed spreads for equipment finance companies.

Looking ahead, Fed policy will dictate how quickly and how high interest rates rise. Consensus expectations are for the Fed to begin scaling back its long-term bond purchases (or “tapering”) in late 2013 or early 2014 and for it to raise short-term rates in 2015. Equipment finance spreads typically lag in a rising rate environment, which does not bode well for net interest margins. Combined with expected slow growth of new business volume, lower profitability is a recipe for a more difficult operating environment.

Percent	Industry	Banks	Captives	Independents
Weighted Average Pre-Tax Yield	4.49%	4.21%	4.54%	8.84%
Weighted Average Pre-Tax Spread	3.07%	2.93%	2.95%	6.17%
Weighted Average Cost of Funds	1.42%	1.28%	1.59%	2.67%
Median Pre-Tax Yield	6.01%	4.41%	6.23%	9.01%
Median Pre-Tax Spread	3.81%	3.14%	3.41%	4.57%
Median Cost of Funds	1.57%	1.24%	1.86%	3.69%

Source: 2013 ELFA Survey of Equipment Finance Activity

The cost of funds hit an all-time low for the equipment finance sector in 2012. Moderate economic growth, low inflation, and the Federal Reserve’s aggressive monetary policies kept interest rates near historical lows throughout 2012. This translated directly into a low cost of capital for the financial sector. More recently, long-term rates have risen, but the Fed discount rate has held steady at 0.75% through August 2013.

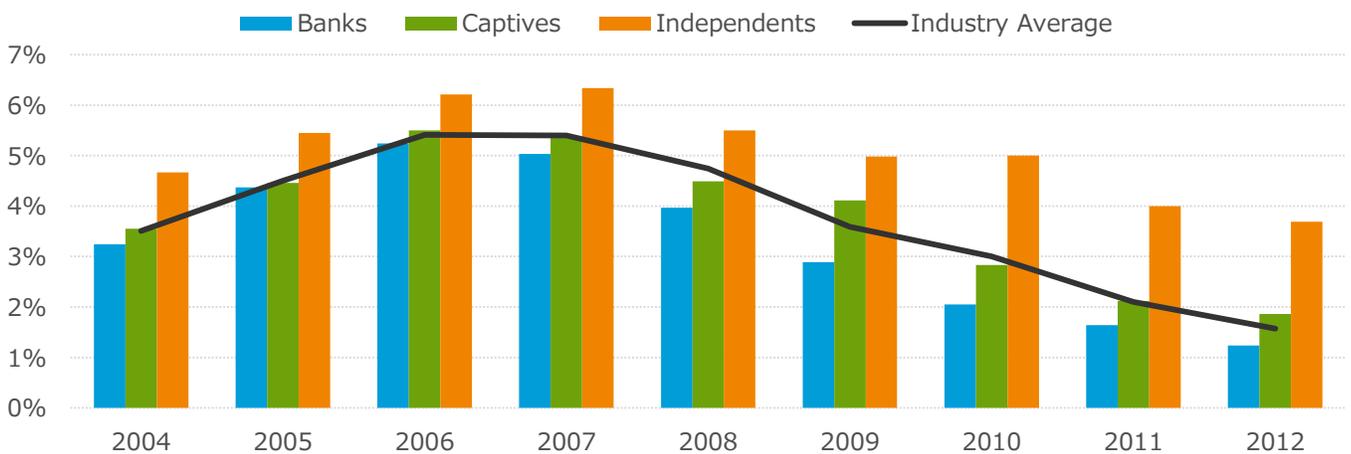
Banks have a competitive advantage on cost of funds. Industry-wide, the cost of funds peaked in 2006-2007 before the financial crisis and subsequent shift in Federal Reserve policy decreased the discount rate to historical lows. From a peak of 5.4% in 2007, the median cost of funds fell to 1.6% in FY 2012. Due to their access to the Fed

discount window, the median cost of funds for Banks was even lower at 1.2%. Captives, due to their size and categorization as “industrial banks,” also have access to relatively low cost of funds, which averaged 1.9% in 2012. Independents have always had a higher cost of capital than Banks and Captives, but there are two noticeable trends over the past 5 years:

- Independents’ median cost of funds fell to 3.7% in 2012. This was a 42% from 2007 to 2012, less than the industry average (-71%), as well as Banks (-75%) and Captives (-65%).
- The difference between Independents and Banks’ cost of funds peaked in 2010 at 2.9%, fell to 2.3% in 2011, and then edged back up to 2.4% in 2012. The latest figure is well-above pre-recession differentials which averaged about 1.1%. This is an indication that lenders still view Independent equipment lessors as relatively risky.

Median Cost of Funds

(percent)



Source: 2013 ELFA Survey of Equipment Finance Activity

The industry has experienced spread compression from 2009 to 2012. Weighted-average pre-tax spreads compressed from 2009 to 2012, from 3.85% to 3.09%. Median spreads also declined slightly over the same period, from 3.92% to 3.81%.

Spread compression was more noticeable in the middle-ticket market in 2012. Middle-ticket spreads dropped 56 basis points from 2011 to 2012, the largest absolute decline in the industry. Large-ticket and small-ticket segments experienced only mild spread contraction in 2012, and micro-ticket spreads actually increased.

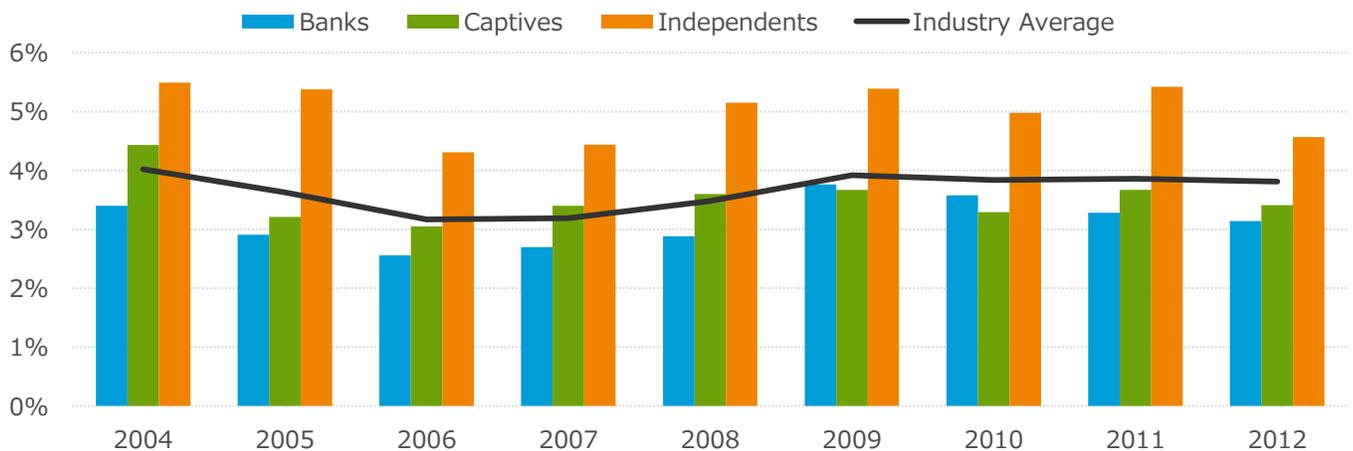
Industry competition has compressed spreads in 2012 and 2013. As the economy has stabilized, investors have become more comfortable taking on risk. However, in a hyper-low interest rate environment, investors are employing creative ways to earn a yield on their assets. This has included putting money to work in the equipment finance market. Greater liquidity has increased industry competition, which has tightened spreads for Banks, Captives, and Independents alike. Based on conversations with industry experts, intense competition in the large-ticket market in 2013 has put immense pressure on pricing and caused spreads to compress more than in other segments.

Non-traditional players (e.g., private equity) have entered the equipment finance market in a noticeable way. However, there are signs that their participation is a response to historically low interest rates and, as such, this source of funds may not last as interest rates begin to normalize in 2014 and beyond. In particular, if private equity attempts to exit the market by selling off assets to banks, but banks are reluctant to buy the portfolios (which are more likely to have smaller-ticket deals and higher-risk credits), it could have repercussions for the value of equipment leases as an asset class.

Banks have experienced steadily declining spreads for the past 4 years. Captives and Independents were able to increase spreads in 2011, but experienced spread compression in 2012. Spreads at the organizational level are driven by the underlying business models and funding strategies. In 2012, Banks held the largest share of middle-ticket transactions (the area of greatest spread compression) and the smallest share of micro-ticket transactions (where spreads have increased). As a result, three quarters of bank SEFA respondents experienced a decline in pre-tax spreads in 2012. Captives and Independents had a greater mix of market segments, and therefore had mixed experiences with spreads — more than half of SEFA respondents reported an increase in spreads.

Median Pre-Tax Spread

(percent)



Source: 2013 ELFA Survey of Equipment Finance Activity

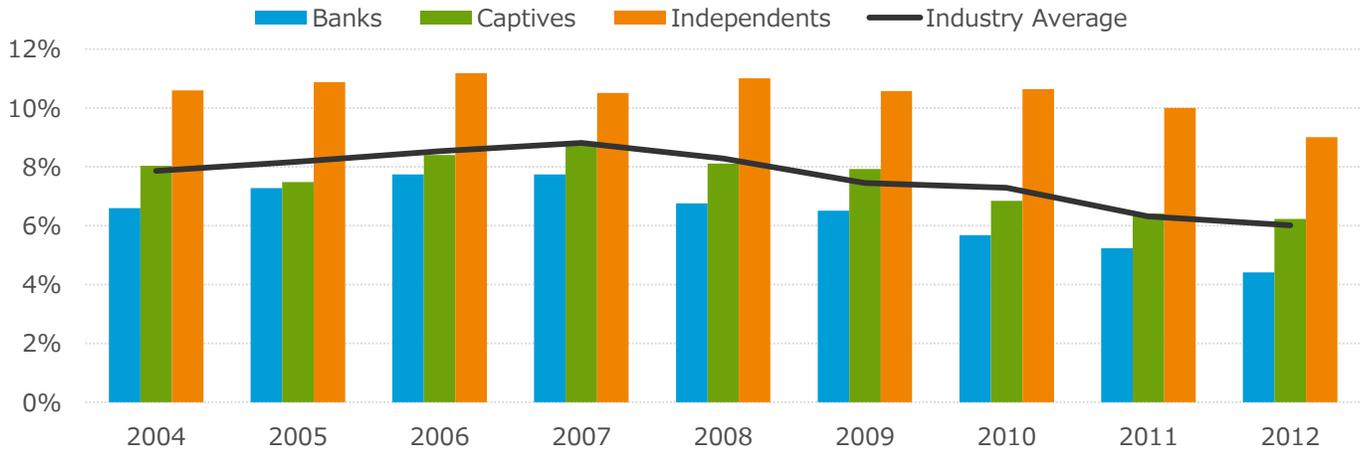
As the cost of funds and spreads declined in 2012, yields also fell. Since 2006, the industry-wide weighted average pre-tax yield has declined from 8.30% to just 4.49% in 2012. Yields are lowest for Banks, at 4.21%, followed by Captives at 4.53% and 8.84% for Independents. Bank yields declined more than other lessors, as an influx of capital has driven down interest rates from 7.74% in 2006 to 4.41% in 2012.

By market segment, yields are a function of the source of financing. As discussed previously, banks have the lowest cost of funds, and have also experienced a squeeze on spreads as market competition has increased. As banks have rapidly grown their large-ticket portfolios, this has driven down yields on larger transactions. Indeed, the SEFA data indicate that pre-tax yields are noticeably lower for large-ticket deals — average yields have fallen from 6.17% in

2009 to 3.81% in 2012. Pre-tax yields for middle, small, and micro-ticket transactions are significantly higher (4.34%, 4.97%, and 11.36%, respectively).

Median Pre-Tax Yield

(percent)

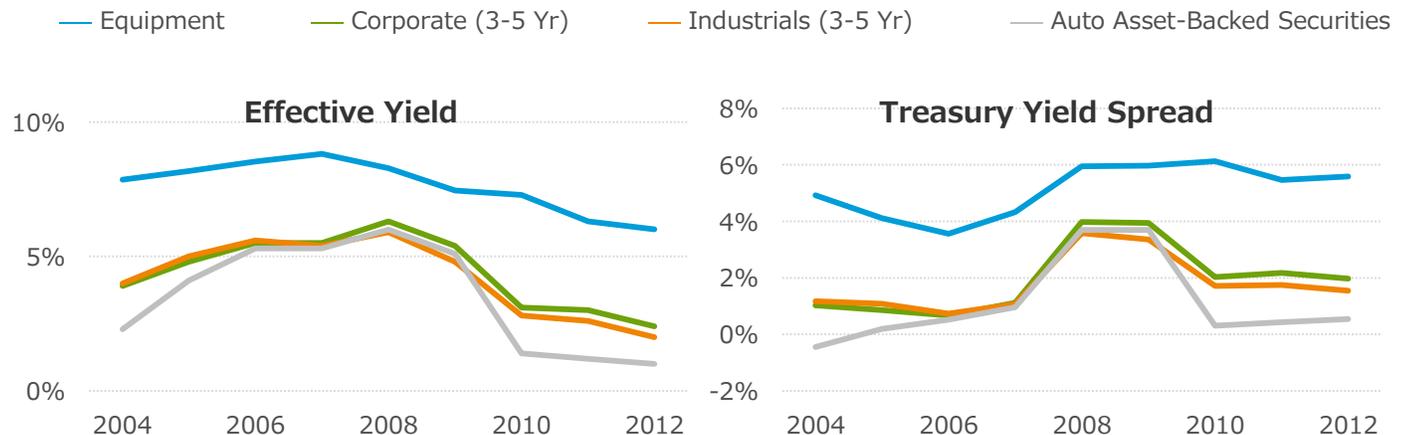


Source: 2013 ELFA Survey of Equipment Finance Activity

The equipment industry’s high yields and spreads are attractive to investors. While yields have been driven down across financial markets, the yield on equipment finance has remained relatively high compared to other types of corporate debt and asset-backed securities. Additionally, the spread on equipment finance compared to 3-year U.S. Treasuries has generally risen since 2006, while spreads on corporate, industrial, and Auto asset-backed securities have been flat since 2010 (after spiking and declining from 2008-2010). Combined with a favorable risk profile, this has presented a relatively attractive investment opportunity. Looking forward, spreads are likely to lag given the consensus view that interest rates will rise in the coming years. As such, finance companies may need to cover at least part of the rising cost of funds in 2014, to the detriment of their net interest margins.

Yield & Spread Comparison

(percent)

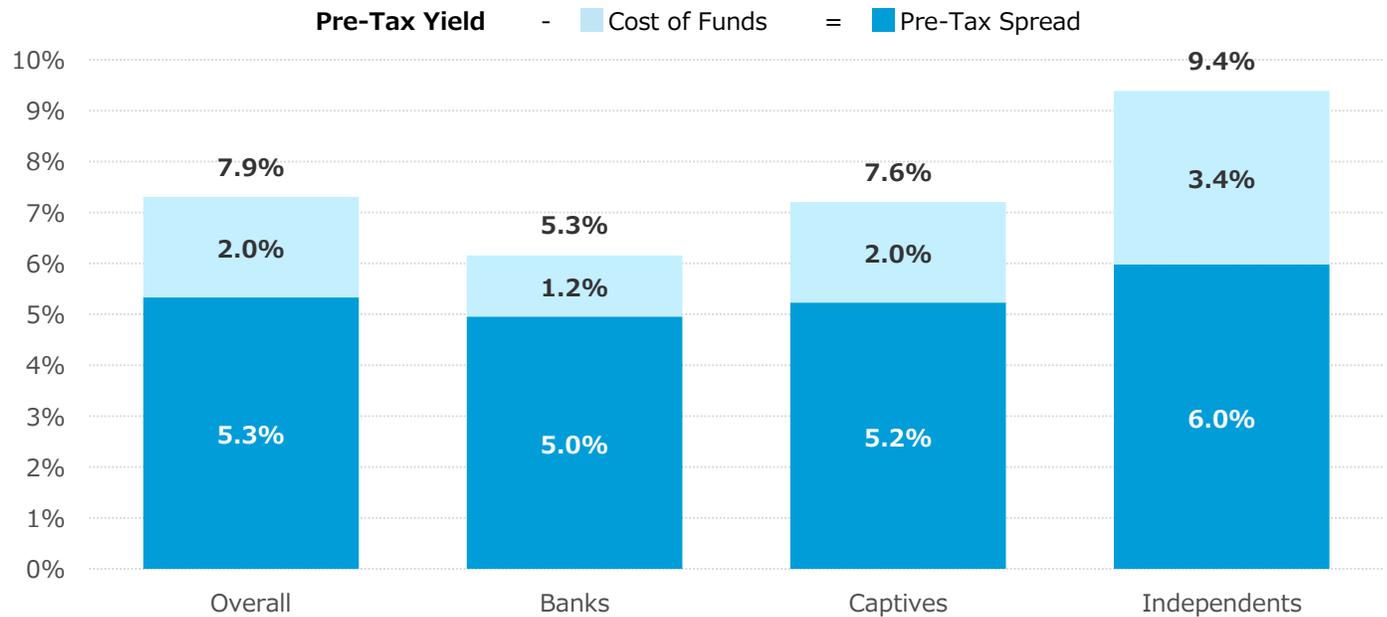


Source: 2013 ELFA Survey of Equipment Finance Activity, Haver Analytics, Keybridge Research

The cost of funds declined and spreads compressed in the small-ticket market in 2012. The median small-ticket pre-tax spread declined to 5.33% in 2012 from 5.60% in 2011. Banks continue to have the lowest cost of funds, yet do not have as high pre-tax spread as either Captives or Independents. Captives’ cost of funds is on par with small-ticket-wide trends, despite their pre-tax yield being slightly lower.

Small-Ticket Equipment Finance Yield & Funding

(median; based on dollar amount)



Source: 2013 ELFA Survey of Small-Ticket Equipment Finance Activity

Yields in the small-ticket market continue to be priced higher than the overall market. Small-ticket transactions are inherently riskier than larger-ticket deals. Most small-ticket financing is for small businesses, which tend to have more volatile earnings and cash flows. As a result, small-ticket yields have been and will continue to be higher than the broader market average. From 2011 to 2012, there was a slight decline in the pre-tax yield; yet, it remains well above the equipment finance industry average.

As for costs of funds, two competing forces are at play. On one hand, the low-interest rate environment pushed down capital costs, which dropped overall from 2.03% in 2011 to 1.74% in 2012. On the other hand, a lack of capital for small businesses makes them “price takers” in capital markets. A 2012 Small Business Access to Capital Survey conducted by the National Small Business Administration found that almost 43% of small business owners were unable to find sources of capital^{ix}. The survey also found that recent regulation might be helpful for small businesses going forward. Almost 20% of respondents reported that they are more likely to seek outside investors due to the passage of the JOBS Act, which has been aimed at easing restrictions on funding sources for small businesses. In the meantime, the under-supply of small business capital places upward pressure on small ticket yields.

Portfolio Performance

2012 was one of the strongest years on record for the equipment finance industry in terms of portfolio performance. By some metrics, equipment leasing and finance achieved a higher portfolio quality than other forms of credit. The quality of equipment portfolios improved across the board, as delinquencies, nonaccruals, and charges-offs all declined from 2011 levels. This was a result of improved corporate balance sheets and cash flows, and also because less credit was made available to lower quality borrowers. The latest MLFI-25 survey shows that performance has continued to improve in 2013. However, record-level portfolio quality is unlikely to continue for a prolonged period of time. As the economy improves, credit standards will inevitably loosen, and delinquencies and charge-offs will likely increase. From a macro perspective, this could be considered a positive trend — it will mean that more businesses and lenders are taking calculated risks and are optimistic about growth prospects. The key for the equipment finance sector is to remember the lessons from the recent financial crisis — most importantly, that clever deal structures cannot eliminate risk.

Percent	Industry	Banks	Captives	Independents
Delinquent Portfolio Over 30 Days (weighted-average)	1.6%	0.6%	4.6%	1.3%
Non-accrual assets as a percentage of receivables and non-accrual assets (weighted-average)	0.5%	0.4%	0.7%	1.0%
Net Full-Year Loss (Charge-off) as a Percentage of Full-Year Average Receivables (median)	0.21%	0.03%	0.32%	0.56%

Source: 2013 ELFA Survey of Equipment Finance Activity

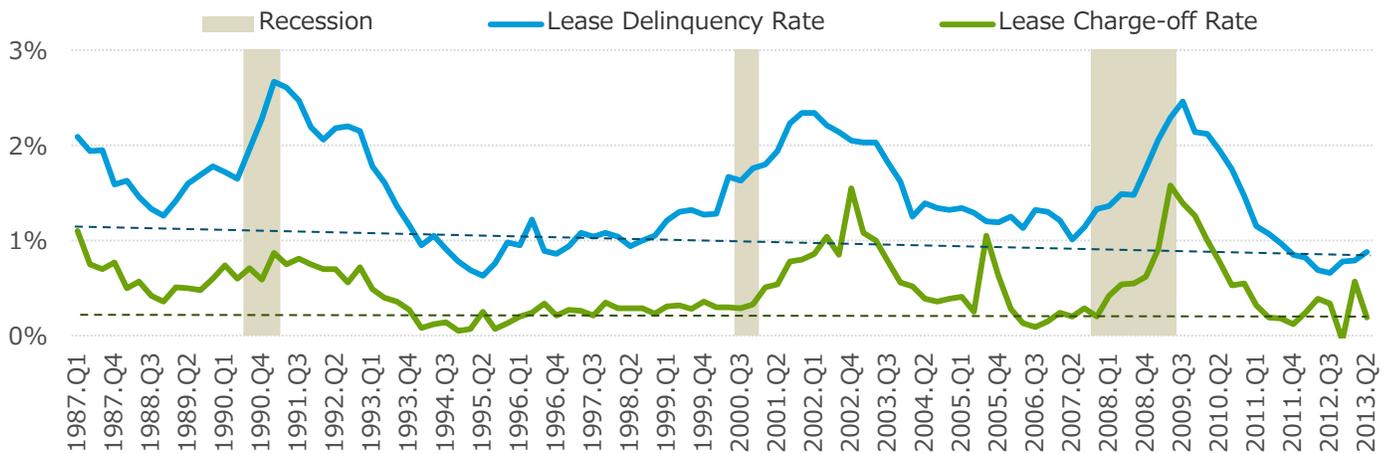
As the economy recovers, delinquencies have declined across all asset classes. Since the financial crisis of 2008-09, the business and household sectors have gone through a massive deleveraging cycle. While banks have greatly improved their balance sheets (including writing off bad loans), improving economic conditions and tighter lending standards have led to improvements in loan and lease performance. As of Q2 2013, delinquency rates on consumer loans, business loans, and agricultural loans have all fallen to pre-recession levels. Commercial real estate loan delinquencies have dropped from a peak of 8.8% to 3.3%, but remain above normal levels of 1.5–2.0%. Similarly, residential real estate loan delinquencies have fallen from a peak of 11.3% to 9.4%, but remain well above pre-recession levels of about 2.0%.

The equipment finance industry has enjoyed strong portfolio performance. ELFA’s latest MLFI-25 data showed that in August 2013, aging of receivables over 30 days was just 1.6%, and has averaged 1.7% for 2013 — below pre-recession levels of 2.0–2.2%. Additionally, average losses (charge-offs) as a percentage of net receivables are very low (0.4% year-over-year) and have been so for four consecutive months. Although overall macroeconomic growth has been choppy over the past few quarters, the financial positions of lessees are continuing to improve. This trend, combined with more prudent risk and portfolio management practices, has led to fewer long-term delinquencies and charge-offs in portfolios for many types of organizations across the entire industry.

Delinquencies and charge-offs are tied to the broader economy, and the U.S. is mid-cycle with respect to portfolio performance. Unsurprisingly, portfolio performance is highly correlated with the economic cycle. Over the past 30 years, lease delinquencies and charge-offs peaked during or shortly after a recession – from peak to trough, the “performance cycle” has averaged about 9 years. During these cycles, normalized delinquency and charge-off rates averaged 1.5% and 0.5%, respectively. Given the current state, it appears that the U.S. is roughly halfway through the performance cycle. That is, delinquencies and charge-offs are bottoming out and are likely to edge upwards as the economy recovers, more businesses access credit markets, and credit standards loosen.

Lease Delinquencies and Charge-offs for all U.S. Commercial Banks

(annualized percent rate)



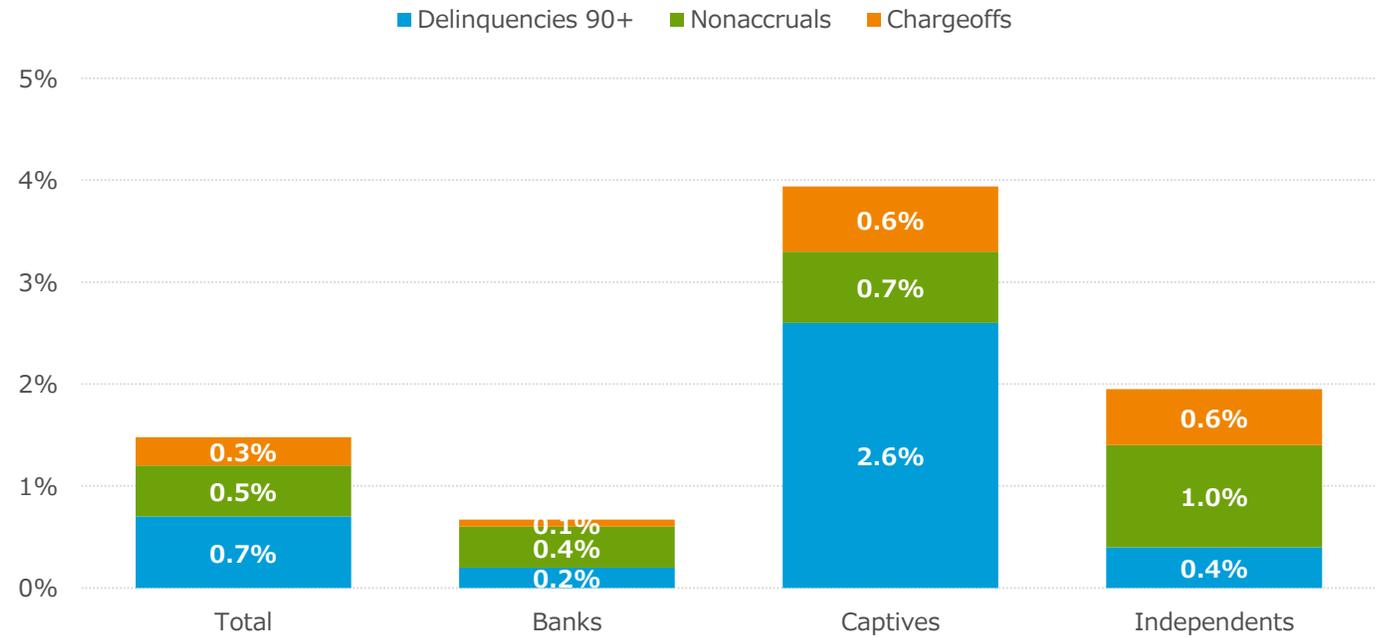
Source: Haver Analytics

By lessor, delinquencies and charge-offs are tied to business models. Banks continue to lead in portfolio performance, with delinquencies over 90 days of just 0.2%, non-accruals of 0.4%, and charge-offs of just 0.07% — the lowest level for all performance metrics among the three market segmentations. One bank-owned lessor commented that banks continue to focus on improving the quality of credit, as having a clean balance sheet is critical in today’s highly competitive and regulated environment. Banks’ focus on and access to investment-grade clients through cross-marketing with its commercial lending arms is a strong contributor to their superior portfolio performance.

Captives and Independents’ business models have higher built-in risk. Captives are driven by a mission to serve their parent company, and in an effort to support sales growth, are sometimes willing to take on more risk. Specifically, Captives have more flexibility on credit risk and in assuming higher residual values. Due to their cost of funds disadvantage, Independents typically operate in riskier segments of the market and operate further out on the risk-return curve.

Portfolio Quality by Type of Organization

(weighted-average percent)



Source: 2013 ELFA Survey of Equipment Finance Activity

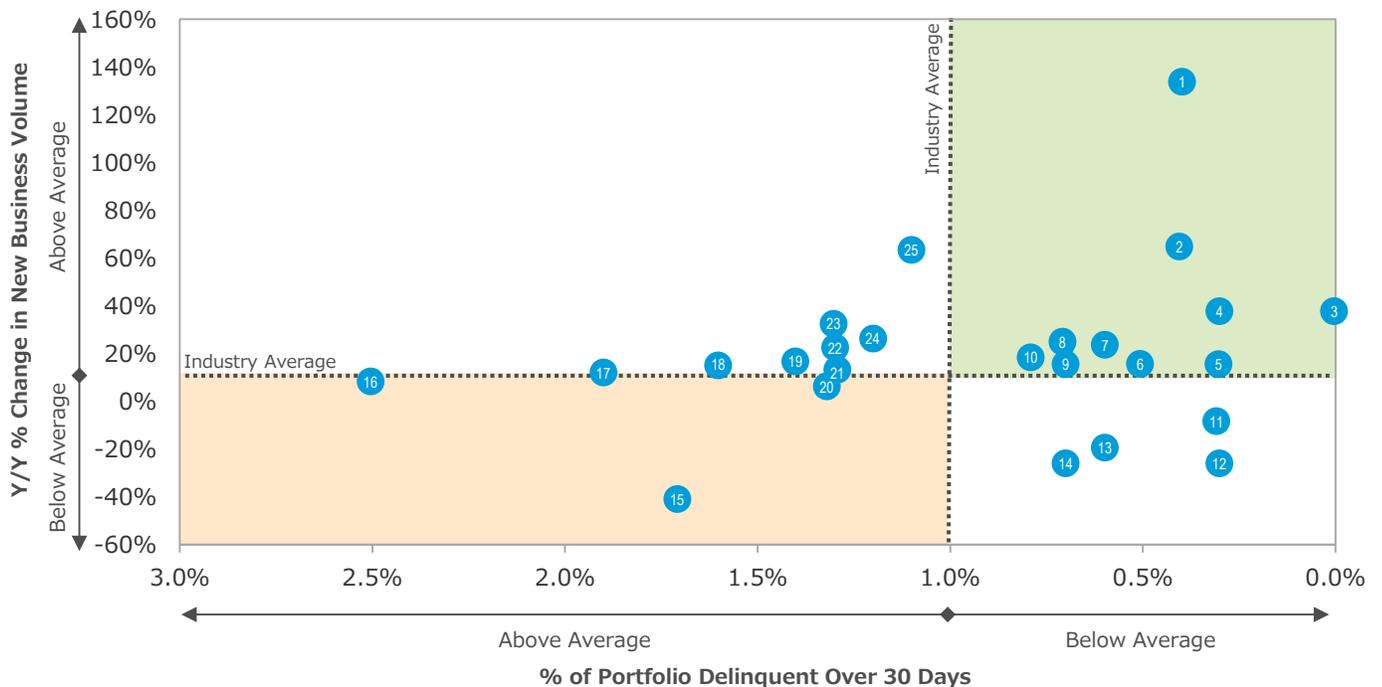
Analysis of end-user industry trends shows a clear mix of strong- and weak-performing industries. A few industries continue to struggle with high delinquencies; but, on the whole, industry-level trends are improving. The Printing and Publishing industry had the worst delinquency rate, with 2.5% of receivables delinquent by over 30 days and 2.1% classified as non-accrual assets. Printing and Publishing has been struggling for years due to the emergence of electronic-reading technologies, and several interviewees mentioned that they are avoiding this sector. Construction was the second-worst performing industry, with 1.9% of receivables delinquent more than 30 days and 1.9% classified as non-accrual assets. Despite the recent rebound in housing activity, the housing sector is still fragile. One Captive lessor who leases construction equipment commented that underwater mortgages and rising mortgage rates could be two wrenches in the housing market’s recovery.

Water & Air Transportation industries had the lowest delinquency and non-accrual rates. Increases in the re-shoring of manufacturing back to the United States and the overall “Energy Renaissance” that is occurring in North America appear to be supporting an increase in inland barge shipments across waterways, which has benefited the Water Transportation industry. Meanwhile, Air Transportation — particularly in the corporate sector — has rebounded with improving overall economic conditions. Leasing continues to offer the best financial solution for acquiring aircraft

for many corporations, and several lessors commented that they expect activity in this niche market to continue to accelerate.

Pairing delinquency rates and growth in new business volumes reveals attractive industries that equipment lessors and financiers can target. Differentiation among industries is a crucial focal point for businesses who seek to either increase their business volume in existing markets or to penetrate new markets. In terms of equipment-intensive industries, some continue to grow, while others continue to lag – which has a salient effect on their ability to remain current on loans and leases. The figure below plots the year-over-year change in new business volume and delinquency rates by end-user industry. The matrix offers insight into the movement of industries over the past year and can be instructive for equipment asset allocation and business expansion efforts.

Risk-Growth Analysis by End-User Industry



- | | | |
|--------------------------------------|-----------------------------------|-------------------------------------|
| 1. Transportation – Railroad | 10. Wholesale/Retail | 19. Services – Accomod. / Food |
| 2. Services – Transportation | 11. Transportation – Air | 20. Services – Health |
| 3. Transportation – Water | 12. Pipelines | 21. Agriculture, Forestry, Fishing |
| 4. Utilities | 13. Industrial – Manuf. / Other | 22. Mining / Oil & Gas Extraction |
| 5. Transportation – Bus, Transit | 14. Telecommunications | 23. Services – Other |
| 6. Finance, Insurance, real Estate | 15. Government – Federal | 24. Indus. / Manuf. – Metal & Mach. |
| 7. Government – State & Local | 16. Printing, Publishing | 25. Transportation - Truck |
| 8. Services – Educational | 17. Construction | |
| 9. Services – Arts, Entertain., Rec. | 18. Indus. / Manuf. – Wood, Other | |

Source: 2013 ELFA Survey of Equipment Finance Activity

Transportation, utilities, and other services industries showed the strongest growth and lowest risk. In the chart above, the industries within the top right quadrant of the matrix – Transportation-Railroad, Services-Transportation, Transportation-Water and Utilities, among others – were among the fastest growing and best

performing industries in 2012. Conversely, equipment that is allocated to end-user industries such as the Printing/Publishing Industry experienced higher delinquencies and slower growth (or even contraction).

Difficult industry-wide conditions during the recession and the slow recovery still remain prevalent in lessors' memories. As the industry has adjusted to the recent weak economic environment and increased its competitiveness in different niche areas of the market, it is clear that the prevalence of high-credit risk borrowers has been reduced. Many interviewees commented that they now lease only to investment-grade credits, thereby solidifying their location in the credit market and avoiding “downstream” markets — even if it means sacrificing new business volume.

Going forward, interviewees are focused on adhering to the best possible risk management and credit analysis. In addition to macroeconomic conditions, lax lending standards can drive portfolio performance, particularly during a credit event such as the housing market collapse. During interviews, most industry experts provided introspective lessons learned from the 2008-09 financial crisis. Upon reflecting on past mistakes, a key takeaway is that equipment lessors should not sacrifice the quality of a loan in order to complete a deal. Put another way, risk cannot be “structured away”.

Expect marginally higher delinquency rates in 2014. Delinquencies have remained at historically low levels for most of 2012 and 2013. Many industry experts believe that due to the economic downturn, some lower-quality borrowers — in particular, many small businesses — were extended less credit, which may have resulted in selection bias in the performance benchmarks. As equipment lessors and financiers look for more business opportunities and broaden their lending base, it is possible that delinquencies could rise marginally as the composition of the lending base changes. This will be a trend to watch and potentially be concerned about if risk is not appropriately priced. Particularly in an environment where companies fight for market share, lowering credit standards is one way for businesses to grow, but may adversely affect the industry's risk/return profile.

Regulation may shape portfolio performance in the coming years. Credit and transaction-size selection biases, whether stemming from internal or external sources, have affected the industry's portfolio performance, and it has been particularly noteworthy when analyzing the industry by type of organization. Interviews with industry experts reveal that increased regulation has been a key contributor to stronger portfolio quality. With increased compliance standards from Dodd-Frank and other regulations looming, Banks, have shifted their business models to avoid future compliance costs. For example, Banks are more likely to lend to higher-quality credits, as this is less burdensome than adding costs to address new compliance measures. Notably, many industry experts believe that requirements for increased compliance are unnecessary for the equipment finance sector given that it is one of the few financial markets that fared well during the crisis and recession. Although the decision to focus on higher-quality credit clients has led to decreased spreads in some instances, the strategy has also reduced compliance costs and opened up opportunities for Captives and Independents to target smaller- and medium-sized transactions.

Portfolio performance in the small-ticket equipment finance market improved slightly in 2012. Delinquencies over thirty days ticked down slightly from 2.7% to 2.5%, while nonaccruals declined from 0.8% to 0.7%. The largest

decline, however, was in charged-off assets, which declined from 1.3% to 0.9%. In the context of relatively stagnant small business revenue growth, any improvement in portfolio performance is a good sign; but, may also be a signal of low access to capital and highly-selective lending.

Stubbornly high delinquencies remain for Captives and for organizations mid-sized lenders. Captives continue to experience the highest rates for small-ticket delinquencies and charge-offs, while in this past year, Banks had the largest percentage of nonaccruals as a percentage of receivables and non-accrual assets. Relative to the previous year, Captives' small-ticket delinquencies declined slightly. Captives' small-ticket delinquent portfolios over thirty days were 5.8% in 2011 and fell to 5.4% in 2012. Additionally, mid-sized organizations (those between \$50 million and \$1 billion in organization size) had the highest nonaccruals, while the largest and smallest organizations enjoyed comparably lower levels of nonaccruals over the past year.



Business Operations

The trends in business operations through 2012 suggest that companies are focused on improving efficiency and productivity in an increasingly competitive industry — in short, “doing more with less”. Productivity gains have been driven in part by efficiency improvements achieved through technology solutions that improve the customer experience and also by competitive industry conditions that require companies to look for new ways to improve their bottom line. Among other trends, different business models have increasingly distinguished themselves in their operations. Technology and analytics have also become more important. Finally, there is an increased focus on human capital investments that produce tailored and differentiated service product offerings — which has led to an expanded role of equipment lessors as “asset consultants” in addition to providers of capital.

Percent	Industry	Banks	Captives	Independents
Booked & Funded/Sold as a Percent of Approved (based on \$ amount)	71.5%	68.9%	79.7%	68.3%
Credit Decision Turnaround time: \$250,000 - \$5 million Transaction (weighted-average)	3.4 days	4.1 days	2.2 days	5.6 days
Residual or Salvage Position as a Percent of Original Equipment Cost	22.5%	20.8%	29.1%	20.8%
Percentage of Full-Time Equivalents (FTE) in Sales/Origination	23.0%	25.6%	17.4%	25.1%
New Business Volume per Sales Full-Time Equivalent	\$20,389	\$21,468	\$29,103	\$5,937
Sales, Gen & Admin Expense per FTE	\$289	\$187	\$258	\$544

Source: 2013 ELFA Survey of Equipment Finance Activity

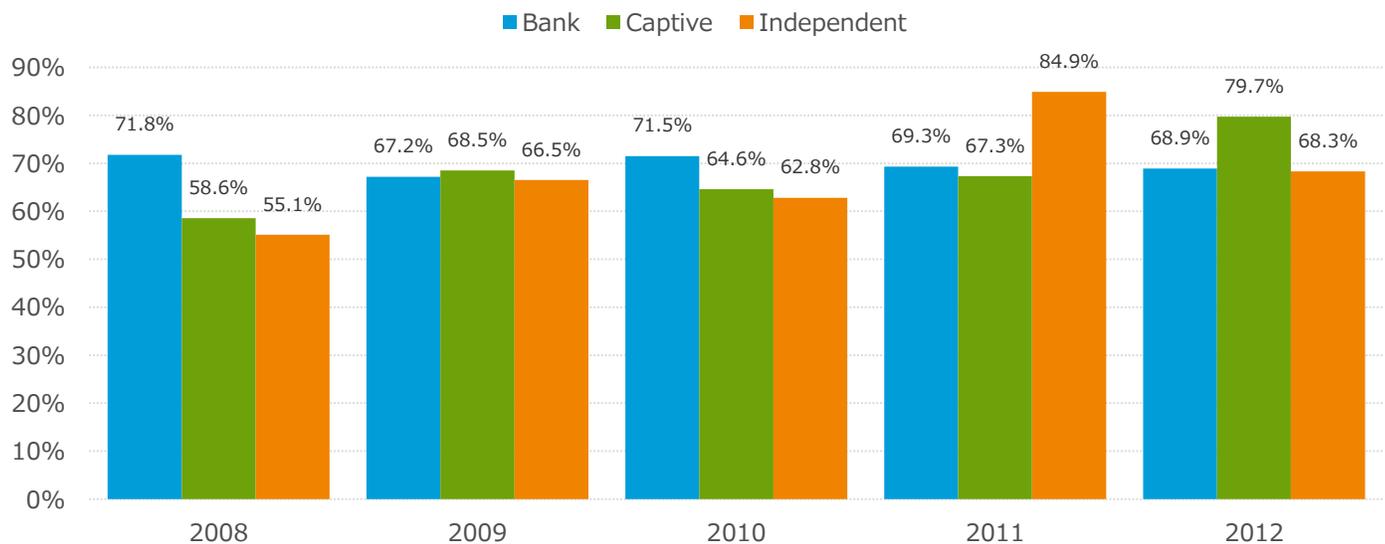
The 2013 SEFA, along with anecdotal information from interviews with industry professionals, point to a growing focus on customer relationships and employment amidst the changing conditions of the industry. Multiple interviewees mentioned the importance of increasing the attention paid to human capital allocation within their work forces in order to improve job satisfaction, decrease turnover, and improve customer service. Other noteworthy trends include increasing the prevalence of centralized sales teams and online transactions. As always, customer relationships are critical, but their nature has changed significantly over the past few years. In-person meetings are not necessarily a vestige of the past, but successful companies are finding ways to strengthen relationships by making life easier for their customers – e.g., online billing tools and knowledgeable sales staff.

Data from the SEFA cover a wide range of business operations data, from all stages of the new business that equipment lessors and financiers execute. This report discusses the most important metrics within the context of broader trends in business operations.

Application approvals as a percentage of those submitted were largely unchanged in 2012. The dollar amount of applications booked and funded/sold as a percent of applications approved was essentially unchanged — from 71.4% in 2011 to 71.5% in 2012. Captives had the highest “booked/funded/sold-to-approved” ratio (79.7%), compared to 68.9% and 68.3% for Banks and Independents, respectively (see figure below). This is a direct result of Captives’ business models – their role in supporting their parent company’s sales necessitates a high approval and funding ratio. One Independent lessor commented that automated application processing is crucial to his business operations. Streamlining application processing is one “front-office” mechanism through which equipment lessors and financiers can grow business and improve operations in a straightforward way.

Applications Books & Funded/Sold as a Percent of Approved

(based on dollar amount)



Source: 2009 through 2013 ELFA Surveys of Equipment Finance Activity

Application efficiency is largely driven by business model. As mentioned above, this point is perhaps best illustrated by Captives’ relationships with their parent companies, and their subsequently high approval and funding rates and fast turnaround times. In 2012, Captive equipment finance companies led the industry along several productivity metrics, including:

- Captives approve more applications in their initial stages;
- Captives maintain the highest “yield” of booking and funding approved applications; and
- Captives had the quickest weighted-average credit decision turnaround time among all organizations and in all transaction size ranges.

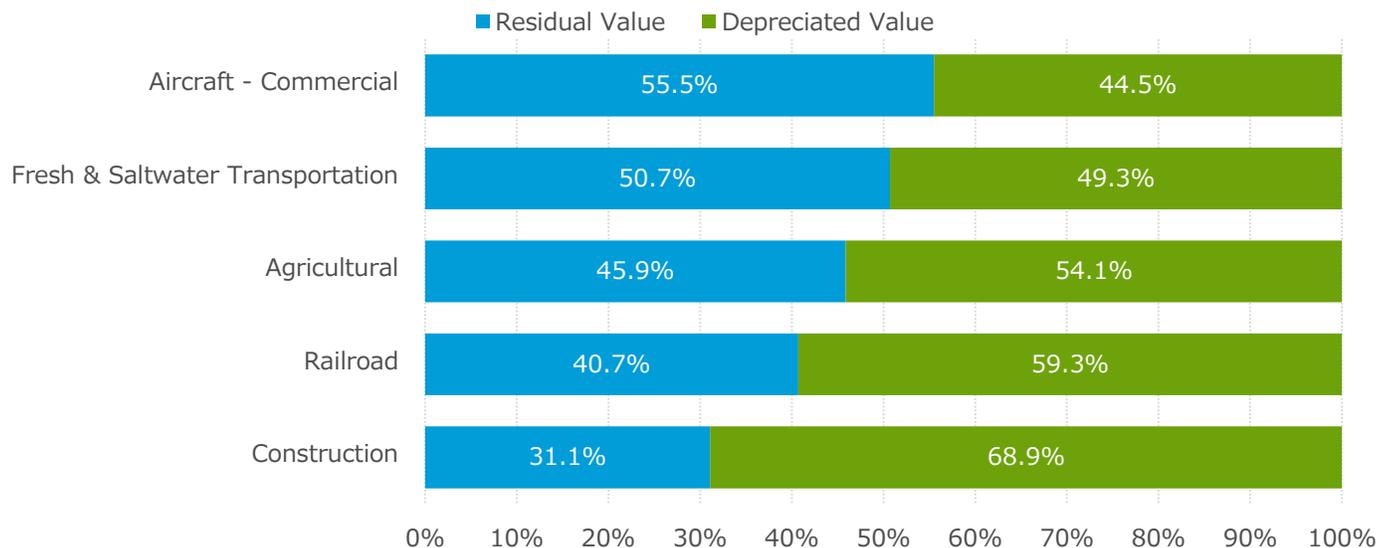
Captives’ primary mission is to facilitate the sale of their parent manufacturers’ products. One captive mentioned that being “fast and easy” was crucial for his business. They largely strive to provide a one-stop-shop for customers who wish to purchase equipment. In that sense, efficiency and the customer experience go hand-in-hand. Customer satisfaction is often a function of high approval ratios and quick turnarounds rather than marginally lower rates that may be available at a larger bank. Even so, Captives are sometimes more flexible on credit quality and rates than Banks. Relative to Captives, Banks are much more selective in the new business pipeline. In 2012, Banks’ approved applications as a percent of submitted applications was 65.1%, compared to 87.1% for Captives.

The average residual position as a percentage of original equipment cost (OEC) increased from 21.7% in 2011 to 22.5% in 2012. Captives had the highest residual positions: in 2012, Captives reported a 29.1% position as a percentage of OEC, significantly higher than Banks and Independents at 20.8%. Because of the higher residual values that Captives are able to retain, they are thus able to lower their rates for customers. Additionally, Captives are also more confident in their ability to recover the collateral value of their parent company’s equipment, which helps mitigate residual risk.

Below are the five equipment types with the highest residual value as a percentage of the original equipment cost – Commercial Aircraft, Fresh & Saltwater Transportation, Agricultural, Railroad, and Construction. Conversely, among those equipment types with the lowest residual value as a percentage of original equipment cost are Office Machines (8.4%), Telecommunications (7.8%), Printing (7.1%), and Computer Equipment (6.5%).

Top Five Equipment Types with Highest Residual Value

(based on dollar amount)



Source: 2013 ELFA Survey of Equipment Finance Activity

Higher residual values point towards leasing as an effective way to extract the most value out of ownership of a particular asset. Offering multiple lifecycles on equipment such as aircraft and railroad equipment is one method that equipment lessors use to maximize profitability. Equipment verticals with fast-growing residual values

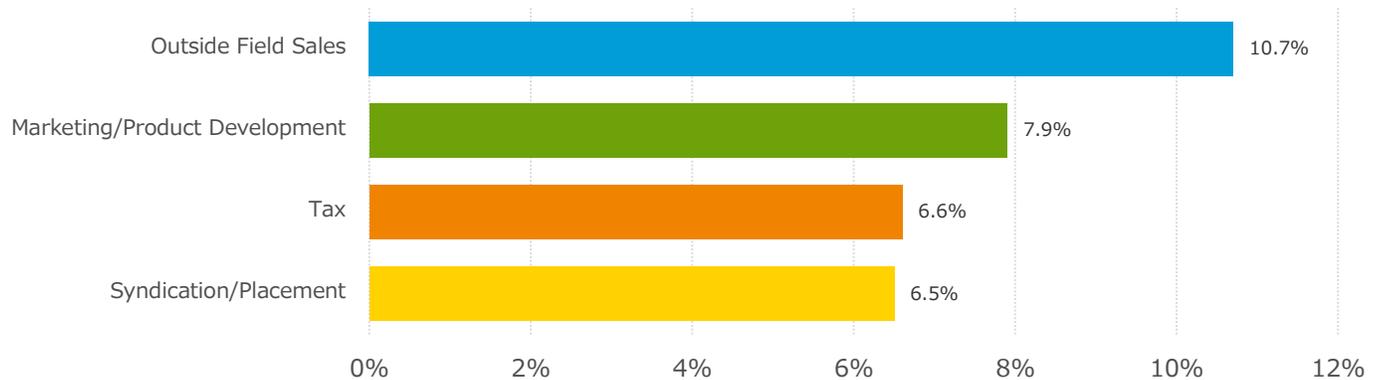
include Renewable Energy and Agriculture equipment. Although their residual values may still be relatively low, the fast growth that has occurred in these equipment verticals help companies retain value and create opportunities for viable secondary or tertiary markets for equipment.

Managing residual risk has become increasingly important as uncertainty has dissuaded many businesses from large capital expenditures and long-term financing. Economic data and anecdotal evidence show that many businesses have extended the life-cycle of their equipment. As a percentage of its original purchased cost, current equipment and software in the U.S. has decreased steadily over the past few quarters. Amidst political and economic uncertainty, businesses have been hesitant to invest in new capital equipment. One captive who leases construction equipment commented that his equipment often goes through three life-cycles before it is retired, and holding that value becomes crucial for obtaining multiple, profitable lease transactions.

Employment among SEFA respondents on the whole decreased 0.3% in 2012, which lags employment gains in the broader economy. However, an examination of employment sub-sectors reveals that some areas experienced growth over the past year, including in legal & compliance, tax, and syndication/placement fields. In addition, there was marked growth among designations that fall within the “Sales Force” designation of an equipment lessor’s full-time equivalents (FTEs). The data demonstrates a straightforward management objective – efficient allocation of workforce has led to productivity gains.

Changes in Employment: Select Sub-Categories

(year-over-year percent change)

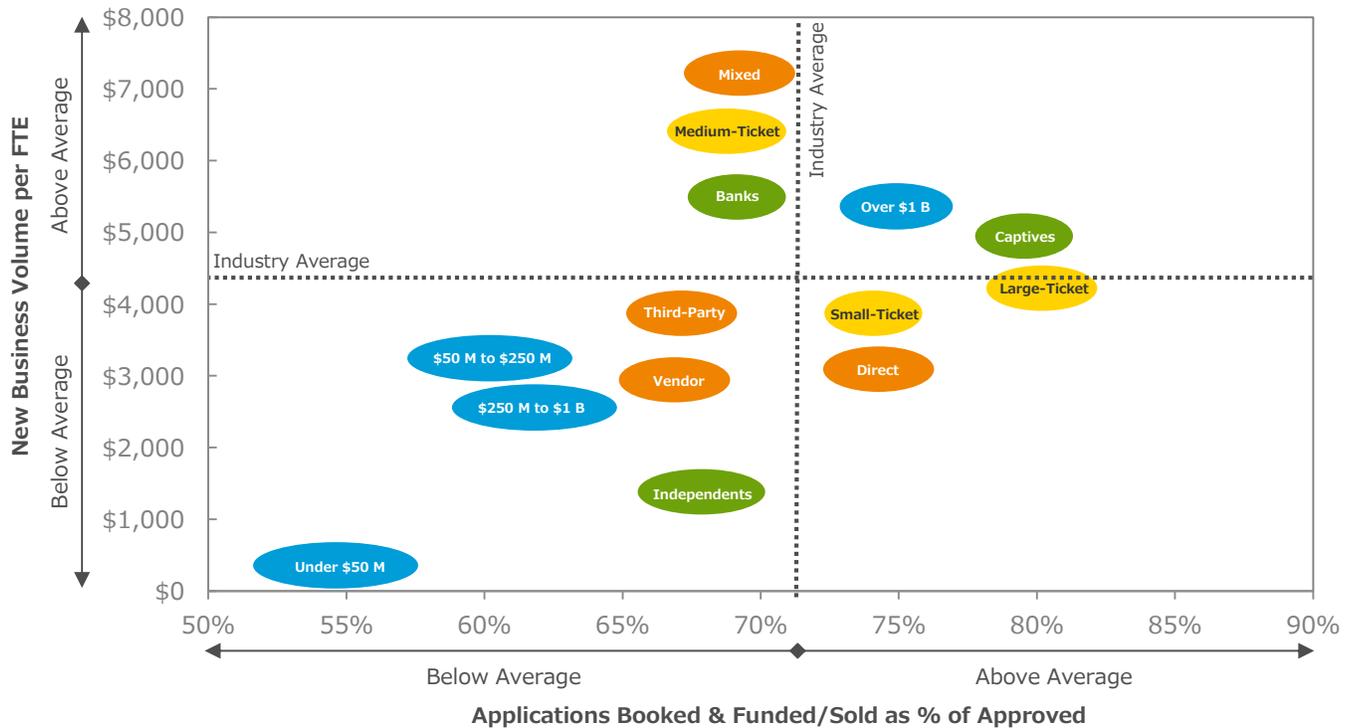


Source: 2013 ELFA Survey of Equipment Finance Activity

Productivity has rebounded steadily since bottoming out during the recession. Many interviewees mentioned that they have re-focused on their core business model, which has led to strong profitability and improved processes. However, productivity trends at the organizational level have diverged over the past five years. Specifically, Captives have experienced increasing productivity from their sales forces since 2009. Conversely, business volume per Sales FTE for Banks has been comparatively flat, while the same measure has declined precipitously over the past five years for Independents before rebounding slightly in 2012. The apparent divergent trends reaffirm the differences between these three groups identified during industry interviews.

Analyzing efficiency and productivity together helps give a strong industry-wide assessment of what organizations have some of the best overall business operations. Below is a two-by-two matrix that plots productivity and efficiency by organization type (Banks, Captives, and Independents), ticket size (small, medium, and large), origination channels (direct, vendor, third-party, and mixed), and lessor size (under \$50 million in new originations, \$50 million to \$250 million, \$250 million to \$1 billion, and over \$1 billion).

Efficiency & Productivity Matrix



Source: 2013 ELFA Survey of Equipment Finance Activity

Only two specific organization types – Captives and lessors with more than \$1 billion in new originations – were above the industry average in both efficiency and productivity in 2012. Captives’ high volume of applications and active lending strategy help them achieve this position. Additionally, organizations with over \$1 billion in origination also have a clear competitive advantage, as larger-scale organizations are able to benefit from stronger economies of scale.

Looking forward, increasing mergers and acquisitions (M&A) activity in the industry could affect efficiency and productivity trends. One bank-owned lessor commented that the financial services sector could further consolidate in the future. Indeed, as Banks look for new ways to deploy capital, they may look to enter fast growing niche markets, which may lead to increased merger activity. Another independent lessor commented that specializing in focused markets will be a key factor that allows for equipment lessors and financiers to gain market share and improve their overall profitability.

Overall, strategic business decisions are leading to high rates of productivity for many industry participants, despite lukewarm macroeconomic conditions. Investment in human relationships — including sales, technology enablers, and service offerings — is a core driver of productivity. The industry was already highly relationship-driven; however, the new norm appears to be strengthening and broadening these relationships with tailored solutions and equipment advisory services through all stages of the equipment life-cycle. Simple financing has become commoditized. In order for businesses to improve their top line, they will have to continue to find new ways to add value. Streamlined and effective business processes are essential as companies jockey for position within the industry.

Automated credit scoring practices are crucial for growth in the small-ticket market. Data-driven risk analysis and portfolio management solutions (e.g., PayNet) are essential to running a profitable small-ticket finance business. Overall, 56.4% of small-ticket equipment lessors and financiers used credit scoring for transaction decisions. And, of those who used credit scoring transaction decisions, 75.0% made automated decisions based on maximum transaction size. Captives outperformed the industry in both metrics.

Captives' expedient credit decisions help drive parent company sales. Across small-ticket equipment leasing and financing, the average turnaround time for transactions ranging \$50,000 to \$100,000 was 2.1 hours in 2012. Banks were level with this time, while Captives were slightly quicker (1.9 hours) and Independents were noticeably slower (2.8 hours).

The Captive business model is highly effective in small-ticket equipment finance. Captives book and fund the highest percentage of applications approved. They led this operational category with 82.2% (based on dollar amount and number of applications) in 2012, which by far outpaces Banks and Independents at 66.8% and 70.3%, respectively. Furthermore, Captives increased their operational efficiency from 2011 to 2012 by 12.2 percentage points, which is indicative of a concerted effort to increase approved application and funding ratios. Captives trail behind Banks in the average dollar per application booked and funded or sold and the average applications per respondent. Yet, Captives make up this differential by achieving the highest percentage of funded approval among all organization types.

Financial Performance

Financial performance in 2012 was very strong by most measures, and the industry has clearly recovered after some tough conditions in the wake of the recession of 2008-09. Strong growth, near record-level portfolio performance, solid spreads, and productivity gains all drove bottom line performance in 2012. Looking forward, 2013 should be another strong year, but tighter spreads may squeeze margins. In 2014, however, the industry may struggle to maintain recent performance levels. Specifically, as the overall growth of the industry is expected to slow and net interest margins are likely to decline in a rising interest rate environment, performance indicators may decline to long-term average levels.

Percent	Industry	Banks	Captives	Independents
Return on Total Average Assets (ROA)	2.1%	1.8%	2.8%	2.2%
Return on Average Equity (ROE)	16.3%	19.0%	15.5%	15.1%
SGA Expense as Percent of Total Revenue	8.4%	7.5%	4.8%	11.3%
Debt as Percent of Total Assets	75.7%	80.3%	65.7%	77.4%
Debt to Equity	5.3	7.4	3.6	4.4
Liabilities to Equity	5.8	9.4	4.6	4.5

Source: 2013 ELFA Survey of Equipment Finance Activity

Despite the moderate-growth environment in which U.S. businesses are currently operating, many financial and economic fundamentals are actually quite strong. For example, corporate profits have fully recovered from the financial crisis and recession, and as of Q2 2013 are up 4.5% — their highest level ever. Additionally, nonfinancial corporate businesses have a record \$1.8 trillion of cash (and equivalents) on their balance sheets as of Q1 2013. With all of this capital on-hand, businesses are looking to make profitable investments and achieve high returns.

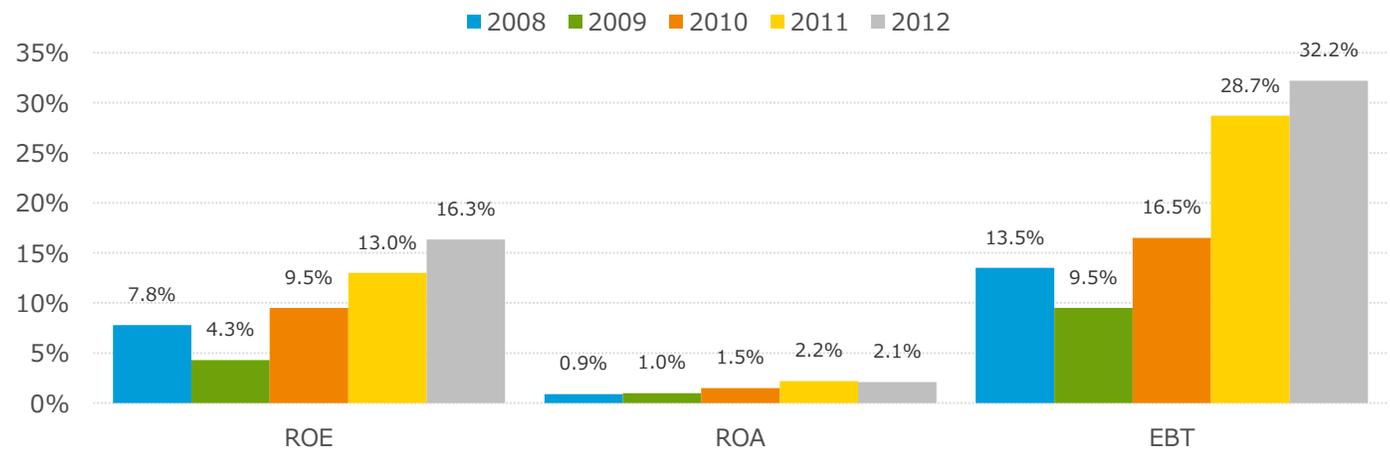
As financial performance trends have improved, the industry remains optimistic. Numerous industry experts commented that the industry's high returns make it an attractive place to invest. Recent industry performance has made equipment finance a very profitable field to be in during this macroeconomic climate. As a result of strong returns and solid portfolio performance capital flows from traditional and non-traditional investors has increased. One industry participant noted that private equity is flooding small, private equipment lessors with capital in search of higher yields, which is a new trend that could shape the marketplace in the future. In turn, this trend could encourage further industry consolidation.

Bottom-line performance for traditional financial activities has been relatively moderate as of late. Return on Assets (ROA) for all insured U.S. commercial banks was 1.14% in Q2 2013, which is below the pre-recession high of 1.41% achieved in late 2003 and early 2004. Return on Equity (ROE) was 10.14%, which also lags behind the pre-recession high of 16.29% achieved in Q1 2000. These moderate performance levels on top of excess liquidity are the main impetus behind investors search for higher yields.

In a difficult macroeconomic climate, equipment finance offers a very profitable field for those with capital to invest. The equipment finance industry has enjoyed record-setting profitability trends over the past few years, as economic fundamentals have improved and business operations have invested in efficiency and productivity measures. The industry median ROA ticked down slightly in 2012 from 2011, from 2.2% to 2.1%; however, this was still the measure’s highest level since 1995. In terms of ROE, the industry median increased from 13.0% in 2011 to 16.3% in 2012, the highest ROE recorded in the SEFA since 1997. Lastly, earnings before taxes (EBT) as a percentage of revenue rose for the third straight year, increasing from 28.7% in 2011 to 32.2% in 2012. Below is the five year historical trend in these three indicators:

Profitability Ratios, Five-Year History

(median)



Source: 2013 ELFA Survey of Equipment Finance Activity

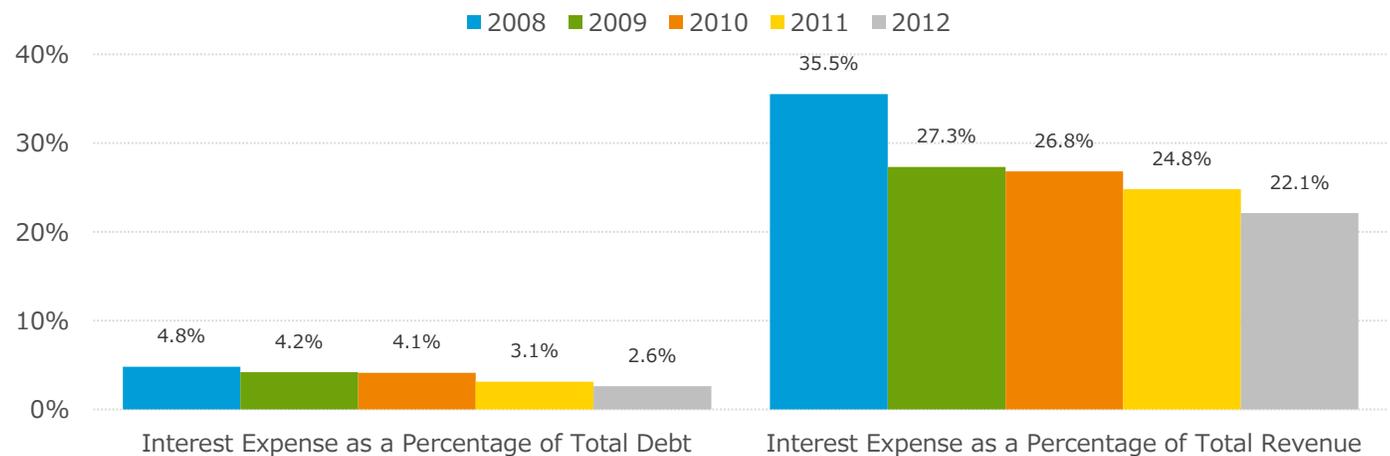
Despite the rising tide, organization-level trends in financial performance have diverged. Banks had the greatest median return on average equity at 19.0%, followed by Captives at 15.5% and Independents at 15.1%. One bank-owned lessor noted that this year is on track to be his best year ever, and that he expects next year to be better still. Banks’ large scale operations allow for them to increase the financial product offerings that they provide to clients, which helps drive their bottom-line performance. Moreover, these broad offerings also are a strong value proposition for customers, who receive more tailored solutions for their businesses’ needs. This trend has been heeded by various organizations and is used to help shape and to improve their business operations. Particularly in equipment fields where life cycles tend to be shorter, organizations that offer superior products as a service are better able to attract long-term customers and improve financial performance.

Banks also continue to benefit from the scale of their businesses and the cross-marketing and cross-selling in which they engage. Relationship managers at Banks are helpful in securing and maintaining new business volumes for the equipment finance sectors of their parent’s company. In recent years, they have profited from this sector and consequently increased the amount of capital and other resources allocated to this segment of their business. Independents have made up ground, but it is unlikely that they will be able to gain the same favorable position that Banks currently occupy.

Trends in coverage ratios echo the recent stellar financial performance of equipment leasing and financing companies. As shown in the figure below, coverage ratios continued their steady decline, both as a percentage of revenues and as a percentage of debt. The median interest expense as a percentage of total debt has decreased from 4.8% in 2008 to 2.6% in 2012. Over the same time horizon, the median interest expense as a percentage of revenue has decreased from 35.5% to 22.1%.

Coverage Ratios, Five-Year History

(median)



Source: 2013 ELFA Survey of Equipment Finance Activity

The low-interest rate environment has been instrumental in driving down coverage ratios for equipment leasing and financing companies. The continued low-interest rate environment, coupled with improving macroeconomic conditions, has helped equipment lessors and financiers offer low rates to customers while also benefitting from lower interest payments. However, interest rates are likely to rise in the near term as the Federal Reserve begins to unwind its bond-purchasing program (“quantitative easing”). Many interviewees commented that the recent upward drift in interest rates may pull forward investment, but not enough to alter their operations or expectations for new business significantly.

Scale of organization also is a strong determinant of the coverage ratio trends within the industry. When analyzing interest expense as a percentage of total debt across multiple segments, some interesting trends appear as well — some of which are divorced from the overall trend in rising interest rates. For example, Banks and Captives, who have some of the lowest costs of funds relative to other industry competitors, are able to have lower interest

expenses than Independents. In that same vein, businesses with lower annual volume have higher interest expenses as a percentage of total debt compared to larger companies. Both of these trends suggest that scale helps larger organizations keep their interest expenses low, and for organizations with more capital, this helps lower their overall expense burden.

Looking forward, 2013 already appears to be a transitional year for financial performance in the equipment leasing and finance industry. Although there is much yet to be seen about how trends in the industry will play out through the rest of the year, key industry data and information from interviewees point towards a slight easing of conditions in the industry. Already, it is apparent that new business volume has been relatively volatile. ELFF’s MLFI-25 data suggests a slowdown in the second half of 2013, which could cause overall year-end performance to dampen.

MLFI-25 New Business Volume

(billions of dollars)



Source: ELFA

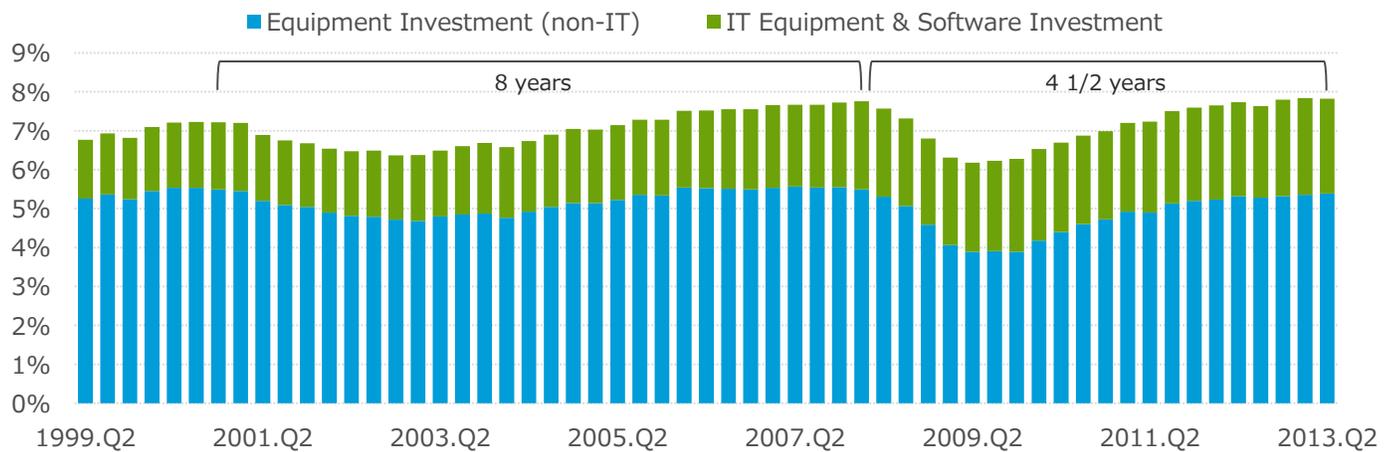
The industry faces multiple external headwinds, along with changing internal conditions that will shape financial performance. Outside economic factors beyond the industry’s control are likely to affect the financial performance of industry participants. For example, over the past year, long-term interest rates have drifted upwards; when compounded with declining levels of confidence in the economy, business volumes have subsequently slowed. Given the increasing number of participants in the industry, it is likely that performance in 2013 and 2014 will fall short of the industry’s recent performance. Similarly, overall industry growth is likely to slow due to a saturated market, and as more industry lessors and financiers work to increase their market shares amidst a slow growth environment, net interest margins and spreads may compress. Financial performance is likely to remain historically strong, but indicators may not be as strong as they have been in the past few years. Interviewees were candid about the changes in the industry that lie ahead, and these changes may further detract from the industry’s financial performance.

Long-term Equipment Investment Trends

Over the next 3 to 5 years, there are several key economic trends that will shape the industry and its growth trajectory. Perhaps the most important factor is the equipment investment cycle, which, as history has shown, follows a pattern similar to the overall economy. During the past 30 years, equipment investment as a share of GDP has peaked 4 times – Q4 1984, Q3 1989, Q3 2000, and Q1 2008 – with an average cycle of 8 years. At no point has equipment and software investment ever exceeded 7.8%, until the past three quarters (Q4 2012 through Q2 2013). This suggests the equipment sector may be at or near another high point even though it has only been 4 ½ years since the last peak. Where the equipment sector is in its cycle has important implications for the growth trajectory of equipment investment and the equipment finance industry. In that context, this section explores the overall macro trends and key factors that will drive growth over the next several years.

Equipment Investment Cycle

(percent of real gdp)



Source: Bureau of Economic Analysis, Keybridge Research

Equipment investment may be nearing a peak. Capital spending by businesses has contributed greatly to the economic recovery. Since the recession officially ended in mid-2009, business investment in equipment alone has contributed, on average, one-half percentage point to GDP growth each quarter. This is compared to about a 0.3% average contribution to GDP during the economic expansion from 2002 through 2007. Additionally, investment in equipment and software is at an all-time high both in terms of dollar value and as a share of GDP. In the second quarter of 2013, business investment in equipment and software hit an annualized rate of \$1.23 trillion dollars (real dollars); and as a share of real GDP, equipment and software investment has been 7.8% for the past 3 quarters.

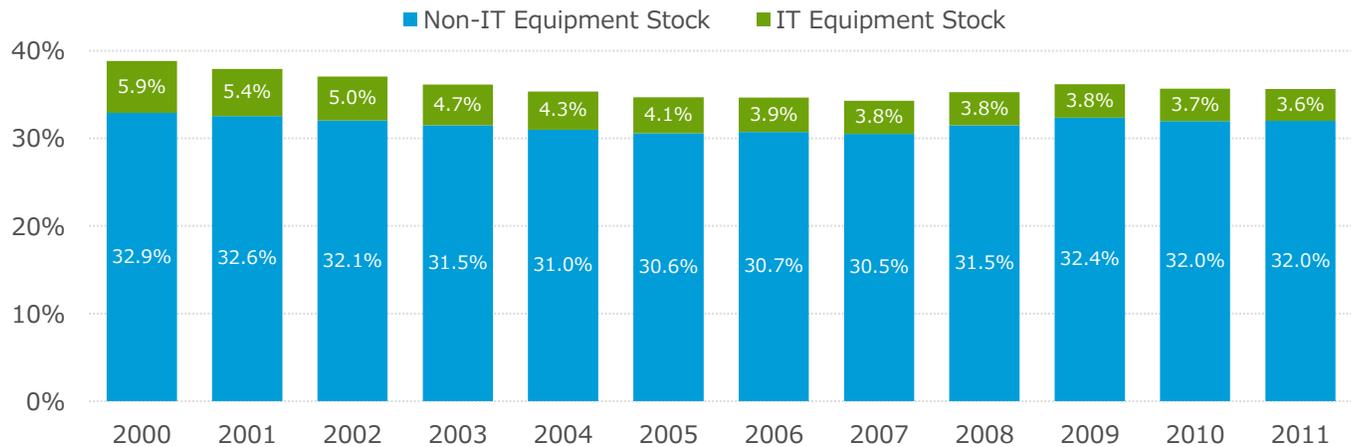
Part of the rise in investment spending is the long-term increase in demand for IT hardware and software. But even stripping out those IT components, investment in equipment is at an all-time high dollar level (\$844 billion, real

dollars, annualized rate as of Q2 2013), and nearly equal to an all-time high share of GDP (5.4% of GDP in Q2 2013, compared to the all-time high of 5.6% in Q2 2007).

Equipment stocks are near historical highs. As of 2011, total equipment and software stocks were 35.6% of GDP, which is just below the average of the prior 10 years (36.0%). Non-IT equipment stocks are 32.0% of GDP, slightly above average (31.6%), while IT stocks are below average, 3.6% compared with 4.4%. However, relatively low IT stock levels are not due to low investment levels; they are a function of higher depreciation rates on IT assets.

Equipment Stock

(percent of real gdp)



Source: Bureau of Economic Analysis, Keybridge Research

The long historical record of the U.S. national accounts provides some key benchmarks for non-IT equipment investment. For the past 20 years, non-IT related equipment investment has generally hovered between 4.5% and 5.5% of GDP, and has ebbed and flowed with the broader economic cycle. As non-IT equipment investment currently stands near the top of this range, the bottom line is that U.S. businesses are unlikely to significantly increase their investment spending in proportion to the overall size of the economy. In other words, growth in non-IT equipment investment is likely to mirror that of the overall economy, but not exceed it significantly or for a sustained period.

On the other hand, IT investment does not have a very long track record, and therefore it is more difficult to know where the natural ceiling is for IT assets. Prior to the mid-1990s, IT was a minor component of business fixed investment. Notwithstanding the “dot-com bubble” bursting in early 2000, IT has grown remarkably over the past 20 years. Including hardware and software, IT spending is now 2.4% of GDP, up from about 1.6% during the late 1990s to early 2000s. In the late 1990s, for every dollar spent on computers, \$5.16 was spent on software. This gap has narrowed, as growth in computer investment has more than doubled that of software. As of Q2 2013, for every dollar businesses spent on computers, \$3.51 is spent on software.

Is there a construction equipment bubble? Prior to the housing bubble, which started in the late 1990s and burst in late 2007, construction equipment investment averaged about \$30 billion on an annualized basis. As shown in the chart on page 52, this translated to about \$10,000 of construction equipment per housing start, and \$0.01 of

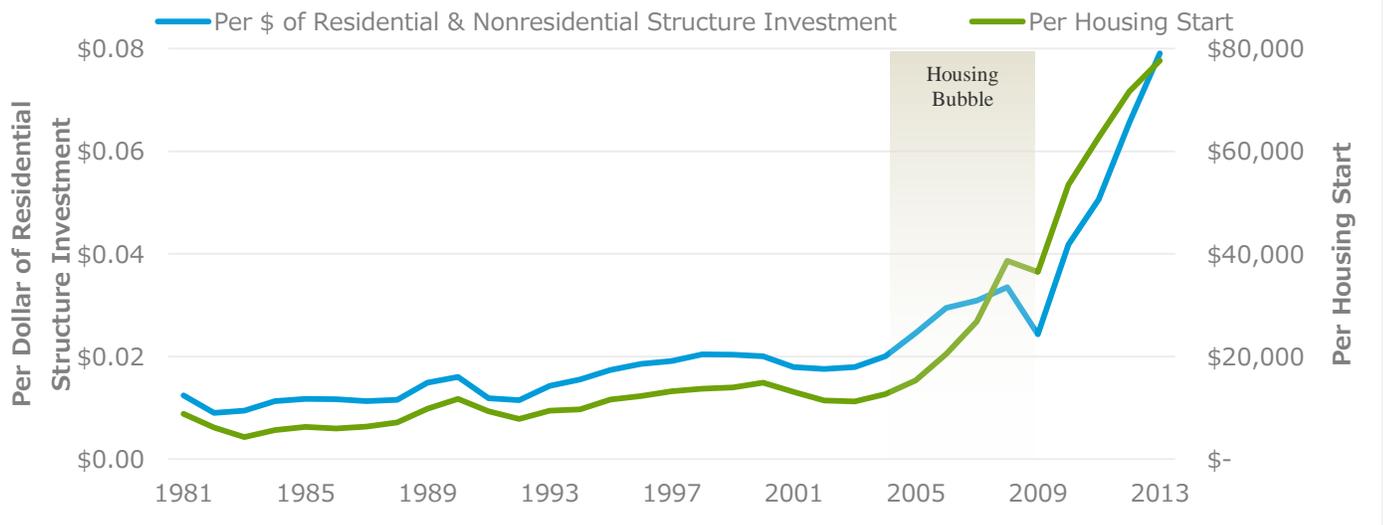
construction equipment for every dollar invested in residential and nonresidential structures. During the peak bubble years (2004-2007), construction equipment investment jumped to \$19,000 per housing start and \$0.03 for every dollar invested in residential and nonresidential structures.



In the past year, however, construction equipment investment has doubled to an annualized rate of \$65 billion. Compared to pre-housing bubble conditions, construction equipment per housing start has increased 5-fold, and it has increased 8-fold as a share of residential and non-residential structure investment. By these measures, construction equipment investment has likely reached an unsustainable level. Interestingly, new equipment finance business volume in construction machinery was relatively flat in 2012, and SEFI interviewees have not seen significant growth in 2013 either. In an effort to manage uncertainty and match expenses with revenue, multiple reports suggest that the construction industry has shifted towards short-term rentals rather than financing or leasing. Rapid expansion of construction machinery rentals could explain the build-up in construction equipment without a commensurate increase in financing volume. But, with what appears to be an excess of construction machinery in the market place, continued rapid growth seems unlikely. This may not negatively impact new business volume for the equipment finance sector, but over-supply of equipment may be a risk for residual values.

Construction Equipment Investment

(per dollar of residential fixed investment, and per housing start)

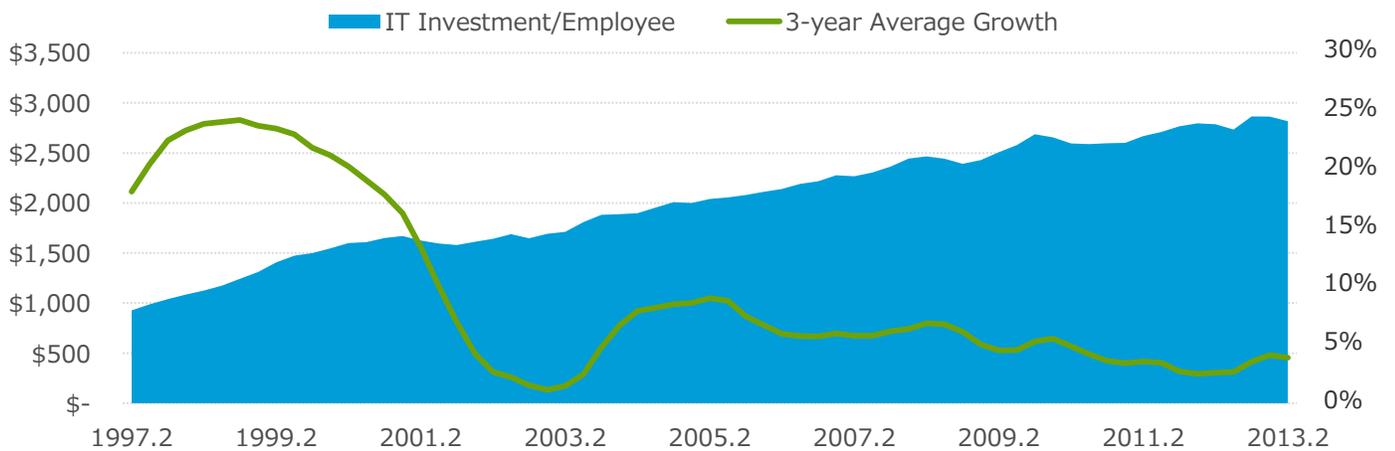


Source: Bureau of Economic Analysis, U.S. Census Bureau, Keybridge Research

Has IT spending hit a ceiling as a share of GDP? Starting in the mid-1990s, businesses ramped up IT spending (hardware and software), and hit a peak of 2.5% of GDP in Q4 2012. There are some signs that IT spending – in relation to the size of the economy and workforce – has slowed sharply over the past 8 years. In particular, IT investment per employee appears to have hit a ceiling around \$2,800 to \$2,900. Growth in IT spending per employee has slowed in the past year, averaging only 2.0% compared with a 5.3% 10-year average. Moreover, industry leaders are concerned that this trend may continue as software solutions become more scalable through new technologies (e.g., cloud computing).

Computer & Software Investment

(per employee, real dollars)



Source: Bureau of Economic Analysis, Keybridge Research

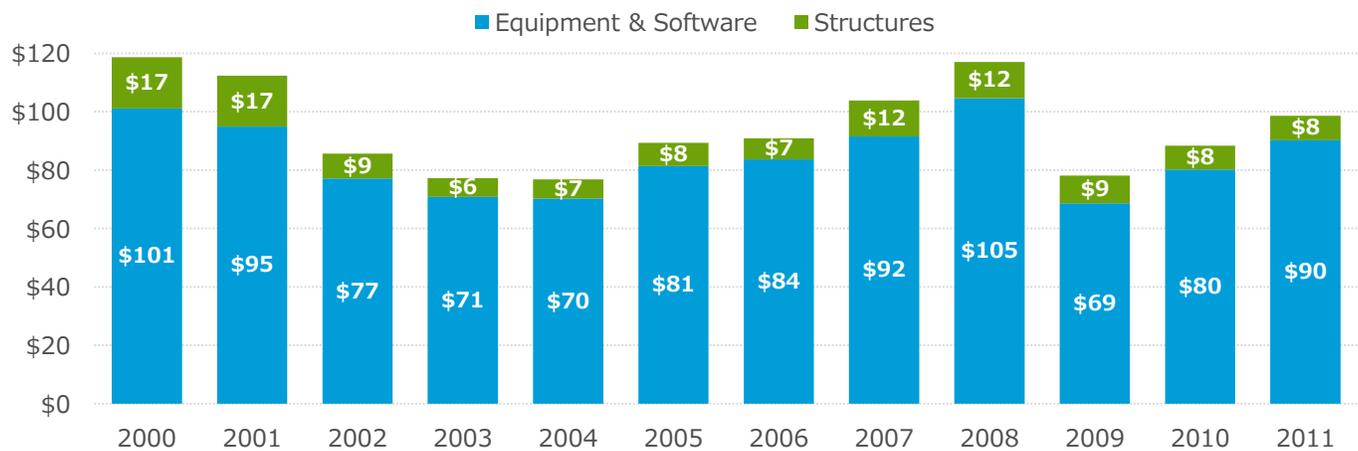
How will the U.S. energy renaissance affect equipment demand? The United States is home to some of the largest shale gas reserves in the world, possessing over 2,000 trillion cubic feet in natural gas reserves. As natural

gas prices have delinked from petroleum prices, unconventional natural gas production has increased and is forecast to increase dramatically over the coming decades. Cheap natural gas – one tenet of the ongoing energy renaissance – in the United States has been one of the main impetuses behind the re-shoring of manufacturing back to the United States. A Boston Consulting Group survey of manufacturers from April 2012 revealed that 37% of manufacturers with annual sales above \$1 billion were planning or actively considering shifting production to the United States. For manufacturers who have production facilities abroad, there are increasing concerns over rising labor, energy, and transportation costs; supply chain disruptions; and protection of intellectual property – all of which are drivers of re-shoring manufacturing to the U.S. The vast majority of this re-shoring is occurring in the durable goods manufacturing sector, which includes machine tool, petrochemical, rubber and plastic production. These industries are highly capital-intensive, and represent a distinct growth opportunity for the equipment finance and leasing industry.

While a number of these investments over the past few years have occurred in building new structures, as production continues and comes “on-line”, there will be a surging demand for equipment and software. Historically, between 80% and 90% of investment made by the durable goods manufacturing industry has been in equipment and software.

Durable Goods Manufacturing Industry Investment

(billions of dollars)



Source: Bureau of Economic Analysis, Keybridge Research

The McKinsey Global Institute estimates that due to the increased usage of natural gas as a fuel for the manufacturing industry, it could add between \$55 billion and \$85 billion to annual manufacturing GDP^x. The pipeline for approval and production of new manufacturing plants has been prolonged slightly by regulatory backlog; however, there is strong evidence that the manufacturing renaissance is real and that it will have future impacts on demand for leased and financed equipment.

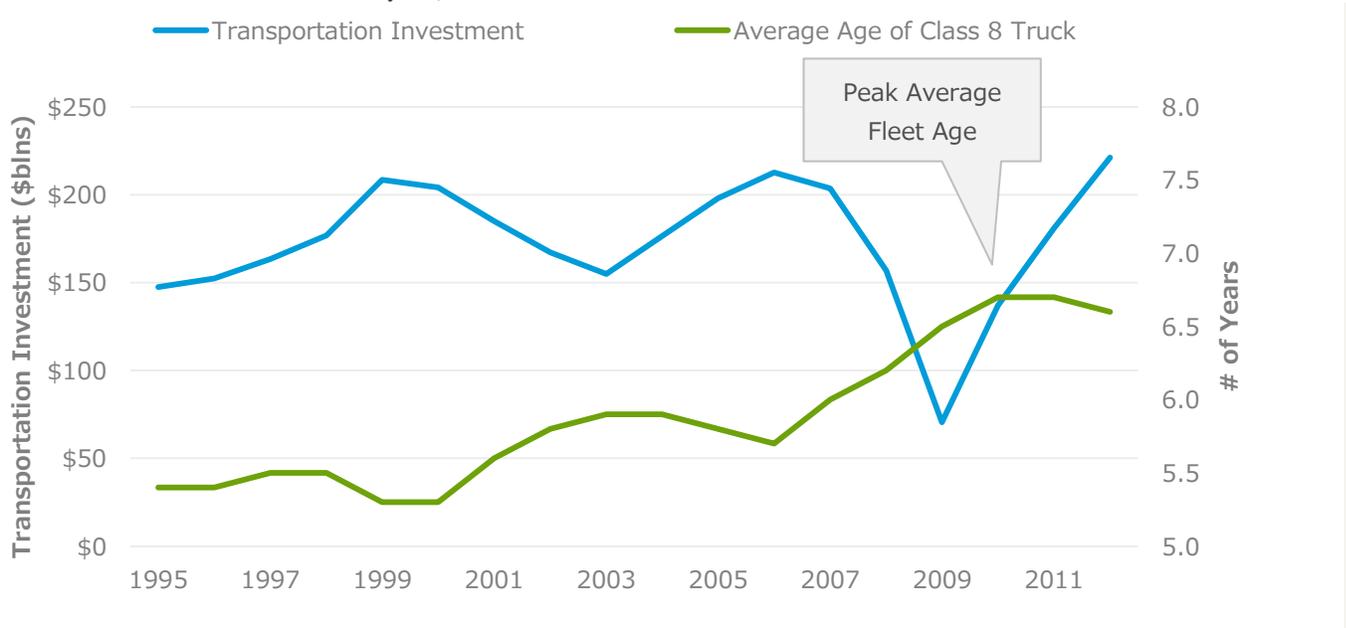
Manufacturers have recently announced roughly \$100 billion worth of investments to take advantage of the cheap natural gas that will occur over the next 5 years^{xi}. A significant portion of this investment will be in equipment and

software, and expanded production capacity will lead to even greater equipment and software investment over the next 3 to 5 years. For example, applying the historical ratio of structures-to-equipment and software investment would suggest that the U.S. energy renaissance could drive up to \$80 or \$90 billion in equipment and software investment in the durable goods manufacturing sector over the next few years.

Has the transportation industry hit the brakes on vehicle replacements? The past few years have witnessed strong levels of investment in transportation equipment, as companies found themselves compelled to replace older units within their commercial fleets. The onset of the recession initially saw a drop in investment (-23% in 2008 and -55% in 2009), as companies delayed capital expenditures and cut costs. This led to an aging of fleets, with the average age of class 8 trucks increasing from about 5.7 years in 2006 to a record 6.7 years in 2011^{xii}. By 2010, escalating maintenance costs and declining performance triggered a widespread wave of equipment replacement, leading to annual investment growth of 94% in 2010 and 32% in 2011. ACT Research also shows a jump in replacement levels in 2010 and 2011, after which rates appear to level off^{xiii}. Experts suggest that this replacement trend has been largely exhausted, coinciding with a slowdown in investment in 2012 (22%) and actual declines in the first half of 2013.

Transportation Equipment Investment and Average Truck Age

(billion dollars of investment and number of years)



Source: ACT Research, Bureau of Economic Analysis, Keybridge Research

Open Roads or Speed Bumps & Detours?



The U.S. economy has been through a volatile business cycle and a relatively modest recovery. New political and regulatory dynamics have added uncertainty to established industries, and the future trajectory of growth remains unclear. ELFF’s industry scenarios are designed to explore this uncertainty by discussing alternative views of the future. The scenarios consider key trends in economics, financial market regulation, politics, and other factors that will affect the equipment leasing and finance industry. The goal is to help build a plausible range of future events to prepare the industry for what may lie ahead.

Although the Great Recession of 2008-09 is more than four years behind us, it has had a lasting effect on domestic and global economic, social, and political dynamics. In the U.S., the financial meltdown resulted from unidentified deep systemic risks. Moreover, the recession called into question the effectiveness of traditional fiscal and monetary responses. The public sector compensated for a large-scale consumer and business deleveraging cycle by expanding public debt at an unprecedented rate. The financial “bailouts” to several of the banking and insurance entities that were at the center of the crisis sowed the seeds for much of the political tension still evident today. As a result, there has been a renewed debate over the proper role of government which has led to increased political polarization, gridlock, and brinkmanship at the expense of economic growth. The private sector has generally had an unfavorable view of much of the regulatory response to the crisis, which has added to economic uncertainty and increased the sector’s dissatisfaction with the policy process.

Crises inevitably bring about change, which can be uncomfortable for businesses. Disrupting the status quo regulatory environment, for better or for worse, may feel like someone is changing the rules of the game during half time. Despite this difficult environment, the U.S. economy has managed to average 2.4 percent growth over the past three years, which is only moderately below the average growth rate of 3.0 percent over the past 30 years. The equipment sector has generally been a growth driver during the recovery, averaging a half percentage point boost to

GDP every quarter since the recovery began. However, the future remains uncertain. Positive cyclical economic forces could take root and propel growth, or self-induced political strife could stifle progress.

In considering what the equipment financing industry might look like in 5–10 years, this report considers two scenarios, each comprising a wide range of factors and likely outcomes. In addition to the detailed analysis of current trends presented earlier in this report, the scenarios provide a high-level overview of the potential trajectory of these trends. In particular, the scenarios are driven by political factors that could have a significant impact on regulation, financial markets, and the economy — including equipment and software demand. The two scenarios, *Open Roads* and *Speed Bumps & Detours*, represent divergent views of the future.

Open Roads is a world of re-balanced political power and restored confidence in the U.S. economic model. After years of moving from one drama to the next, “crisis fatigue” leads voters to demand stability. A return to the “old normal” provides a familiar and comfortable environment for businesses to operate. Open Roads paves a way for more steady growth and job creation, which further eases social and political tension. The role of the public sector is limited, more incremental, and addresses policy challenges in a gradual way. Regulations become more predictable and power is balanced between the branches of government and political parties.

The key factors of this state of the world are political stability, the restoration of businesses’ familiarity with the rules of the road, and a resurgence of American innovation that give way to strong positive cyclical economic forces:

- In this state of the world, lifting the fog of uncertainty has a calming effect on markets. Power is solidified in traditional and predictable circles. The wave of regulations following the 2008-09 financial crisis are implemented in a less aggressive way than originally anticipated. This is viewed as a victory for free market principles, and businesses feel emboldened to invest in growth. Slow but steady reforms of economic and financial institutions allow businesses to adapt, and market forces largely determine the allocation of resources. Positive cyclical forces — in the housing sector, domestic energy, manufacturing, and technology — are unleashed and propel growth forward.
- Innovation begets innovation, as the U.S. remains the leader in technological and scientific breakthroughs. Low domestic energy prices, productivity-enhancing industrial equipment, and skilled workers boost the re-shoring of U.S. manufacturing. Moreover, domestic energy resources solidify the U.S. as a net exporter of energy. The economics of alternative transportation fuels continues to improve, and an uptake in adoption rates begins to shrink the country’s vulnerability to global energy price shocks.
- Stronger economic growth gives way to an environment of steadily rising interest rates and fewer financial market distortions resulting from excessively low yields. This is likely to lead to a number of conflicting outcomes for the equipment finance industry. On one hand, rising rates pull forward equipment investment demand and drive growth despite the equipment investment cycle being near a peak. At the same time, capital flows out of the equipment finance industry as the “search for yield” strategy employed by some nontraditional lenders (e.g., private equity) winds down. A return to a more normal competitive environment allows equipment financing companies to marginally increase spreads, even though the financing side of the business remains commoditized.

While businesses demand longer-term financing as they want to lock-in lower rates, lenders prefer short-term and/or floating rate structures. In the end, lenders who are able to engineer shorter duration portfolios are able to beat industry benchmarks.

Speed Bumps & Detours is an extension and worsening of the current state of affairs. This scenario is characterized by an acute inability to make progress on key policy issues that perpetuates and exacerbates political partisanship and dysfunction. Much like the current budget and debt ceiling debate, there is a heightened sense that government (particularly the federal government) is broken and incapable of implementing policy solutions to the nation's most pressing issues. Political brinkmanship precludes rational deal-making, and full-blown crises are averted only through suboptimal solutions constructed in the eleventh hour. Speed Bumps & Detours results in subpar growth for a prolonged period. Stuck in a "2 Percent World," wealth and income inequality grow, entire classes of workers risk permanent dislodgement from the work force, and key structural changes in economic policy (e.g., tax and entitlement reform) are not realized.

This scenario is marked by the failure of the U.S. to adapt to new circumstances. The key factors of this state of the world are institutional limitations, political and social strife, and more volatile markets:

- Public institutions work through outdated paradigms and ineffective tools to tackle yesterday's problems. They are slow to adapt and are hamstrung by the political process, 24-hour news cycle, and social media from working proactively to anticipate and stem off future risks. The public sector is unable to match the pace of technological change — increased transparency, inter-connectedness, and social activism ("hackers" and "leakers") reveal the often ugly "sausage-making" aspects of the policy process. This leads to further erosion of the public's trust in its elected officials and government institutions.
- Political and institutional limitations only exacerbate economic, political, and social volatility, while reducing the ability to deal with problems in a thoughtful and effective way. As a result, power is concentrated and policy is both created and enforced through a select group of agencies. Relatively new agencies, like the Consumer Finance Protection Bureau, are given longer leashes, and their limited track record raises uncertainty and increases uneasiness in the private sector. These agencies are asked to do too much given their toolsets and authority. A mix of justified criticism and political scapegoating eventually limits their ability to enforce regulations. Moreover, the concentration of power increases the uncertainty, volatility, and abruptness of policymaking from the private sector's perspective.
- The future is marked by periodic manufactured crises (e.g., debt ceiling debates, near-defaults, and threats of government shutdown), haphazard fiscal policy, monetary policy distortions, and changing executive mandates with every new administration. As political partisanship and ill-conceived regulation stifle industry innovation and growth, prolonged periods of stagnation are interrupted by booms and busts. Public finances are not able to stabilize let alone get ahead of the economic cycle, which leaves the government with less "dry powder" and limited room to maneuver in response to future recessions. As a result, debt levels continue to rise.
- Technology spurs innovation, but also speeds up and exacerbates economic cycles, as herd behavior amplifies swings in consumer and investor confidence and demand. Faced with political uncertainty and economic

volatility, businesses remain reluctant to invest and expand operations domestically. Driven by regulatory changes and consumer trends, the equipment finance sector sees a shift in portfolios to shorter deal terms. Rentals cannibalize an increasing percentage of the leasing and finance market as businesses balance rising operating costs with uneven and uncertain revenue streams in addition to the risk of holding long-lived assets with less certain residual values.

Economic Growth Scenarios

Open Roads is characterized by an acceleration in growth as uncertainty eases, positive cyclical forces gain traction, and pent up demand is unleashed. This scenario is marked by two important paradigm shifts in monetary and fiscal policy. First, the Federal Reserve begins tapering its long-term bond purchases at a slow and deliberate pace. Long-term interest rates rise, but their effect on asset prices is outweighed by improving growth expectations. The Fed does not raise short-term rates until 2015, and when it does, clearly communicates its policy changes so as to not alarm the market. Second, Congress reaches a lasting and balanced compromise on near- and longer-term deficit reduction goals. As a result, business confidence, investment, and hiring all increase as the private sector is rejuvenated with confidence in American political institutions. Consumer spending picks up, housing prices continue to improve, and GDP breaks out of the “2% world” in 2014.

The equipment sector benefits from higher capital spending, but as usual, growth varies across equipment verticals. Demand for agriculture machinery increases as drought conditions return to normal, crop prices show sustained strength, and farm incomes rise. IT-related investment continues to grow, driven by stronger employment gains and conversion to the cloud accelerates. Uncertainty around America’s troublesome health care system dissipates, and insurance enrollment increases by the millions. As a result, medical equipment investment rises to meet greater demand for health care services. With the rising tide of the economy, transit of goods and people accelerates, which strains an already aging commercial transportation fleet. Fleet operators invest in new vehicles, which drives truck and rail demand. The rebounding housing sector pushes new housing starts comfortably above 1 million units. Greater certainty in construction trends diverts equipment from short-term rentals back into leasing and financing.

Speed Bumps & Detours is a mid-term low-growth scenario not dissimilar to many of the plaguing issues we see today. Historically, it has taken countries a decade to fully recover from credit crises, and in this scenario the U.S. is no exception. A mixture of political uncertainty, regulatory pressures, constrained credit (in the overall economy, not equipment finance), and continued household deleveraging in the form of higher precautionary savings leads to subpar growth through 2017. Uncertain consumers save their wages in lieu of spending, which slows the largest growth engine within the economy. Additional contributing factors are ongoing fiscal sequestration, concerns about healthcare costs, and businesses’ reluctance to make long-term investment decisions. Slow job growth continues to discourage unemployed workers, drive down workforce participation, and prolong labor market dislocations. As a result, productivity suffers and further drags down growth.

Equipment investment remains in an extended replacement cycle. Continued excess industrial capacity precludes large investments in new production, as tepid demand permeates throughout many sectors of the entire economy. Investments in productivity, especially those in computers, software, and other IT equipment, are essentially a non-factor, as employment gains are muddled. Complicated regulatory issues and tax structures hurt the medical equipment markets, while punitive and overbearing regulations stall transportation investments. Jolting interest rates and a lack of confidence stymie the housing recovery, which prolongs the shift of construction assets into the rental sphere. Continued impasses on subsidies for American farmers leave the agricultural sector in limbo, and the result takes a large cut into their appetite for expansionary capital expenditures. Overall, confidence takes a dive, which permeates into financial markets, cutting the wealth of millions of Americans and leaving the economy stuck in slow growth.

Economic Forecasts

Scenario (percent annual growth)	2013	2014	2015	2016	2017
Baseline					
GDP	1.7%	3.2%	3.4%	3.0%	2.8%
Equipment & Software Investment	3.3%	4.0%	3.5%	3.2%	3.0%
Open Roads					
GDP	1.9%	3.8%	4.0%	3.5%	3.1%
Equipment & Software Investment	3.5%	6.5%	5.0%	4.3%	3.6%
Speed Bumps & Detours					
GDP	1.4%	2.2%	2.5%	2.7%	2.8%
Equipment & Software Investment	2.5%	2.5%	2.7%	2.9%	3.0%

Source: Keybridge Research

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Endnotes

ⁱ www.businessroundtable.org

ⁱⁱ Policy uncertainty is measured by an index developed by business school professors at Stanford University and the University of Chicago.

ⁱⁱⁱ <http://www.mapi.net/system/files/documents/GG2013.pdf>

^{iv} Haver Analytics.

^v Ibid.

^{vi} Ibid.

^{vii} Statistics Canada – Table 380-0068: Gross Fixed Capital Formation.

^{viii} Ibid.

^{ix} National Small Business Association, “2012 Small Business Access to Capital Survey”, July 2012.

^x McKinsey Global Institute, “Game changers: Five opportunities for US growth and renewal”, July 2013.

^{xi} Dow Chemical; Rockwell Automation.

^{xii} ACT Research: Beyond the Soft Patch: A look at NA Commercial Vehicle Markets and the underlying demand drivers that promise to keep the market healthy for several years to come, FRB Chicago Automotive Outlook Symposium, June 1, 2012.

^{xiii} Ibid.



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